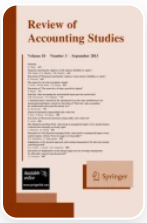
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Ratio Analysis and Equity Valuation: From Research to Practice

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Abstract

Financial statement analysis has traditionally been seen as part of thefundamental analysis required for equity valuation. But the analysis has typicallybeen ad hoc. Drawing on recent research on accounting-based valuation, this paperoutlines a financial statement analysis for use in equity valuation. Standardprofitability analysis is incorporated, and extended, and is complemented with ananalysis of growth. An analysis of operating activities is distinguished from theanalysis of financing activities. The perspective is one of forecasting payoffs to equities. So financial statement analysis is presented as a matter of pro formaanalysis of the future, with forecasted ratios viewed as building blocks offorecasts of payoffs. The analysis of current financial statements is then seen asa matter of identifying current ratios as predictors of the future ratios thatdetermine equity payoffs. The financial statement analysis is hierarchical, withratios lower in the ordering identified as finer information about those higher up.To provide historical benchmarks for forecasting, typical values for ratios aredocumented for the period 1963–1999, along with their cross-sectionalvariation and correlation. And, again

with a view to forecasting, the time seriesbehavior of many of the ratios is also described and their typical “long-run,steady-state” levels are documented.

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