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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 the fundamental analysis required for equity valuation. But the analysis has typically been ad hoc. Drawing on recent research on accounting-based valuation, this paper outlines a financial statement analysis for use in equity valuation. Standard profitability analysis is incorporated, and extended, and is complemented with an analysis of growth. An analysis of operating activities is distinguished from the analysis of financing activities. The perspective is one of forecasting payoffs to equities. So financial statement analysis is presented as a matter of pro forma analysis of the future, with forecasted ratios viewed as building blocks of forecasts of payoffs. The analysis of current financial statements is then seen as a matter of identifying

current ratios as predictors of the future ratios that determine equity payoffs. The financial statement analysis is hierarchical, with ratios lower in the ordering identified as finer information about those higher up. To provide historical benchmarks for forecasting, typical values for ratios are documented for the period 1963–1999, along with their cross-sectional variation and correlation. And, again with a view to forecasting, the time series behavior of many of the ratios is also described and their typical “long-run, steady-state” levels are documented.

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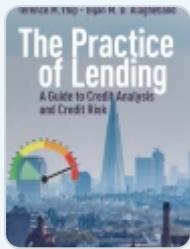
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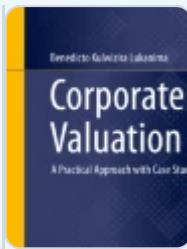
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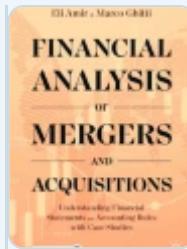
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