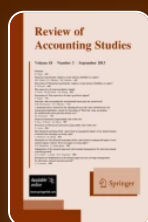


[Home](#) > [Review of Accounting Studies](#) > Article

# Financial Statement Analysis of Leverage and How It Informs About Profitability and Price-to-Book Ratios

Published: December 2003

Volume 8, pages 531–560 (2003) [Cite this article](#)[Save article](#)[View saved research](#) >


## [Review of Accounting Studies](#)

[Aims and scope](#) →[Submit manuscript](#) →Doron Nissim<sup>1</sup> & Stephen H. Penman<sup>1</sup>[5550](#) Accesses [100](#) Citations [Explore all metrics](#) →

## Abstract

This paper presents a financial statement analysis that distinguishes leverage that arises in financing activities from leverage that arises in operations. The analysis yields two leveraging equations, one for borrowing to finance operations and one for borrowing in the course of operations. These leveraging equations describe how the two types of leverage affect book rates of return on equity. An empirical analysis shows that the financial statement analysis explains cross-sectional differences in current and future rates of return as well as price-to-book ratios, which are based on expected rates of return on equity. The paper therefore concludes that balance sheet line items for operating liabilities are priced

differently than those dealing with financing liabilities. Accordingly, financial statement analysis that distinguishes the two types of liabilities informs on future profitability and aids in the evaluation of appropriate price-to-book ratios.

 This is a preview of subscription content, [log in via an institution](#)  to check access.

### Access this article

[Log in via an institution](#) →

### Subscribe and save

Springer+

from €37.37 /Month

- Starting from 10 chapters or articles per month
- Access and download chapters and articles from more than 300k books and 2,500 journals
- Cancel anytime

[View plans](#) →

### Buy Now

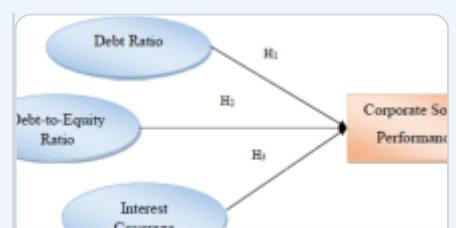
[Buy article PDF 39,95 €](#)

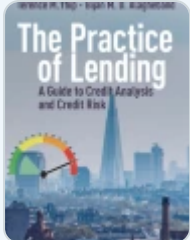
Price includes VAT (Poland)

Instant access to the full article PDF.

[Institutional subscriptions](#) →

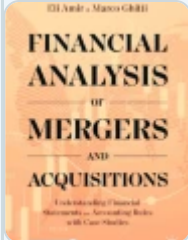
### Similar content being viewed by others





## Financial Statement Analysis

Chapter | © 2020



## Financial Analysis of Business Combinations (Advanced Issues)

Chapter | © 2020

## Analyzing the influence of financial leverage on social performance of selected non-financial companies in Bahrain

Article | 11 December 2024

### Explore related subjects

Discover the latest articles, books and news in related subjects, suggested using machine learning.

[Accounting](#)

[Corporate Finance](#)

[Financial Econometrics](#)

[Financial Reporting](#)

[Statistical Finance](#)

[Financial Accounting](#)

## References

Biais, B. and C. Gollier. (1997). "Trade Credit and Credit Rationing." *The Review of Financial Studies* 10, 903-937.

Fama, E. and K. French. (1998). "Taxes, Financing Decisions, and Firm Value." *Journal of Finance* 53, 819-843.

Fama, E. and J. MacBeth. (1973). "Risk, Return and Equilibrium: Empirical Tests." *Journal of Political Economy* 81, 607-636.

Feltham, J. and J. Ohlson. (1995). "Valuation and Clean Surplus Accounting for Operating and Financing Activities." *Contemporary Accounting Research* 11, 689-731.

Ferris, J. (1981). "A Transactions Theory of Trade Credit Use." *Quarterly Journal of Economics* 94, 243- 270.

- Harris, M. and A. Raviv. (1991). "The Theory of Capital Structure." *Journal of Finance* 46, 297-355.
- Kemsley, D. and D. Nissim. (2002). "Valuation of the Debt-tax Shield." *Journal of Finance* 57, 2045-2074.
- Masulis, R. (1988). *The Debt/Equity Choice*. Cambridge, MA: Ballinger Publishing Co.
- Mian, S. and C. Smith, Jr. (1992). "Accounts Receivable Management Policy: Theory and Evidence." *Journal of Finance* 47, 169-200.
- Modigliani, F. and M. Miller. (1958). "The Cost of Capital, Corporation Finance, and the Theory of Investment." *American Economic Review* 46, 261-297.
- Modigliani, F. and M. Miller. (1963). "Corporation Income Taxes and the Cost of Capital: A Correction." *American Economic Review* 53, 433-443.
- Nissim, D. and S. Penman. (2001). "Ratio Analysis and Equity Valuation: From Research to Practice." *Review of Accounting Studies* 6, 109-154.
- Penman, S. (2004). *Financial Statement Analysis and Security Valuation* 2nd ed. New York: Irwin/ McGraw-Hill.
- Petersen, M. and R. Rajan. (1997). "Trade Credit: Theories and Evidence." *The Review of Financial Studies* 10, 661-691.
- Rajan, R. and L. Zingales. (1995). "What Do We Know about Capital Structure Choice? Some Evidence from International Data." *Journal of Finance* 50, 1421-1460.

Richardson, S., R. Sloan, M. Soliman and I. Tuna. (2002). "Information in Accruals about Earnings Persistence and Future Stock Returns." Working paper, University of Michigan.

Ross, S. (1977). "The Determination of Financial Structure: The Incentive-Signaling Approach." *Bell Journal of Economics* 8, 23-40.

Schwartz, R. (1974). "An Economic Model of Trade Credit." *Journal of Financial and Quantitative Analysis* 9, 643-657.

Sloan, R. G. (1996). "Do Stock Prices Fully Reflect Information in Accruals and Cash Flows about Future Earnings?" *The Accounting Review* 71, 289-315.

Smith, J. (1987). "Trade Credit and Information Asymmetry." *Journal of Finance* 42, 863-872.

Titman, S. and R. Wessels. (1988). "The Determinants of Capital Structure Choice." *Journal of Finance* 43, 1-19.

Zhang, X. (2000). "Conservative Accounting and Equity Valuation." *Journal of Accounting and Economics* 29, 125-149.

## Author information

---

### Authors and Affiliations

**Graduate School of Business, Columbia University, 3022 Broadway, Uris Hall 604, New York, NY, 10027**

Doron Nissim & Stephen H. Penman

# Rights and permissions

---

[Reprints and permissions](#)

## About this article

---

### Cite this article

Nissim, D., Penman, S.H. Financial Statement Analysis of Leverage and How It Informs About Profitability and Price-to-Book Ratios. *Review of Accounting Studies* 8, 531–560 (2003).

<https://doi.org/10.1023/A:1027324317663>

Issue date

December 2003

DOI

<https://doi.org/10.1023/A:1027324317663>

[financing leverage](#)

[operating liability leverage](#)

[rate of return on equity](#)

[price-to-book ratio](#)

## Search

Search by keyword or author



## Navigation

Find a journal

Publish with us

Track your research

