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Book Review

Review of Financial Reporting, Financial Statement Analysis and Valuation: A Strategic Perspective, J.M. Wahlen, S.P. Baginski, M. Bradshaw. 9th ed. Cengage Learning (2018). (995 pp., $228.25), ISBN: 978-1337614689

The book covers in detail important issues in financial reporting and offers comprehensive material on analysis of financial statements and accounting-based valuation. The latest 9th edition builds on the foundations established by the earlier authors, Clyde Stickney and Paul Brown, and is an indication of its popularity and relevance to users that are interested in accounting. I need to stress here that the first edition of the book has appeared in 1990, while the previous edition has taken place in 2015. The latest edition is a joint effort by three accomplished academics in U.S., James M. Wahlen, the James R. Hodge Chair, Professor of Accounting and Chair of the Accounting Department, Stephen P. Baginski, the Herbert E. Miller Chair in Financial Accounting at the University of Georgia's J.M. Tull School of Accounting and Mark T. Bradshaw, Professor of Accounting, Chair of the Department, and William S. McKiernan '78 Family Faculty Fellow at the Carroll School of Management of Boston College.

There exist a wide variety of classic textbooks in the same field, such as Palepu and Heally (2013), Penman (2013), Subramanyam (2014), constituting a challenge for prospective readers to select the most appropriate text. Each of them differs with respect to the emphases given on several necessary steps of financial statement analysis. In particular, the framework in this book for an effective financial statement analysis consists of six interrelated sequential steps as follows: i) understanding industry economics, ii) identifying corporate strategy, iii) assessing accounting quality, iv) assessing profitability and risk, v) forecasting profitability and risk and vi) valuing stocks. Wahlen, Baginski, and Bradshaw in the introductory version, claim that "the premise of this book is that you learn financial statement analysis most effectively by performing the analysis on actual companies" (p. v). In this line, each of the above-mentioned steps of analysis is demonstrated and discussed using the financial statements of Starbucks.

It is a well-organized and structured textbook for financial statement analysis modules in undergraduate and/or graduate programs in accounting and finance. It could be also used by MBA students in introductory financial accounting courses. Further, the book is a helpful reference for analysts in valuing firms and investment managers in making the appropriate top-down decisions on international asset allocation. It is worth noting here, that the text is written in an open – learning style, making it accessible to readers that do not have a strong accounting background.

The book is comprised of 14 chapters that are grouped into four parts. Part 1 has three chapters and lays a conceptual foundation for an effective financial statement analysis and valuation. It gives emphasis on the underlying economics of the industries in which a firm operates, and the appropriate business strategies that a firm must follow to compete within each of these industries. It reviews the basics of financial statements and the impact of the crucial trade-off between relevance and reliability on the properties of accounting numbers. Additionally, it discusses the importance of accrual accounting (i.e., strengths and limitations), and its differences from cash accounting in measuring the performance and financial condition of a firm.

Part 2 contains two chapters that cover the assessment of profitability and risk of a firm based on financial statement ratios and other analytical tools. The analysis of profitability in Chapter 4 focuses on the return on invested capital, and earnings per share. In doing so, the authors disaggregate return on invested capital into important components and integrate industry economic and strategic factors to provide additional insights about company performance. Chapter 5 deals with the analysis of various risks associated with leverage, including short-term liquidity risk, long-term solvency risk, distress risk and fraudulent reporting risk. A unique feature in Chapters 4 and 5 is the linking of the analysis of profitability and risk of various firms within the two chapters.

Part 3 consists of 4 chapters which discuss how financial statements are prepared under U.S. GAAP and IFRS to capture and report the firm's financing, investing and operating activities. Chapter 6 analyses the quality of accounting figures reported in financial statements. Chapter 7 focuses on accounting principles and methods for activities associated with raising capital, Chapter 8 for activities associated with investing capital and Chapter 9 for activities associated with managing operations. Throughout theses chapters the authors highlight important differences between U.S. GAAP and IFRS.

Part 4 is divided into five chapters that focus on accounting based valuation. Chapter 10 presents forecasting procedures to project accounting figures and describes the relevance of prospective analysis to security valuation. Chapter 11 provides a detailed discussion of the measurement of the cost of capital, which plays a central role in equity valuation. Additionally, Chapter 11 demonstrates the dividend-based valuation approach. Valuation based on free cash flows available to stakeholders and free cash flows available to

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equity holders is presented in Chapter 12. Chapter 13 focuses on the earnings-based valuation approach (i.e., residual income approach), while Chapter 14 illustrates how to assess the information in stock prices.

The main text is supplemented with four appendices. Appendix A and B provide all the relevant data (i.e., financial statements, notes, letter to shareholders and management discussion and analysis of operations) for Starbucks, which the authors use to conduct analysis throughout the book. Appendix C provides the results from the financial statement analysis package (FSAP) for Starbucks. Appendix D provides industry statistics on basic financial statement ratios, which could serve as starting point for discussions between graduate students and advisors to select and develop their thesis/dissertation project.[1]

The ultimate objective of the book is to enable users of financial statements to analyze and understand in depth accounting information in order to make rational investment, financing or business decisions. This objective has been sufficiently achieved. A number of the textbook's features can be considered as user friendly. Every chapter has specific learning objectives and an overview. Additionally, the analysis is conducted with a set of examples, questions, exercises, problems and cases based on financial statements of very well-known firms, such as Coca-Cola, Dell, Delta Airlines, Microsoft, Hasbro, Hewlett Packard, General Mills, Georgia Pacific, among others. Several insights from empirical accounting research are included in the text, due to their importance in business analysis and valuation. For instance, Exhibit 6.9 (p. 381) and Exhibit 6.10 (p. 383) illustrate the so-called "accrual anomaly", which refers to the negative association of accounting accruals with future earnings and stock price performance. At the end of each chapter, there is an integrative and continuing case for Walmart, so the reader can apply the tools and methods throughout the text.

As mentioned above, the book addresses topics by reference to the Conceptual Framework for Financial Reporting by both the Federal Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). The authors make good examples based on U.S. and non U.S. firms to illustrate the application techniques and the differences between U.S. GAAP and IFRS. From the user perspective, this is very important, since it highlights the importance of accounting in analyzing financial statements and valuing investments. At the same time, it could add on the ongoing process of convergence between U.S. GAAP and IFRS. Convergence would provide a universal set of standards that would enhance the comparability of financial reporting among businesses and across borders.

Overall the book is well executed. Nonetheless, I would suggest some possible revisions in a forthcoming edition that to my opinion would improve the book. First, the authors could give some emphasis in the introductory version of the book on the double – entry nature of accounting transactions, which could help students to understand in a more consistent manner how financial statements are prepared and qualified. This could be also valuable, on the discussion of accounting quality due to articulation of financial statements and when the analysis requires restatement of financial statements. Further, I think that the authors have to interconnect in more detail the material on the analysis of risk and profitability with the material on accounting based valuation. I would also suggest to the authors to provide a list with relevant references from academic research in accounting and finance at the end of each chapter, which could help students to get deeper in their study.

Notwithstanding the comments on improvements, I enjoy reading this textbook and I strongly recommend it as a valuable resource for an audience interested acquiring skills in reading and interpreting financial statements.

References

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[1] Appendix B and D can be found online at the book's companion website at www.cengagebrain.com.