# PREFACE

This is a book for active value investors willing to make some effort to get an edge. To be sure, the value investing in the book is not the simple "value" versus "growth" investing that is common, but rather a comprehensive analysis for gauging value in a firm and how much to pay for it. Indeed, the analysis exposes traps in the simple scheme as well as in other investing styles.

This is also a book with a particular focus: Valuation is a matter of accounting; the investor accounts for value. This does not mean the investor just learns how to handle accounting numbers, nor does it mean that he or she can run through the mechanics of financial statement analysis, though both are involved. Rather, it is a matter of thinking about value in an accounting framework involving balance sheets and income statements under the governance of double entry. That protects from making mistakes but also gives the prudent investor confidence in making risky investments.

So, the investor keeps a book, an accounting book, maybe formally or maybe mentally. The book ahead of you explains how. The design of the accounting book embeds good thinking about how firms generate value for investors and good thinking about risk and return. That good thinking tells the investor how to challenge the prevailing price the market is asking him or her to pay, for that price might not embed the good thinking.

A theme in the book warns investors about paying for growth, for growth is risky. The appropriate accounting for value not only identifies growth to be paid for but also protects against paying too much for growth. The speculative part of the market price is in the pricing of growth, so the investor has the thinking and the tools to challenge this speculation.

You will find the book contrasts with many investment books. The ubiquitous beta is not of highest priority by far. The common discounted cash flow (DCF) is put aside. Indeed, the book is skeptical about valuation models in general. Perhaps surprisingly, the book takes the position that it is best to think that "intrinsic value" does not exist. For a value investor that sounds like heresy, but intrinsic value is just too hard to pin down. That requires an alternative approach to be put on the table, one that challenges the market price with confidence. Some investors see the alternative as trading on multiples, smart-beta investing, factor investing, and more. The book brings a critique to these schemes. So, for example, it explains what is involved in a P/E ratio or a P/B (fundamentally) and how to trade on them (fundamentally).

These statements are just one-liners, so dig in to grasp the detail. The book builds on themes in Penman's *Accounting for Value* (Columbia University Press) and, under those themes, extends the financial statement analysis in his *Financial Statement Analysis and Security Valuation*. Its debt to the value investing classics, Graham and Dodd, *Security Analysis* (1934) and Benjamin Graham's *The Intelligent Investor* (1949) will be clear to the reader. But the reader will also see how the book takes the investing principles in those books and combines them with the principles of modern finance and, indeed, accounting principles. Keeping an accounting book on value is a matter of honoring all those principles.

The book is a text for the student of fundamental analysis and valuation. However, we have tried to avoid using the dry style of the standard text, preferring the style of the active investor. We believe that knowledge is best gained and retained when the student sees it actively applied in a practical way. That, of course, also makes it a book for the professional investor. Afterall, we are all students, always learning! We invite you to the book and trust you will enjoy it. That joy will come from "seeing the light turn on" as you proceed. The book will make you an intelligent investor and, we hope, a successful one. You might be a student coming to the topic for the first time or a seasoned investor. Whatever the case may be, the book will lead you in becoming a continuing student of value investing. To this end, the Your Library feature on the book's website leads you to further reading. There is also a Case Book and Exercise Book to which you are directed at the end of each chapter. For instructors, there are other materials, including PowerPoint presentations for each chapter and solutions for exercises and cases. And, for both investment professionals and students, there is a website, a blog, where we ask you to join the conversation, sharing questions and experiences with fellow readers and with us, your authors. Go to the website at penmanpope4value.com.

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# FINANCIAL STATEMENT ANALYSIS FOR VALUE INVESTING