

FINANCIAL STATEMENT ANALYSIS



SEVENTH EDITION

John J. Wild • Leopold A. Bernstein • K. R. Subramanyam

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*To my wife Gail and children Kimberly, Jonathan,
Stephanie, and Trevor*

—J. J. W.

*To my wife Cynthia, children Debbie and Jeffrey, and
Distinguished Professor Emanuel Saxe*

—L. A. B.

To my wife Jayasree and our parents

—K. R. S.

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♦ This book is printed on acid-free paper.

3 4 5 6 7 8 9 0 VNH/VNH 0 9 8 7 6 5 4 3 2 1

ISBN 0-07-232113-X

Publisher: *Jeffrey J. Shelstad*
Sponsoring editor: *Steve Hazelwood*
Marketing manager: *Rich Kolasa*
Editorial assistant: *Angela Jacobs*
Project manager: *Kimberly Hooker*
Senior production supervisor: *Lori Koettters*
Coordinator freelance design: *Mary Christianson*
Supplement coordinator: *Rose Range*
Media technology producer: *Edward Przyzyczny*
Freelance designer: *Andrew Curtis*
Cover image: © *Stone*
Compositor: *GAC/Indianapolis*
Typeface: *10/12 Caslon Book BE*
Printer: *Von Hoffmann Press, Inc.*

Library of Congress Cataloging-in-Publication Data

Wild, John J.

Financial statement analysis / John J. Wild, Leopold A. Bernstein, K. R.
Subramanyam.—7th ed.

p. cm

Leopold A. Bernstein's name appears first on the previous eds.

Includes bibliographical references and index.

ISBN 0-07-232113-X (alk. paper)

1. Financial statements. I. Bernstein, Leopold A. II. Sybramanyam, K. R. III. Title.

HF5681.B2 B46 2001
657'.3—dc21

00-061282

P R E F A C E

Welcome to the seventh edition of *Financial Statement Analysis*. This book is the product of extensive market surveys, chapter reviews, and correspondence with instructors and students. We are delighted that an overwhelming number of instructors, students, practitioners, and organizations agree with our approach to analysis of financial statements. This book forges a unique path in financial statement analysis, one that responds to the requests and demands of modern-day analysts. From the outset, a main goal in writing this book was to respond to these needs by providing the most progressive, accessible, current, and user-driven textbook in the field. We are pleased that the book's reception in the United States and across the world has exceeded expectations.

Analysis of financial statements is exciting and dynamic, with enormous implications for business decisions, resource allocation, and individual wealth. This book reveals the keys to effective analysis to give readers a competitive advantage in an increasingly competitive marketplace. We know financial statements are relevant to the decisions of many individuals including investors, creditors, consultants, managers, auditors, directors, analysts, regulators, and employees. This book equips these individuals with the analytical skills necessary to succeed in business. Yet, experience in teaching this material tells us that we can only engage readers by demonstrating the relevance of analysis. This book continually demonstrates that relevance with applications to real world companies. The book aims to benefit a broad readership, ranging from those with a simple curiosity in financial markets to those with years of experience in accounting and finance.

ORGANIZATION AND CONTENT

This book's organization accommodates different teaching styles. While the book is comprehensive, its layout allows instructors to choose topics and depth of coverage as desired. Readers are told in Chapter 1 how the book's topics are related to each other and how they fit within the broad discipline of financial statement analysis. The book is organized into three parts:

1. Analysis Overview
2. Accounting Analysis
3. Financial Analysis

ANALYSIS OVERVIEW

Part One gives an overview of financial statement analysis. We introduce financial statement analysis as an integral part of the broader framework of business analysis. We examine the role of financial statement analysis in different types of business analysis such as equity analysis and credit analysis. We emphasize the understanding of business activities—planning, financing, investing, and operating. We describe the strategies underlying business activities and their effects on financial statements. We also emphasize the

importance of accrual accounting for analysis and the relevance of conducting accounting analysis to make appropriate adjustments to financial statements before embarking on financial analysis. We apply several popular tools and techniques in analyzing and interpreting financial statements. An important and unique feature is our use of Eastman Kodak's annual report as a means to immediately engage readers and to instill relevance. Part One comprises two chapters:

- *Chapter 1.* We begin the analysis of financial statements by considering their relevance to business decisions. This leads to a focus on users, including what they need and how analysis serves them. We describe business activities and how they are reflected in financial statements. We also discuss both debt and equity valuation.
- *Chapter 2.* This chapter explains the nature and purpose of financial accounting and reporting, including the broader environment under which financial statements are prepared and used. We highlight the importance of accrual accounting in comparison to cash accounting. We identify and discuss myths and truths of these two measurement systems. The importance and limitations of accounting data for analysis purposes are described along with the significance of conducting accounting analysis for financial analysis.

ACCOUNTING ANALYSIS

To aid in accounting analysis, Part Two explains and analyzes the accounting measurement and reporting practices underlying financial statements. We organize this analysis around financing (liabilities and equity), investing (assets), and operating (income) activities. We show how operating activities are outcomes of changes in investing and financing activities. We provide insights into income determination and asset and liability measurement. Most important, we discuss procedures and clues for the analysis and adjustment of financial statements to enhance their economic content for meaningful financial analysis. Part Two comprises four chapters:

- *Chapter 3.* Chapter 3 begins the detailed analysis of the numbers reflecting financing activities. It explains how those numbers are the raw material for financial analysis. Our focus is on explaining, analyzing, interpreting, and adjusting those reported numbers to better reflect financing activities. Crucial topics include leases, pensions, off-balance-sheet financing, and shareholders' equity.
- *Chapter 4.* This chapter extends the analysis to investing activities. We show how to analyze and adjust (as necessary) numbers that reflect assets such as securities, receivables, derivatives, inventories, property, equipment, and intangibles. We explain what those numbers reveal about financial position and performance, including future performance.
- *Chapter 5.* Chapter 5 extends the analysis to special investing activities—intercompany and international. We analyze intercorporate investments and business combinations from the perspective of a parent company. We examine international investments and their reporting implications for financial statements. We show how interpreting and adjusting the disclosures on intercompany and international activities are an important part of analysis.
- *Chapter 6.* This chapter focuses on analysis of operating activities and income. We discuss the concept and measurement of income as distinct from cash flows. We analyze accrual measures in yielding net income. Understanding recognition methods of both revenues and expenses is stressed. We analyze and adjust the income

statement and its components, including nonrecurring items such as restructuring charges, asset impairments, and employee stock options.

FINANCIAL ANALYSIS

Part Three examines the processes and methods of financial analysis (including prospective analysis). We stress the objectives of different users and describe analytical tools and techniques to meet those objectives. The means of analysis range from computation of ratio and cash flow measures to earnings prediction and equity valuation. We apply analysis tools that enable one to reconstruct the economic reality embedded in financial statements. We demonstrate how analysis tools and techniques enhance users' decisions—including company valuation and lending decisions. We show how financial statement analysis reduces uncertainty and increases confidence in business decisions. Part Three is composed of six chapters and a Comprehensive Case:

- *Chapter 7.* This chapter begins our study of the application and interpretation of financial analysis tools. We analyze cash flow measures for insights into all business activities, with special emphasis on operating activities. Attention is directed at company and industry conditions when analyzing cash flows.
- *Chapter 8.* Chapter 8 emphasizes return on invested capital and explains variations in its measurement. Attention is directed at return on assets and return on equity. We disaggregate both return measures and describe their relevance. Financial leverage also is explained.
- *Chapter 9.* This chapter expands the returns analysis to profitability. We emphasize the components of income and the adjustments necessary for their proper evaluation. Attention is directed at sales, cost of sales, taxes, selling, and financing expenses. Profitability-based analysis tools are demonstrated, including their interpretation and application.
- *Chapter 10.* We describe forecasting and pro forma analysis of financial statements. We explain the flow of cash through a company's business activities and its implications for liquidity. Both short- and long-term forecasting of cash flows are described, and attention is aimed at effectively applying these analysis tools.
- *Chapter 11.* This chapter focuses on credit analysis, both liquidity and solvency. We first present analysis tools to assess liquidity—including accounting-based ratios, turnover, and operating activity measures. Then, we focus on capital structure and its implications for solvency. We analyze the importance of financial leverage and its effects on risk and return. Analytical adjustments are explained for tests of liquidity and solvency. We describe earnings-coverage measures and their interpretation.
- *Chapter 12.* The final chapter emphasizes earnings-based analysis and equity valuation. The earnings-based analysis focuses on earnings quality, earnings persistence, and earning power. Attention is directed at techniques for measuring and applying these concepts. Discussion of equity valuation focuses on forecasting accounting numbers and estimating company value.
- *Comprehensive Case.* This case is a comprehensive analysis of financial statements and related notes. We describe steps in analyzing the statements and the essential attributes of an analysis report. Our analysis is organized around key components of financial statement analysis: cash analysis, return on invested capital, asset utilization, operating performance, profitability, forecasting, liquidity, capital structure, and solvency.

KEY CHANGES IN THIS EDITION

Many readers provided useful suggestions through chapter reviews, surveys, and correspondence. We made the following changes in response to these suggestions:

- Increased the discussion of financial statement analysis in the broader context of business analysis in Chapter 1. Eastman Kodak is used as an illustrative case for this purpose. An expanded description of both debt and equity valuation models also is included.
- Expanded the analysis of accrual accounting versus cash accounting in Chapter 2, including a new section on the myths and truths of these two accounting systems.
- Reorganization of Chapters 3, 4, 5, and 6 by transactions and events. For example, we discuss both balance sheet and income statement effects of leases in one chapter (Chapter 3).
- Greater emphasis on accounting analysis. This includes further explanations of the necessary adjustments to financial statements.
- Increased excerpts of actual company disclosures on each topic—typically, we select a company, probe its detailed note disclosures, and then demonstrate the adjustments needed for effective financial analysis.
- Expanded the analysis of financing activities in Chapter 3, with new step-by-step analysis schedules for both leases and pensions.
- Expanded the evaluation of operating activities in Chapter 4, with new detailed analysis of derivatives.
- Revised Chapter 5 to include the current debate on pooling versus purchase accounting and the implications for analysis.
- Included new material in Chapter 6 involving different measures of income, strategies for earnings management, and the analysis of stock options, restructurings, impairments, and special charges.
- Merged liquidity and solvency analysis into Chapter 11 under the broad heading of credit analysis.
- Revised all chapters to reflect current accounting and finance research in the area, including the addition of new Analysis Research features throughout the chapters.
- Substantially expanded and revised the end-of-chapter assignments, including questions, exercises, problems, cases, and Web activities. This expanded material facilitates different teaching and learning styles—instructors can select from a wide variety of assignments to find those that best fit their instructional style. There also is a wide assortment of assignments within each category, allowing for maximum flexibility in instruction—both within and outside of class.
- Added numerous new examples throughout the book to illustrate concepts from current practice.
- Increased the emphasis on making the material accessible and engaging. Several features are apparent, others are more subtle. For example, we describe theoretical concepts and specialized analyses in simple terms. We present data and illustrations in readable and understandable frameworks. We introduce industry and economic data throughout the book, often in graphical form.
- Enhanced visual appeal. Extensive use of graphs, charts, and schedules engage the reader.
- Improved clarity. We took care to write in a clear, readable, and lively style. Extensive reviews and feedback from instructors helped achieve this clarity.

INNOVATIVE PEDAGOGY

We believe people learn best when provided with motivation and structure. The pedagogical features of this book facilitate those learning goals. Features include:

- **Analysis Feature.** An article featuring an actual company launches each chapter to highlight the relevance of that chapter's materials. In-chapter analysis is performed on that company. Experience shows readers are motivated to learn when their interests are piqued.
- **Analysis Objectives.** Chapters open with key analysis objectives that highlight important chapter goals.
- **Analysis Linkages.** Linkages launch each chapter to establish bridges between topics and concepts in prior, current, and upcoming chapters. This roadmap—titled *A Look Back*, *A Look at This Chapter*, and *A Look Ahead*—provides structure for learning.
- **Analysis Preview.** A preview kicks off each chapter by describing its content and importance.
- **Analysis Viewpoint.** Multiple role-playing scenarios in each chapter are a unique feature that show the relevance of financial statement analysis to a wide assortment of decision makers.
- **Analysis Excerpt.** Numerous excerpts from practice—including annual report disclosures, newspaper clippings, and press releases—illustrate key points and topics. Excerpts reinforce the relevance of the analysis and engage the reader.
- **Analysis Research.** Multiple, short boxes in each chapter discuss current research relevant to the analysis and interpretation of financial statements.
- **Analysis Annotations.** Each chapter includes marginal annotations. These are aimed at relevant, interesting, and topical happenings from business that bear on financial statement analysis.
- **Analysis Feedback.** End-of-chapter assignments include numerous traditional and innovative assignments augmented by several cases that draw on actual financial statements such as those from Wal-Mart, Kmart, Nike, Reebok, Allied Signal, Lucent Technologies, IBM, Dell, Rite Aid, Motorola, Yahoo!, Baxter International, Columbia Pictures, Abbott, Philip Morris, Merck, and Coca-Cola. Assignments are of five types: *Questions*, *Exercises*, *Problems*, *Cases*, and *Web Activities*. Each assignment is titled to reflect its purpose—many require critical thinking, communication skills, interpretation, and decision making. This book stands out in both its diversity and number of end-of-chapter assignments. Key check figures are selectively printed in the margins.
- **Analysis Focus Companies.** Entire financial statements of four companies—Eastman Kodak, Adaptec, Campbell Soup, and Quaker Oats—are reproduced in the book and used in numerous assignments. Experience shows that frequent use of annual reports heightens interest and learning. These reports include notes and other financial information.

TARGET AUDIENCE

This best-selling book is targeted to readers of all business-related fields. Students and professionals alike find the book beneficial in their careers as they are rewarded with an understanding of both the techniques of analysis and the expertise to apply them. Rewards also include the skills to successfully recognize business opportunities and the knowledge to capitalize on them.

The book accommodates courses extending over one quarter, one semester, or two quarters. It is suitable for a wide range of courses focusing on analysis of financial statements, including upper-level “capstone” courses. The book is used at both the undergraduate and graduate levels, as well as in professional programs. It is the book of choice in modern financial statement analysis education.

SUPPLEMENT PACKAGE

This book is supported by a wide array of supplements aimed at the needs of both students and instructors of financial statement analysis. They include:

- **Instructor’s Solutions Manual.** An Instructor’s Solutions Manual contains complete solutions for assignments. It is carefully prepared, reviewed, and checked for accuracy, and is available in both print and electronic forms. The Manual contains chapter summaries, analysis objectives, and other helpful materials. It has transition notes to instructors for ease in moving from the sixth to the seventh edition, including cross-referencing of assignment material between both editions.
- **Test Bank.** The Test Bank contains a variety of test materials with varying levels of difficulty. All materials are carefully reviewed for consistency with the book and thoroughly examined for accuracy. It is available in both print and electronic forms.
- **Chapter Lecture Slides.** A set of PowerPoint slides is available for each chapter. They can be used to augment the instructor’s lecture materials or as an aid to students in supplementing in-class lectures.
- **Book Web site.** [<http://www.mhhe.com/fsa>] The Web is increasingly important for financial statement analysis. This book has its own dedicated Web site, which is an excellent starting point for analysis resources. The site includes links to key Web sites as well as additional support materials for both instructors and students. There is online delivery of PowerPoint slides and other instructional materials.
- **eVal Valuation CD.** eVal is an Excel application CD that performs financial and valuation analyses. It imports real company data, conducts simple ratio and cash flow analyses, and helps guide users through forecasting and valuation using both residual income and cash flow models.
- **Analysis Projects.** Computerized analysis projects are available to aid students in the basics of financial statement analysis. They include (1) *Understanding Annual Reports Project*—ISBN: 0-07-238714-9, and (2) *Financial Statement Analysis Project*—ISBN: 0-256-19077-1.
- **Casebook Support.** Some instructors augment the book with additional case materials. While practical illustrations and case materials are abundant in the text, more are available. These include (1) *Primis* custom case selection [www.mhhe.com/primis], (2) *International Financial Reporting & Analysis*—ISBN: 0-07-289142-4, (3) *Financial Accounting & Reporting*—ISBN: 0-256-16696-X, and (4) *Readings & Notes on Financial Accounting*—ISBN: 0-07-073006-7.
- **Financial Accounting Video Library.** The Financial Accounting Video Library includes short, action-oriented videos for lively classroom discussion of topics, including Ben & Jerry’s disclosure practices, the role of International Accounting Standards, and the impact of regulators. (Vols. 1–5: ISBN: 0-256-22142-1; ISBN: 0-256-22143-X; ISBN: 0-256-22144-8; ISBN: 0-256-22690-3; ISBN: 0-256-22122-7).
- **Prerequisite Skills Development.** There are materials to aid readers in understanding basic accounting and finance concepts: (1) *Accounting, Finance & Quantitative CD*—ISBN: 0-07-229668-2, and (2) *Essentials of Finance & Accounting CD*—ISBN: 0-07-303978-0.

- **Online Resources.** [<http://www.mhhe.com/business/accounting/oscar>] McGraw-Hill offers additional Internet resources on a number of accounting and analysis-related topics.
- **IEM: Iowa Electronic Markets.** ISBN 0-256-23307-1 IEM is an interactive, real-money electronics futures market designed as a teaching supplement. Students use real money accounts to trade contracts with payoffs based on actual events like earnings announcements. Students have incentives to learn about markets and follow company, industry, and economic news. Visit <http://www.biz.uiowa.edu/iem> and log into a free practice session.
- **Customer Service.** Call 1-800-634-3963 or access <http://www.mhhe.com/business>.

ACKNOWLEDGEMENTS

We are thankful for the encouragement, suggestions, and counsel provided by many instructors, professionals, and students in writing this book. It has been a team effort and we recognize the contributions of all these individuals. They include the following professionals who read portions of this book in various forms:

Kenneth Alterman
(*Standard & Poor's*)

Michael Ashton
(*Ashton Analytics*)

Clyde Bartter
(*Portfolio Advisory Co.*)

Laurie Dodge
(*Interbrand Corp.*)

Vincent C. Fung
(*PricewaterhouseCoopers*)

Hyman C. Grossman
(*Standard & Poor's*)

Richard Huff
(*Standard & Poor's*)

Michael A. Hyland
(*First Boston Corp.*)

Robert J. Mebus
(*Standard & Poor's*)

Robert Mednick
(*Arthur Andersen*)

William C. Norby
(*Financial Analyst*)

David Norr
(*First Manhattan Corp.*)

Thornton L. O'Glove
(*Quality of Earnings Report*)

Paul Rosenfield
(*AICPA*)

George B. Sharp
(*CITIBANK*)

Fred Spindel
(*PricewaterhouseCoopers*)

Frances Stone
(*Merrill Lynch & Co.*)

Jon A. Stroble
(*Jon A. Stroble & Associates*)

Jack L. Treynor
(*Treynor-Arbit Associates*)

Neil Weiss
(*Jon A. Stroble & Associates*)

Gerald White
(*Grace & White, Inc.*)

We also want to recognize the following instructors and colleagues who provided valuable comments and suggestions:

Rashad Abdel-Khalik
(*University of Florida*)

M. J. Abdolmohammadi
(*Bentley College*)

Robert N. Anthony
(*Harvard University*)

Hector R. Anton
(*New York University*)

Terry Arndt
(*Central Michigan University*)

Dick Baker
(*Northern Illinois University*)

Mark Bauman
(*University of Illinois-Chicago*)

William T. Baxter
(*CUNY-Baruch*)

Martin Benis
(*CUNY-Baruch*)

Shyam Bhandari
(*Bradley University*)

Fred Bien
(*Louisiana State University*)

John S. Bildersee
(*New York University*)

Vince Brenner
(*Louisiana State University*)

Abraham J. Briloff
(*CUNY-Baruch*)

Gary Bulmash
(*American University*)

Joseph Bylinski
(*University of North Carolina*)

Douglas Carmichael
(*CUNY-Baruch*)

Philip Chuey
(*Youngstown State University*)

- | | | |
|--|--|---|
| Benny R. Copeland
(University of North Texas) | Henry Jaenicke
(Drexel University) | Chris Prestigiacomo
(Stephens College) |
| Maurice P. Corrigan
(Teikyo Post University) | Kenneth H. Johnson
(Georgia Southern University) | Larry Prober
(Rider University) |
| Wallace N. Davidson III
(University of North Texas) | Jo Koehn
(Central Missouri State) | William Ruland
(CUNY-Baruch) |
| Harry Davis
(CUNY-Baruch) | Homer Kripke
(New York University) | Stanley C. W. Salvary
(Canisius College) |
| Peter Lloyd Davis
(CUNY-Baruch) | Russ Langer
(San Francisco State University) | Emanuel Saxe
(CUNY-Baruch) |
| Peter Easton
(Ohio State University) | Burton T. Lefkowitz
(C. W. Post College) | Don Shannon
(DePaul University) |
| James M. Emig
(Villanova University) | Barbara Leonard
(Loyola University, Chicago) | Ken Shaw
(University of Maryland) |
| Eric S. Emory
(Sacred Heart University) | Steven Lillien
(CUNY-Baruch) | Lenny Soffer
(Northwestern University) |
| William P. Enderlein
(Golden Gate University) | Thomas Lopez
(Pace University) | Reed Storey
(Financial Accounting Standards Board) |
| Calvin Engler
(Iona College) | Mostafa Maksy
(Northeastern Illinois University) | Rebecca Todd
(Boston University) |
| Thomas J. Frecka
(University of Notre Dame) | Brenda Mallouk
(University of Toronto) | Bob Trezevant
(University of Southern California) |
| John Gentis
(Ball State University) | Ann Martin
(University of Colorado-Denver) | Jerrold Weiss
(Lehman College) |
| Philip Gerdin
(University of New Haven) | Martin Mellman
(Hofstra University) | J. Scott Whisenant
(Georgetown University) |
| Edwin Grossnickle
(Western Michigan University) | Belinda Mucklow
(University of Wisconsin) | Kenneth L. Wild
(University of London) |
| Peter M. Gutman
(CUNY-Baruch) | Hugo Nurnberg
(CUNY-Baruch) | Richard F. Williams
(Wright State University) |
| J. Larry Hagler
(East Carolina University) | Per Olsson
(University of Wisconsin) | Philip Wolitzer
(Marymount Manhattan College) |
| Bob Halsey
(Babson College) | Stephen Penman
(University of California at Berkeley) | Christine V. Zavgren
(Clarkson University) |
| Jerry Han
(SUNY-Buffalo) | Tom Porter
(Boston College) | Stephen Zeff
(Rice University) |
| Frank Heflin
(Purdue University) | | |
| Yong-Ha Hyon
(Temple University) | | |

We acknowledge permission to use materials adapted from examinations of the Association for Investment Management and Research (AIMR) and the American Institute of Certified Public Accountants (AICPA). Also, we are fortunate to work with an outstanding team of McGraw-Hill/Irwin professionals, extending from editorial to marketing to sales.

Special thanks go to our families for their patience, understanding, and inspiration in completing this book, and we dedicate the book to them.

John J. Wild
Leopold A. Bernstein
K. R. Subramanyam

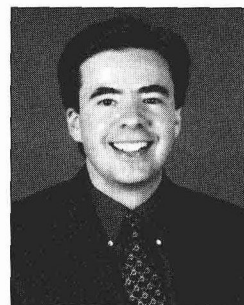
ABOUT THE AUTHORS

As a team, John Wild, Leo Bernstein, and K. R. Subramanyam provide a blend of skills uniquely suited to writing a financial statement analysis textbook. They combine award-winning teaching and research with a broad view of accounting and analysis gained through years of professional and teaching experiences.

John J. Wild is professor of business and Vilas Research Scholar at the University of Wisconsin at Madison. He previously held appointments at Michigan State University and the University of Manchester in England. He received his BBA, MS, and PhD from The University of Wisconsin.

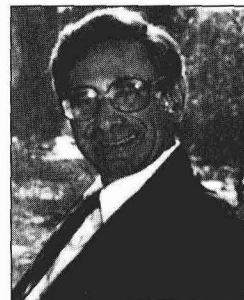
Professor Wild teaches courses in accounting and analysis at both the undergraduate and graduate levels. He has received the Chipman Excellence-in-Teaching Award and the Departmental Excellence-in-Teaching Award from the University of Wisconsin. He also received the Beta Alpha Psi and Salmonson Excellence-in-Teaching Award from Michigan State University. Professor Wild is a past KPMG Peat Marwick National Fellow and is a prior recipient of fellowships from the American Accounting Association and the Ernst and Young Foundation.

Professor Wild is an active member of the American Accounting Association and its sections. He has served on several committees of these organizations, including the Outstanding Accounting Educator Award, Wildman Award, National Program Advisory, Publications, and Research Committees. Professor Wild is author of the best-selling book, *Financial Accounting*, published by McGraw-Hill/Irwin. His many research articles on financial accounting and analysis appear in *The Accounting Review*, *Journal of Accounting Research*, *Journal of Accounting and Economics*, *Contemporary Accounting Research*, *Journal of Accounting*, *Auditing & Finance*, *Journal of Accounting and Public Policy*, *Auditing: A Journal of Theory and Practice*, and other accounting and business periodicals. He is associate editor of *Contemporary Accounting Research* and has served on editorial boards of several respected journals, including *The Accounting Review* and the *Journal of Accounting and Public Policy*.



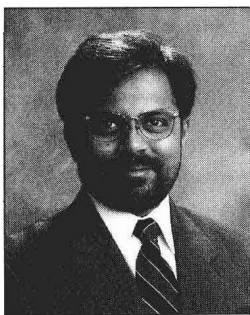
Leopold A. Bernstein is professor of business at Bernard M. Baruch College, City University of New York. He received his MBA from Harvard University and his PhD from New York University. Professor Bernstein is a consultant to many financial institutions and accounting firms and is a Certified Public Accountant.

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the *Journal of Accountancy*, and the Gold Medal Award from the Massachusetts Society of CPAs. He is sought after for expert witness testimony in financial statement analysis and company valuation, and he conducts professional training programs for major domestic and international financial institutions.

Professor Bernstein is active in several important organizations. He is also the author of several notable books including *Analysis of Financial Statements*, *Cases in Financial Statement Reporting and Analysis*, *Advanced Accounting*, and *Understanding Corporate Reports: A Guide to Financial Statement Analysis*. His more than 30 research publications appear in the *Financial Analysts Journal*, *Harvard Business Review*, *The Accounting Review*, *The Journal of Commercial Bank Lending*, *The Journal of Accountancy*, *The Financial Review*, *The CPA Journal*, and many other business and professional periodicals.



K. R. Subramanyam is associate professor of accounting at the Marshall School of Business, University of Southern California. He received his MBA from the Indian Institute of Management and his PhD from the University of Wisconsin. Prior to obtaining his PhD he worked as an international management consultant and as a financial planner for General Foods.

Professor Subramanyam has taught courses in financial statement analysis, financial accounting, and managerial accounting at both the graduate and undergraduate levels. He is a highly regarded teacher, recognized for his commitment and creativity in business education. His course in financial statement analysis is one of the most popular courses in the Marshall School of Business. Professor Subramanyam is a National Talent Scholar, a member of Beta Alpha Psi, and a Deloitte and Touche National Fellow. He is also the recipient of Robert Beyer and Arthur Andersen Scholarships. Professor Subramanyam is actively involved in several national and international organizations, including the American Accounting Association. He has served these organizations in several capacities, including as a member of the Committee to Identify Seminal Contributions to Accounting.

Professor Subramanyam's research interests span a wide range, including the economic effects of financial statements, implications of earnings management, and financial statement analysis and valuation. He has won both national and international awards for his research contributions. His articles appear in leading academic journals such as *The Accounting Review*, *Contemporary Accounting Research*, *Journal of Accounting Research*, *Journal of Accounting and Economics*, and the *Journal of Business, Finance and Accounting*.

ABOUT THE CONTRIBUTORS

An expert set of contributors complements the authors' rich experiences and success.

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