PART I

LEARNING OUTCOMES, SUMMARY OVERVIEW, AND PROBLEMS

CHAPTER 1

FINANCIAL STATEMENT ANALYSIS: AN INTRODUCTION

LEARNING OUTCOMES

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

- describe the roles of financial reporting and financial statement analysis;
- describe the roles of the key financial statements (statement of financial position, statement of comprehensive income, statement of changes in equity, and statement of cash flows) in evaluating a company's performance and financial position;
- describe the importance of financial statement notes and supplementary information—including disclosures of accounting policies, methods, and estimates—and management's commentary;
- describe the objective of audits of financial statements, the types of audit reports, and the importance of effective internal controls;
- identify and describe information sources that analysts use in financial statement analysis besides annual financial statements and supplementary information;
- describe the steps in the financial statement analysis framework.

SUMMARY OVERVIEW

- 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 and notes—and other reports—including management's commentary or management's discussion and analysis—allows the financial analyst to assess a company's financial position and performance and trends in that performance.
- The basic financial statements are the statement of financial position (i.e., the balance sheet), the statement of comprehensive income (i.e., a single statement of comprehensive income

or two statements consisting of an income statement and a statement of comprehensive income), the statement of changes in equity, and the statement of cash flows.

- The balance sheet discloses what resources a company controls (assets) and what it owes (liabilities) at a specific point in time. Owners' equity represents the net assets of the company; it is the owners' residual interest in or residual claim on the company's assets after deducting its liabilities. The relationship among the three parts of the balance sheet (assets, liabilities, and owners' equity) may be shown in equation form as follows: Assets = Liabilities + 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 and other income the company generated during a period and what expenses, including losses, it incurred in connection with generating that revenue and other income. The basic equation underlying the income statement is Revenue + Other income – Expenses = Net income.
- The statement of comprehensive income includes all items that change owners' equity except transactions with owners. Some of these items are included as part of net income, and some are reported as other comprehensive income (OCI).
- The statement of changes in equity provides information about increases or decreases in the various components of owners' equity.
- Although the income statement and balance sheet provide measures 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 helps creditors, investors, and other statement users evaluate the company's liquidity, solvency, and financial flexibility.
- The notes (also referred to as footnotes) that accompany the financial statements are an integral part of those statements and provide information that is essential to understanding the statements. Analysts should evaluate note disclosures regarding the use of alternative accounting methods, estimates, and assumptions.
- In addition to the financial statements, a company provides other sources of information that are useful to the financial analyst. As part of his or her analysis, the financial analyst should read and assess this additional information, particularly that presented in the management commentary (also called management report[ing], operating and financial review, and management's discussion and analysis [MD&A]).
- A publicly traded company must have an independent audit performed on its annual financial statements. The auditor's report expresses an opinion on the financial statements and provides some assurance about whether the financial statements fairly present a company's financial position, performance, and cash flows. In addition, for US publicly traded companies, auditors must also express an opinion on the company's internal control systems.
- Information on the economy, industry, and peer companies is useful in putting the company's financial performance and position in perspective and in assessing the company's future. In most cases, information from sources apart from the company are crucial to an analyst's effectiveness.
- The financial statement analysis framework provides steps that can be followed in any financial statement analysis project. These steps are:
  - articulate the purpose and context of the analysis;
  - collect input data;
  - process data;
  - analyze/interpret the processed data;
  - develop and communicate conclusions and recommendations; and
  - 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. statement of cash flows.
3. A company's profitability for a period would *best* be evaluated using the:
   A. balance sheet.
   B. income statement.
   C. statement of cash flows.
4. Accounting policies, methods, and estimates used in preparing financial statements are *most likely* found in the:
   A. auditor's report.
   B. management commentary.
   C. notes to the financial statements.
5. Information about management and director compensation would *least likely* be found in the:
   A. auditor's report.
   B. proxy statement.
   C. notes to the financial statements.
6. Information about a company's objectives, strategies, and significant risks would *most likely* be found in the:
   A. auditor's report.
   B. management commentary.
   C. notes to the financial statements.
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 statement analysis framework?
   A. Process data.
   B. Collect input data.
   C. Analyze/interpret the processed data.