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Digital Area for Networking Teachers and Educators

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Introduction to Financial Statement Analysis

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Introduction

- **The roles of financial reporting** and financial statement analysis.
- **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.
- The importance of financial statement notes and supplementary information—including disclosures of accounting policies, methods, and estimates—and management's commentary.
- **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.
- **The steps in the financial statement** analysis framework.

Roles of financial reporting and financial statement analysis

- **Is to provide information about a company's performance**, **financial position**, and **changes in financial position** that is useful to a wide range of users in making economi.

- Is to **use financial reports** prepared by companies to **evaluate the past, current, and potential performance and financial position** of a company for the purpose of making investment, credit, and other economic decisions.

In evaluating financial reports, analysts have a specific economic decision in mind. are the following:

- Evaluating **an equity investment** for inclusion in a portfolio.
- Evaluating **a merger** or acquisition candidate.
- Evaluating **a subsidiary** or operating division of a parent company.
- Deciding whether to make **a venture capital** or other private equity investment.
- Determining **the creditworthiness of a company** in order to decide whether to extend a loan to the company and if so, what terms to offer.

Roles of financial reporting and financial statement analysis

- **Extending** credit to a customer.
- **Examining** compliance with debt covenants or other contractual arrangements.
- **Assigning** a debt rating to a company or bond issue.
- **Valuing** a security for making an investment recommendation to others.
- **Forecasting** future net income and cash flow.

Assignment

- Sennett Designs (SD) sells furniture on a retail basis. SD began operations during **December 2022** and sold furniture for **€ 250,000 in cash**. The furniture sold by SD was purchased on **credit for € 150,000** and delivered by the supplier during December. The credit terms granted by the supplier required SD to **pay the € 150,000 in January** for the furniture it received **during December**. In addition to the purchase and sale of furniture, in **December, SD paid € 20,000 in cash for rent and salaries.**

Questions

- How much is SD's **profit for December 2022** if no other transactions occurred?
- How much is SD's **cash flow for December 2022**?
- If SD purchases and sells exactly the same amount **in January 2023 as** it did **in December** and under the same terms (receiving cash for the sales and making purchases on credit that will be due in February), how much will the company's **profit and cash flow be for the month of January**?

Solution

Solution to 1:

- SD's **profit for December 2022 is** the excess of the sales price (**€ 250,000**) over the cost of the goods that were sold (€ 150,000) and rent and salaries (€ 20,000), or €80,000.

Solution to 2:

- **The December 2022 cash flow is €230,000**, the amount of cash received from the customer (€ 250,000) less the cash paid for rent and salaries (€ 20,000).

Solution to 3:

- **SD's profit for January 2023 will be identical to its profit in December: € 80,000**, calculated as the sales price (€ 250,000) minus the cost of the goods that were sold (€ 150,000) and minus rent and salaries (€ 20,000). SD's **cash flow in January 2023 will also equal € 80,000**, calculated as the amount of cash received from the customer € 250,000) minus the cash paid for rent and salaries (€ 20,000) and minus the € 150,000 that SD owes for the goods it had purchased on credit in the prior month.

Primary financial statements and other information sources

- Companies **prepare** financial reports **at regular intervals** (annually, semiannually, and/or quarterly depending on the applicable regulat
- Financial reports **include financial statements** along with supplemental disclosures necessary to **assess the company's financial position and periodic performance**.
- **Financial statements are the result** of an accounting process that records a company's economic activities, following the applicable accounting standards and principles.
- **The statements summarize the accounting information**, mainly for users outside the company (such as investors, creditors, analysts, and others)
- **Financial statements are always audited by independent accountants**, who provide an opinion on whether the financial statements present fairly the company's performance and financial position, in accordance with a specified, applicable set of accounting standards and principles.

Financial statements and supplementary information

- A statement of financial position (i.e., a balance sheet),
- A statement of comprehensive income (i.e., a single statement of comprehensive income or an income statement and a statement of comprehensive income),
- A statement of changes in equity, and a statement of cash flows.

The Balance Sheet

- **The balance sheet** (also called the statement of financial position or statement of financial condition) **presents a company's financial position** by disclosing the resources the company controls (assets) and its obligations to lenders and other creditors (liabilities) at a specific point in time.

- **Owners' equity** (sometimes called "net assets") **represents the excess of assets over liabilities**.

- The relationship among **the three parts of the balance sheet** (assets, liabilities, and owners' equity) can be expressed in the following equation form:

Assets = Liabilities + Owners' equity.

- This equation shows that **the total amount of assets must equal** or balance with **the combined total amounts of liabilities and owners' equity.**

Income Statement

- The income statement **presents information** on the financial performance of a company's business activities over a period of time.
- How much revenue and other income the company generated during a period and the expenses it incurred to generate that revenue and other income.
- **Revenue typically refers** to amounts charged for the delivery of goods or services in the ordinary activities of a business.
- **Other income** may include gains that may or may not arise in the ordinary activities of the business, such as profit on a business disposal.
- **Expenses** reflect outflows, depletions of assets, and incurrences of liabilities that decrease equity.
- **Expenses typically include** such items as cost of sales (cost of goods sold), administrative expenses, and income tax expenses and may be defined to include losses.

Income Statement

- **Net income** may also be referred to as "**net earnings**," "**net profit**," and "**profit or loss**."
- In the event that **expenses exceed revenues and other income**, the result is referred to as "**net loss.**"
- **The income statement** is sometimes referred to as a statement of operations or **profit and loss (P&L) statement.**
- The basic equation underlying the income statement is:

Revenue + Other income – Expenses = Income – Expenses = Net income.

Statement of Changes in equity

- **The statement of changes in equity**, sometimes called the “statement of changes in owners’ equity” or “statement of changes in shareholders’ equity,” **primarily serves** to report changes in the owners’ investment in the business over time.

- The basic components of owners’ equity **are paid-in capital and retained earnings**.

- **The statement of changes in equity is organized to present**, for each component of equity, the beginning balance, any increases during the period, any decreases during the period, and the ending balance.

Cash Flow Statement

- The cash flow statement classifies **all cash flows of the company** into three categories: operating, investing, and financing.

- Cash flows from **operating activities** generally involve the cash effects of transactions involved in the determination of net income and, hence, comprise the day-to-day operations of the company.

- Cash flows from **investing activities** are associated with the acquisition and disposal of longterm assets, such as property and equipment.

- Cash flows from **financing activities** relate to obtaining or repaying capital to be used in the business.

- **The sum of the net cash flows** from operating, investing, and financing activities and the effect of exchange rates on cash **equals the net change in cash during the fiscal year.**

Financial Notes and Supplementary Schedules

- The notes disclose **the basis** of preparation for the financial statements.
- The notes also disclose **information about** the accounting policies, methods, and estimates used to prepare the financial statements.

Auditor’s Reports

- Financial statements presented in companies’ annual reports are generally required to be audited (examined) **by an independent accounting firm in accordance with specified auditing standards.**

- The independent auditor provides a written opinion on the financial statements, which is referred to as **the audit report**.

- **International standards on auditing (ISAs)** have been developed by **the International Auditing and Assurance Standards Board (IAASB).**

Auditor’s Reports

Under international standards for auditing (ISAs), the **overall objectives of an auditor** in conducting an audit of financial statements are:

- To obtain reasonable assurance about whether **the financial statements** as a whole are **free from material misstatement**, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

- **To report on the financial statements**, and communicate as required by the ISAs, in accordance with the auditor’s findings.

The steps in the financial statement analysis framework.

- 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.

Summary

- The information presented in financial and other reports, including the financial statements, notes, and management's commentary, **help the financial analyst to assess a company's performance and financial position.**

- 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 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.**

Summary

- The balance sheet discloses what resources a company controls (assets) and what it owes (liabilities) at a specific point in time.
- The income statement presents information on the financial results of a company's business activities over a period of time. 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.
- The notes that accompany the financial statements are an integral part of those statements and provide information that is essential to understanding the statements.
- A publicly traded company must have an independent audit performed on its annual financial statements.

Summary

The financial statement analysis framework provides steps that can be followed n 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.

Control Questions

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

A company's financial position would best be evaluated using the:

a) Balance sheet.

b) Income statement.

c) Statement of cash flows.

Control Questions

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.

A company’s profitability over a period of time is best evaluated using the:

a) A Balance sheet.

b) B Income statement.

c) C Cash flow statement.ncial results from business activities.

Control Questions

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.

An independent audit report is most likely to provide:

a) A absolute assurance about the accuracy of the financial statements.

b) B reasonable assurance that the financial statements are fairly presented.

c) C a qualified opinion with respect to the transparency of the financial statements.

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