

# Chapter 2

## Introduction to Financial Statement Analysis

### ■ Solutions to Chapter 2 Data Case

Numerical solutions to this case are available in Excel spreadsheet form, available on the Instructor's Resource Center at [www.pearsonhighered.com/irc](http://www.pearsonhighered.com/irc) and on the Instructor's Resource CD-Rom.

Model solution based on Dec 2006–Dec 2009 data for Caterpillar, and June 2007–June 2010 data for Microsoft. Industry ratios change over time and so will likely differ from what is in the solution.

#### Caterpillar

1. See the spreadsheet solution.
2. See the spreadsheet solution.
3. See the spreadsheet solution.
4. As of fiscal year 2009, one could see the clear contraction and recovery in Caterpillar's performance during and after the global financial crisis. Overall, they are in a strong position relative to their industry, except that their debt levels are high. Their interest coverage ratio is better-than-average for their industry, however.
5. Neither of these companies have valuation ratios below industry averages, so they would not likely qualify as value stocks. Nor do they fit well into the growth stock category either. Despite their relatively high valuation ratios, both are mature firms in their industries with most of their high growth behind them. Caterpillar's very high P/E is primarily due to the fact that it is based on a forward-looking stock price and trailing earnings that still reflect the contraction.
6. With the recent rebound in Caterpillar's stock price, its valuation ratios have improved. The high P/E ratio in particular suggests a positive outlook for Caterpillar.
7. The enterprise value fell fairly drastically in 2008, but rebounded slightly in 2009.

#### Microsoft

1. See the spreadsheet solution.
2. See the spreadsheet solution.
3. See the spreadsheet solution.
4. While MSFT is still a strong company, its slowing growth has led to declining valuation ratios which are now below or basically at industry average. Its profitability is still very high. MSFT has traditionally maintained a very conservative balance sheet with almost no debt, so its leverage is low and interest coverage is high relative to industry (indeed, in 2006 and 2007, it had no interest, so its interest coverage was meaningless).
5. Since its most recent P/E ratio has dropped, many students may not view this as a growth firm, while others may argue that because its market-to-book ratio is still above the average, it is a growth firm. In reality, MSFT is mature, rather than truly a growth firm, and its declining valuation ratios are evidence of this. Nonetheless, its value has not dropped to the point where it would not be in a value investor's portfolio either.
6. Microsoft's declining valuation ratios, despite high profitability and relatively stable (or growing) earnings, the market has doubts about Microsoft's future.
7. Due to the poor stock price performance, the enterprise value has been trending downward.