

Financial Analysis, Modeling, and Forecasting

Table of Contents

Chapter 1 – Break-Even and Contribution Margin Analysis	1
Learning Objectives	1
Introduction.....	1
Cost-Volume-Profit Analysis.....	1
Applications of the CVP Model.....	1
What and Why of Break-Even Analysis	2
Break-Even Point.....	2
The Formula Approach	5
What Is Margin Of Safety?.....	6
Cash Break-Even Point.....	6
Operating Leverage	7
Sales Mix Analysis.....	8
Contribution Margin Analysis.....	9
Concepts of Relevant Costs.....	10
Accepting or Rejecting a Special Order.....	10
Analyzing the Make-or-Buy Decision.....	11
Determining Whether to Sell or Process Further.....	12
Adding or Dropping a Product Line.....	12
Utilizing Scarce Resources	13
Don't Forget the Qualitative Factors.....	14
Conclusion.....	14
Review Questions.....	15
Review Answers	16
Chapter 2 – Understanding and Applying the Time Value of Money Concept.....	17
Learning Objectives	17
Introduction.....	17
Assumptions of Present Value and Future Value Techniques.....	17
Present Value Table	17
Future Value Table	18
Both Present Value and Future Value Tables.....	18
Perpetuities	27
Conclusion.....	27
Review Questions.....	28
Review Answers	29
Chapter 3 – How to Assess Capital Expenditure Proposals for Strategic Decision Making.....	31
Learning Objectives	31
Introduction.....	31
Capital Budgeting Methods	33
Payback Period	33
Discounted Payback Period	34
Accounting Rate of Return	34
Net Present Value.....	35
Internal Rate of Return.....	35
Profitability Index	36
How to Select the Best Mix of Projects with a Limited Budget.....	37
How to Handle Mutually Exclusive Investments.....	37
Risk Analysis in Capital Budgeting	38
Probability Distributions.....	38
Risk-Adjusted Discount Rate.....	39
Certainty Equivalent Approach.....	40
Simulation.....	41
Sensitivity Analysis	41

Table of Contents

Decision Trees.....	41
Conclusion.....	42
Review Questions.....	43
Review Answers	44
Chapter 4 – Analyzing Financial Statements for Financial Fitness.....	45
Learning Objectives	45
Introduction.....	45
Who Uses Financial Analysis.....	45
Internal Managers.....	45
External Users	45
Horizontal and Vertical Analysis.....	45
Financial Statement Analysis	46
Trend Analysis.....	46
Horizontal Analysis	46
Vertical Analysis	48
Ratio Analysis.....	50
Liquidity Analysis	50
Accounts-Receivable Ratios	53
Inventory Ratios.....	54
Interrelationship of Liquidity and Activity to Earnings	54
Measuring A Company's Ability to Pay Its Long-Term Debt	55
Profitability Ratios	56
Evaluating Stock as an Investment.....	58
Conclusion – Limitations of Ratio Analysis	59
Review Questions.....	60
Review Answers	61
Chapter 5 – Analyzing Quality of Earnings	63
Learning Objectives	63
Introduction.....	63
Quality of Earnings	63
Analysis of Discretionary Costs.....	64
Accounting Estimates	65
Internal Control and Management Honesty	66
Auditor Relations and Reports	66
Conclusion.....	66
Review Questions.....	68
Review Answers	69
Chapter 6 – Analysis of Variance Analysis for Cost Control.....	71
Learning Objectives	71
Introduction.....	71
Responsibility Accounting and Responsibility Center.....	71
Standard Costs and Variance Analysis.....	72
General Model for Variance Analysis	73
Materials Variances	74
Labor Variances.....	74
Variable Overhead Variances	75
Flexible Budgets and Performance Reports	75
Nonfinancial Performance Measures.....	77
Conclusion.....	78
Review Questions.....	79
Review Answers	80
Chapter 7 – Analysis of Segmental Performance and Profit Variance.....	81
Learning Objectives	81
Introduction.....	81

Table of Contents

Segmental Reporting for Profit Centers.....	81
Profit Variance Analysis	82
Types of Standards in Profit Variance Analysis	83
Single Product Firms.....	83
Multi-Product Firms.....	84
Sales Mix Analysis.....	87
Performance Reports.....	88
Conclusion.....	88
Review Questions.....	89
Review Answers	90
Chapter 8 – Evaluating Divisional Performance.....	91
Learning Objectives	91
Introduction.....	91
Rate of Return on Investment (ROI).....	91
The Breakdown of ROI—Du Pont Formula.....	91
ROI and Profit Planning	93
Residual Income (RI)	94
Residual Income and Economic Value Added	94
Investment Decisions under ROI and RI.....	95
Conclusion.....	95
Review Questions.....	96
Review Answers	97
Chapter 9 – Analyzing Working Capital.....	99
Learning Objectives	99
Introduction.....	99
Evaluating Working Capital	99
Cash Management	100
Acceleration of Cash Inflow.....	100
Delay of Cash Outlay	103
Cash Models.....	104
Management of Accounts Receivable	106
Credit Policies.....	106
Monitoring Receivables.....	107
Credit Policy	107
Determining the Investment in Accounts Receivable	107
Discount Policy	108
Inventory Management	112
Quantity Discount	113
Investment in Inventory	113
Determining Carrying and Ordering Costs	114
Control of Stockouts.....	117
Conclusion.....	117
Review Questions.....	118
Review Answers	119
Chapter 10 – Corporate Investments.....	121
Learning Objectives	121
Introduction.....	121
Accounting Aspects	121
Analytical Implications.....	121
Obtaining Information.....	122
Market Information and Indexes.....	123
Economic and Political Events	123
Industry and Company Analysis.....	123
Electronic Databases	124

Table of Contents

Risk versus Return	124
Financial Assets.....	125
Common Stock	125
Preferred Stock.....	126
Bonds	126
Convertible Securities	127
Warrants.....	127
Options.....	127
Futures Contracts	129
Real Assets	130
Real Estate.....	131
Precious Metals.....	131
Portfolio Analysis	132
Mutual Funds.....	132
Fundamental Analysis.....	133
Technical Analysis	133
Key Indicators.....	133
Charting.....	137
Conclusion.....	140
Review Questions.....	141
Review Answers	142
Chapter 11 – Obtaining Funds: Short-Term and Long-Term Financing.....	143
Learning Objectives	143
Introduction.....	143
Financial Planning	143
Short-Term Financing	143
Using Trade Credit.....	144
Bank Loans	144
Commercial Finance Loans.....	146
Commercial Paper	146
Using Receivables for Financing	147
Using Inventories for Financing	147
Financing with Other Assets.....	148
Intermediate-Term Financing: Term Loans and Leasing	148
Purposes of Intermediate term Bank Loans.....	148
Types of Long-Term Debt	148
Mortgages	149
Bonds	149
Cost of Capital	149
Computing Individual Costs of Capital.....	150
Cost of Debt	150
Cost of Preferred Stock.....	151
Cost of Equity Capital	151
Cost of Retained Earnings	153
Measuring The Overall Cost of Capital	153
Historical Weights	153
Conclusion.....	155
Review Questions.....	156
Review Answers	157
Chapter 12 – Analyzing Mergers and Acquisitions.....	159
Learning Objectives	159
Introduction.....	159
Mergers	159
Advantages of a Merger.....	160
Disadvantages of a Merger	161

Table of Contents

Deciding on Acquisition Terms.....	161
Acquisition of Another Business	162
Impact of Merger on Earnings per Share and Market Price per Share	164
Risk	166
Holding Company	166
Conclusion.....	168
Review Questions.....	169
Review Answers	170
Chapter 13 – Forecasting and Financial Planning	171
Learning Objectives	171
Introduction.....	171
Who Uses Forecasts?.....	171
Forecasting Methods	172
Selection of Forecasting Method	173
The Qualitative Approach.....	174
Executive Opinions	174
The Delphi Method	174
Sales-Force Polling.....	175
Consumer Surveys	175
PERT-Derived Forecasts	175
Common Features and Assumptions Inherent in Forecasting	176
Conclusion.....	176
Steps in the Forecasting Process	176
Review Questions.....	177
Review Answers	178
Chapter 14 – Forecasting Methodology	179
Learning Objectives	179
Introduction.....	179
Naive Models.....	179
Smoothing Techniques	180
Moving Averages	180
Exponential Smoothing	182
Forecasting Using Decomposition of Time Series.....	184
Conclusion.....	189
Review Questions.....	190
Review Answers	191
Chapter 15 – Forecasting with Regression and Markov Methods.....	193
Learning Objectives	193
Introduction.....	193
The Least-Squares Method.....	193
Trend Analysis.....	195
Regression Statistics	198
Statistics to Look for in Multiple Regressions.....	201
t-Statistics.....	202
R-bar Squared (\bar{R}^2) and F-Statistic.....	202
Multicollinearity	202
Autocorrelation (Serial Correlation)	203
Checklists – How to Choose the Best Forecasting Equation.....	203
How to Eliminate Losers	203
How to Choose the Best Equation.....	203
A Computer Statistical Package for Multiple Regression.....	204
Measuring Accuracy of Forecasts	209
MAD and MSE.....	209
The U Statistic and Turning Point Errors	210

Table of Contents

Control of Forecasts.....	210
Forecasting Sales with the Markov Model	211
Conclusion.....	213
Review Questions.....	215
Review Answers	216
Chapter 16 – Financial Forecasting and Budgeting Tools.....	217
Learning Objectives	217
Introduction.....	217
Forecasting External Financing Needs – The Percent-of-Sales Method.....	217
Budgeting and Financial Planning	218
How the Budget Works: An Example.....	221
The Sales Budget	222
Monthly Cash Collections from Customers.....	222
The Production Budget	223
Inventory Purchases – Merchandising Firm.....	223
The Direct Material Budget	224
The Direct Labor Budget.....	225
The Factory Overhead Budget.....	225
The Ending Finished Goods Inventory Budget.....	226
The Selling and Administrative Expense Budget	226
The Cash Budget.....	227
The Budgeted Income Statement.....	228
The Budgeted Balance Sheet	229
Some Financial Calculations	231
Zero-Base Budgeting	231
Conclusion.....	235
Review Questions.....	236
Review Answers	237
Chapter 17 – Forecasting Cash Flows.....	239
Learning Objectives	239
Introduction.....	239
Markov Approach.....	239
Lagged Regression Approach.....	241
Cash Flow Software.....	244
Conclusion.....	245
Review Questions.....	246
Review Answers	247
Chapter 18 – How to Use Corporate Planning Models.....	249
Learning Objectives	249
Introduction.....	249
Types of Analysis.....	249
Typical Questions Addressed via Corporate Modeling.....	250
Types of Models	250
History of Models.....	250
Current Trends in Modeling.....	251
Attitudes and Problems.....	252
State-of-the-Art and Recommended Practice	253
The Future of Corporate Planning Models.....	255
Conclusion.....	255
Review Questions.....	256
Review Answers	257
Chapter 19 – Financial Modeling for What-If Analysis.....	259
Learning Objectives	259
Introduction.....	259

Table of Contents

A Financial Model	259
Types of Financial Models	259
Applications and Uses of Financial Modeling.....	259
Putting Financial Modeling into Practice.....	260
Quantitative Methods Used in Financial Models	261
Developing Financial Models	261
Definition of Variables and Input Parameters.....	261
Model Specification.....	262
Definitional Equations	262
Behavioral Equations.....	263
Model Structure	263
Decision Rules.....	264
Lagged Model Structure.....	265
Conclusion.....	265
Review Questions.....	266
Review Answers	267
Chapter 20 – Using Optimization Techniques to Build Optimal Budgets	269
Learning Objectives	269
Introduction.....	269
Use of Linear Programming	269
Applications of LP	269
Formulation of the LP Model	270
Generation of Budgets on the Basis of Optimal Mix.....	272
Use of Goal Programming (GP)	274
Conclusion.....	276
Review Questions.....	277
Review Answers	278
Chapter 21 – Financial Modeling Packages and Executive Training.....	279
Learning Objectives	279
Introduction.....	279
Spreadsheet Modeling	279
Forecasting Financial Distress with Z Score.....	282
Z-Score Model	282
More Applications of the Z Score	284
Words of Caution.....	284
Budgeting and Planning Software	284
Budget Maestro and Planning Maestro.....	284
Training with Management Games.....	286
Executive Management Games	287
Advantages and Disadvantages of Executive Games.....	288
Validating the Game	288
Conclusion.....	289
Review Questions.....	290
Review Answers	291
Glossary.....	293
Index	303