

PART I

LEARNING OBJECTIVES, SUMMARY OVERVIEW, AND PROBLEMS

COPYRIGHTED MATERIAL

INTRODUCTION TO FINANCIAL STATEMENT ANALYSIS

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 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 information presented in financial and other reports, including the financial statements, notes, and management's commentary, helps the financial analyst to assess a company's performance and financial position. An analyst may be called on to perform a financial analysis for a variety of reasons, including the valuation of equity securities, the assessment of credit risk, the performance of due diligence on an acquisition, and the evaluation of a subsidiary's performance relative to other business units. Major considerations in both equity analysis and

credit analysis are evaluating a company's financial position, its ability to generate profits and cash flow, and its potential to generate future growth in profits and cash flow.

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 the reports—including the financial statements and notes and 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 primary financial statements are the statement of financial position (i.e., the balance sheet), the 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: $\text{Assets} = \text{Liabilities} + \text{Owners' equity}$.
- 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 $\text{Revenue} + \text{Other income} - \text{Expenses} = \text{Net income}$.
- 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. Which of the following *best* describes the role of financial statement analysis?
 - A. To provide information about a company's performance.
 - B. To provide information about a company's changes in financial position.
 - C. To form expectations about a company's future performance and financial position.
3. The role of financial statement analysis is *best* described as:
 - A. providing information useful for making investment decisions.
 - B. evaluating a company for the purpose of making economic decisions.
 - C. using financial reports prepared by analysts to make economic decisions.
4. A company's financial position would *best* be evaluated using the:
 - A. balance sheet.
 - B. income statement.
 - C. statement of cash flows.
5. A company's profitability for a period would *best* be evaluated using the:
 - A. balance sheet.
 - B. income statement.
 - C. statement of cash flows.
6. The financial statement that presents a shareholder's residual claim on assets is the:
 - A. balance sheet.
 - B. income statement.
 - C. cash flow statement.

7. A company's profitability over a period of time is *best* evaluated using the:
 - A. balance sheet.
 - B. income statement.
 - C. cash flow statement.
8. The income statement is *best* used to evaluate a company's:
 - A. financial position.
 - B. sources of cash flow.
 - C. financial results from business activities.
9. Accounting policies, methods, and estimates used in preparing financial statements are *most likely* to be found in the:
 - A. auditor's report.
 - B. management commentary.
 - C. notes to the financial statements.
10. Information about management and director compensation are *least likely* to be found in the:
 - A. auditor's report.
 - B. proxy statement.
 - C. notes to the financial statements.
11. Information about a company's objectives, strategies, and significant risks are *most likely* to be found in the:
 - A. auditor's report.
 - B. management commentary.
 - C. notes to the financial statements.
12. Which of the following *best* describes why the notes that accompany the financial statements are required? The notes:
 - A. permit flexibility in statement preparation.
 - B. standardize financial reporting across companies.
 - C. provide information necessary to understand the financial statements.
13. What type of audit opinion is preferred when analyzing financial statements?
 - A. Qualified.
 - B. Adverse.
 - C. Unqualified.
14. An auditor determines that a company's financial statements are prepared in accordance with applicable accounting standards except with respect to inventory reporting. This exception is *most likely* to result in an audit opinion that is:
 - A. adverse.
 - B. qualified.
 - C. unqualified.
15. An independent audit report is *most likely* to provide:
 - A. absolute assurance about the accuracy of the financial statements.
 - B. reasonable assurance that the financial statements are fairly presented.
 - C. a qualified opinion with respect to the transparency of the financial statements.

-
16. Interim financial reports released by a company are *most likely* to be:
 - A. monthly.
 - B. unaudited.
 - C. unqualified.
 17. Which of the following sources of information used by analysts is found outside a company's annual report?
 - A. Auditor's report.
 - B. Peer company analysis.
 - C. Management's discussion and analysis.
 18. 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.
 19. Which phase in the financial statement analysis framework is *most likely* to involve producing updated reports and recommendations?
 - A. Follow-up.
 - B. Analyze/interpret the processed data.
 - C. Develop and communicate conclusions and recommendations.

