

PART I

LEARNING OUTCOMES, SUMMARY OVERVIEW, AND PROBLEMS

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CHAPTER 1

FINANCIAL STATEMENT ANALYSIS: AN INTRODUCTION

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LEARNING OUTCOMES

After completing this chapter, you will be able to do the following:

- Discuss the roles of financial reporting and financial statement analysis.
- Discuss the roles of the key financial statements (income statement, balance sheet, cash flow statement, and statement of changes in owners' equity) in evaluating a company's performance and financial position.

- Discuss the importance of financial statement notes and supplementary information (including disclosures of accounting methods, estimates, and assumptions) and management's discussion and analysis.
- Discuss the objective of audits of financial statements, the types of audit reports, and the importance of effective internal controls.
- Identify and explain information sources besides annual financial statements and supplementary information that analysts use in financial statement analysis.
- Describe the steps in the financial statement analysis framework.

SUMMARY OVERVIEW

This chapter has presented an overview of financial statement analysis. Among the major points covered are the following:

- The primary purpose of financial reports is to provide information and data about a company's financial position and performance, including profitability and cash flows. The information presented in financial reports—including the financial statements, financial notes, and management's discussion and analysis—allows the financial analyst to assess a company's financial position and performance and trends in that performance.
- Key financial statements that are a primary focus of analysis include the income statement, balance sheet, cash flow statement, and statement of owners' equity.
- The income statement presents information on the financial results of a company's business activities over a period of time. The income statement communicates how much revenue the company generated during a period and what costs it incurred in connection with generating that revenue. The basic equation underlying the income statement is $\text{Revenue} - \text{Expense} = \text{Net income}$.
- The balance sheet discloses what a company owns (assets) and what it owes (liabilities) at a specific point in time. Owners' equity represents the portion belonging to the owners or shareholders of the business; it is the residual interest in the assets of an entity after deducting its liabilities. The three parts of the balance sheet are formulated in the accounting relationship of $\text{Assets} = \text{Liabilities} + \text{Owners' equity}$.
- Although the income statement and balance sheet provide a measure of a company's success, cash and cash flow are also vital to a company's long-term success. Disclosing the sources and uses of cash in the cash flow statement helps creditors, investors, and other statement users evaluate the company's liquidity, solvency, and financial flexibility.
- The statement of changes in owners' equity reflects information about the increases or decreases to a company's owners' equity.
- In addition to the financial statements, a company provides other sources of financial information that are useful to the financial analyst. As part of his or her analysis, the financial analyst should read and assess the information presented in the company's financial note disclosures and supplementary schedules as well as the information contained in the MD&A. Analysts must also evaluate footnote disclosures regarding the use of alternative accounting methods, estimates, and assumptions.
- A publicly traded company must have an independent audit performed on its year-end financial statements. The auditor's opinion provides some assurance about whether the

financial statements fairly reflect a company's performance and financial position. In addition, for U.S. publicly traded companies, management must demonstrate that the company's internal controls are effective.

- The financial statement analysis framework provides steps that can be followed in any financial statement analysis project, including the following:
 - Articulate the purpose and context of the analysis.
 - Collect input data.
 - Process data.
 - Analyze/interpret the processed data.
 - Develop and communicate conclusions and recommendations.
 - Follow up.

PROBLEMS

1. Providing information about the performance and financial position of companies so that users can make economic decisions *best* describes the role of
 - A. auditing.
 - B. financial reporting.
 - C. financial statement analysis.
2. A company's current financial position would *best* be evaluated using the
 - A. balance sheet.
 - B. income statement.
 - C. cash flow statement.
3. A company's profitability for a period would *best* be evaluated using the
 - A. balance sheet.
 - B. income statement.
 - C. cash flow statement.
4. Accounting methods, estimates, and assumptions used in preparing financial statements are found
 - A. in footnotes.
 - B. in the auditor's report.
 - C. in the proxy statement.
5. Information about management and director compensation would *best* be found
 - A. in footnotes.
 - B. in the auditor's report.
 - C. in the proxy statement.
6. Information about material events and uncertainties would *best* be found in
 - A. footnotes.
 - B. the proxy statement.
 - C. management's discussion and analysis.

7. What type of audit opinion is preferred when analyzing financial statements?
 - A. Qualified.
 - B. Adverse.
 - C. Unqualified.

8. Ratios are an input into which step in the financial analysis framework?
 - A. Process data.
 - B. Collect input data.
 - C. Analyze/interpret the processed data.