

Contents

1 The main ideas	1
Overview 2, Introduction to accounting 2, Return on capital 3, Accounting analysis 4, Exhibit: GAAP history and institutions 5, Using this book 6	
Part 1 Introduction to accounting	9
2 Basics of accounting	11
Assets and income	12
What is a firm?	13
Shareholders' funds 14	
The accounting process for a firm	15
Recording transactions 15, Accounting adjustments 18, Accruals and provisions 18, Depreciation and amortisation 19,	
The financial statements	20
The balance sheet 20, The income statement 21, Income vocabulary 22	
Some further events	23
The effect of accruals and provisions 24, Profit or loss on disposal 24, Capitalisation and write off 25	
Review	27
3 Reading the balance sheet and income statement	29
Reading published financial statements	30
A group of firms 30	
The elements of a balance sheet	32
Fixed assets and working capital 32, Operating and financing 32, Shareholders' funds 33, GAAP: balance sheet formats 34	
Balance sheets in different businesses	36
The elements of an income statement	38
GAAP: Income statement formats 39, EBIT 39, Earnings and comprehensive income 39, Some issues in finding EBIT 41	
Review	45
ANNEX Tiffany's balance sheets and income statements 46	
4 Accounting models	49
The accounting identity	50
The accounting model 50, In the end, it's just timing 52, Does the balance sheet <i>actually</i> drive income? 53, Exhibit: Hicksian income 53, Exhibit: History of the income statement 54, The investment accounting model 55	
Balance sheet completeness	56
Exhibit: The role of the balance sheet 57, The challenge of a complete balance sheet 58, GAAP conservatism 58	
Balance sheet valuation	60
Some theory 60, Revaluation in practice 60	

Income	62
A division of labour	63
Realisation versus expectation 63, Opportunity cost valuation 64	
Review	65
Part 2 Return on capital	67
5 Measures of return on capital	69
Return on equity	70
Return on capital employed	71
Defining the denominator 71, Alternative measures of return 72, Issues in measuring capital employed 74, The consistency test 75	
After-tax return on capital employed	76
Separating tax into operating and financing 76	
Economic profit	78
The cost of capital 78	
Review	80
6 Value metrics	81
Value creation	82
Value added and value retention 84	
Accounting return as a measure of IRR	85
Some theory 85, Tax consistency 86	
Accounting biases	87
A strategy for adjusting the accounting 87, Usually, accounting flatters return on capital 88	
Economic profit and EVA	90
Performance measurement within the firm 91, Accounting adjustments 92	
Stock returns and accounting return on capital	93
Market capitalisation is a mix of assets and expectations 94, Stock return as a signal of value creation 95, Price to book as a measure of NPV 96	
Review	98
Part 3 Financial analysis	99
7 Operating profitability	101
The profitability equation	102
The drivers of margin and asset turn 103, Disclosure and data 105, GAAP: Narrative disclosure 105	
Working capital	106
Segment analysis	107
GAAP: Segment disclosure 107, Non-operating and transitory income 108, GAAP: Transitory components of income 108	
The effect of operating leverage	109

Gross margin in cost analysis 111, Case: Amazon cost analysis 112	
The effect of business model	114
Business models 114, Vertical integration 115, Outsourcing 116, Business model innovation 117, The lighter-than-air balance sheet 118	
Review	120
ANNEX Tiffany's operating drivers 121	
8 Cash flow	123
Format of a Cash flow statement	124
EBITDA 125, Cash from operations 126, Operating free cash flow 126, Cash flow before financing and change in cash 127, Equity free cash flow 130	
Interpreting the cash flow statement	132
Cash flow is a story, not a number 132, The effect of growth on cash flow 132 The effect of business model 134, The effect of accounting 138	
Formatting published cash flow statements	140
GAAP: Cash flow formats 140	
Review	146
9 Capital structure	147
Asset cover	148
Equity to total assets 148, Solvency ratios 149	
Gearing	150
Book gearing 150, Interest cover 151, Vulnerability of book gearing to accounting 151, Market gearing 152, GAAP: Disclosure of market value of debt 152	
The weighted average cost of capital	154
Credit scores 155	
The effect of financial leverage	156
Exhibit: The equity premium 157, The drivers of return on equity 158, The love-hate relationship with debt 159	
Review	160
10 Growth	163
The analysis of growth	164
GAAP: Growth disclosures 164	
Organic growth	165
Volume, price and inflation	168
Volume and price 168, Nominal growth and real growth 168, International differences in inflation 169, How international firms report inflation effects 172	
Review	173

Part 4 Accounting analysis	175
11 Assets	177
The GAAP approach to asset recognition	178
GAAP: Tests for asset recognition 178, The effect of expensing intangibles on return on capital 179	
The nature of intangibles	182
The value of intangibles 182, The risk of intangibles 183, GAAP: Treatment of R&D 184	
Research and development	184
The effect of capitalising R&D 184, Exhibit: Intangibles, goodwill and the price to book ratio 187	
Purchase accounting of acquisitions	188
Pooling 190	
Goodwill and intangibles in financial analysis	192
Review	194
ANNEX BS Group – an example of purchase accounting 195	
12 Liabilities	197
The GAAP approach to liability recognition	198
GAAP: Tests for liability recognition 198, Liabilities must be unavoidable 200	
Pensions	201
Pensions concepts and vocabulary 201, GAAP: Pension accounting 203, How to treat pensions in financial analysis 204, Healthcare benefits 206	
Tax assets and liabilities	206
Deferred tax accounting 207, GAAP: Deferred tax 209, Tax losses and tax assets 210, GAAP: Tax losses 211	
Review	212
13 Asset/liability netting	213
The GAAP approach to asset/liability netting	214
Determining ownership 214, Separation of the existence and ownership issues 215, GAAP: Offsetting assets and liabilities 216	
Receivables financing	216
GAAP: Financial asset derecognition 217	
Leasing	218
GAAP: Lessee accounting 218, Capitalising operating leases from outside 220, The debate about operating leasing 223, Exhibit: The economic case for leasing 225	
Consolidation and equity accounting	225
GAAP: Consolidation and equity accounting 226, The power of equity accounting 227	
Review	230

14 Balance sheet valuation	231
The GAAP approach to balance sheet valuation	232
GAAP: Valuation of tangible and intangible assets 232,	
GAAP: Valuation of financial assets 233	
Opportunity cost valuation	234
The relationship between RC, RV and EV 234, Deprival value 235,	
Measuring current value in practice 236, The preference for historic	
cost 237, Exhibit: Some inflation history 239	
The cost of fixed assets	240
Joint costs and exploration costs 240	
The cost of inventory	242
Added value 242, Original cost 242, GAAP: Inventory valuation 244	
Depreciation	245
Exhibit: Depreciation – some history 245, Depreciation is a real cost 246	
Impairment	248
GAAP: Asset impairment 248, Impairment of goodwill and purchased intangibles 249	
The historic cost bias	251
Review	253
15 Income	255
GAAP approach to cost recognition	256
Cost capitalisation 256	
Revenue recognition	258
GAAP: Revenue recognition 258, Delivery 259, GAAP: Long-term	
construction contracts 260, Detaching revenue from activity 261	
Detecting rogue accounting	262
Watch the balance sheet 263, Watch the effective tax rate 264,	
Stock options	265
The value of an employee stock option 265, GAAP: employee stock options 266	
Presentation	268
Comprehensive income 268, Exceptionals and extraordinary 268,	
Pro-forma earnings 269, The presentation of costs and revenues 269	
Review	271
Appendix Financial arithmetic	273
Present values and future values	274
Annuities 275	
Net present value and internal rate of return	276
Net present value 276, Internal rate of return 277, Using Excel 277	
Perpetuities	278
Economic profit valuation	280
Glossary of terms	285
Glossary of financial ratios	303

