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.

1. INTRODUCTION

Analysts are employed in a number of functional areas. Commonly, analysts evaluate an investment in some type of security that has characteristics of equity (representing an ownership position) or debt (representing a lending position). In arriving at investment decisions or recommendations, analysts need to evaluate the performance, financial position, and value of the company issuing the securities. Company financial reports, which include financial statements and other data, provide the information necessary to evaluate the company and its securities. Consequently, the analyst must have a firm understanding of the information provided in each company's financial reports, including the financial notes and other forms of supplementary information.

This chapter is organized as follows: Section 2 discusses the scope of financial statement analysis. Section 3 describes the sources of information used in financial statement analysis, including the primary financial statements (income statement, balance sheet, and cash flow statement). Section 4 provides a framework for guiding the financial statement analysis process, and section 5 summarizes the key points of the chapter. Practice problems in the CFA Institute multiple-choice format conclude the chapter.

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2. SCOPE OF FINANCIAL STATEMENT ANALYSIS

The role of financial reporting by companies is to provide information about their performance, financial position, and changes in financial position that is useful to a wide range of users in making economic decisions.[1] The role of financial statement analysis is to take financial reports prepared by companies, combined with other information, to evaluate the past, current, and prospective performance and financial position of a company for the purpose of making investment, credit, and other economic decisions.

In evaluating financial reports, analysts typically have an economic decision in mind. Examples include 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.

[1] See paragraph 12 of the *Framework for the Preparation and Presentation of Financial Statements,* originally published by the International Accounting Standards Committee in 1989 and then adopted by the International Accounting Standards Board in 2001.

- Deciding whether to make a venture capital or other private equity investment.
- Determining the creditworthiness of a company that has made a loan request.
- 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.

There are certain themes in financial analysis. In general, analysts seek to examine the performance and financial position of companies as well as forecast future performance and financial position. Analysts are also concerned about factors that affect risks to the company's future performance and financial position. An examination of performance can include an assessment of a company's profitability (the ability to earn a profit from delivering goods and services) and its cash flow–generating ability (the ability to produce cash receipts in excess of cash disbursements). Profit and cash flow are not equivalent. Profit represents the excess of the prices at which goods or services are sold over all the costs of providing those goods and services (regardless of when cash is received or paid). Example 1-1 illustrates the distinction between profit and cash flow.

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EXAMPLE 1-1 Profit versus Cash Flow

Sennett Designs (SD) sells imported furniture on a retail basis. SD began operations during December 2006 and sold furniture for cash of €250,000. The furniture that was sold by SD was delivered by the supplier during December, but the supplier has granted SD credit terms, according to which payment is not due until January 2007. SD is obligated to pay €220,000 in January for the furniture it sold during December.

1. How much is SD's profit for December 2006 if no other transactions occurred?
2. How much is SD's cash flow for December 2006?

Solution to 1. SD's profit for December 2006 is the excess of the sales price (€250,000) over the cost of the goods that were sold (€220,000), or €30,000.

Solution to 2. The December 2006 cash flow is €250,000.

Although profitability is important, so is the ability to generate positive cash flow. Cash flow is important because, ultimately, cash is needed to pay employees, suppliers, and others to continue as a going concern. A company that generates positive cash flow from operations has more flexibility in funding needed investments and taking advantage of attractive business opportunities than an otherwise comparable company without positive cash flow. Additionally, cash flow is the source of returns to providers of capital. Therefore, the expected magnitude of future cash flows is important in valuing corporate securities and in determining the company's ability to meet its obligations. The ability to meet short-term obligations is generally referred to as **liquidity**, and the ability to meet long-term obligations is generally referred to as **solvency**. However, as shown in Example 1-1, cash flow in a given period is not

a complete measure of performance in that period; for example, a company may be obligated to make future cash payments as a result of a transaction generating positive cash flow in the current period.

As noted earlier, profits reflect the ability of a company to deliver goods and services at prices in excess of the costs of delivering the goods and services. Profits also provide useful information about future (and past) cash flows. If the transaction of Example 1-1 were repeated year after year, the long-term average annual cash flow of SD would be €30,000, its annual profit. Many analysts not only evaluate past profitability but also forecast future profitability.

Exhibit 1-1 shows how news media coverage of corporate earnings announcements places corporate results in the context of analysts' expectations. Furthermore, analysts frequently use earnings in valuation, for example, when they value shares of a company on the basis of the price-to-earnings ratio (P/E) in relation to peer companies' P/Es or when they use a present value model of valuation that is based on forecasted future earnings.

Analysts are also interested in the current financial position of a company. The financial position can be measured by comparing the resources controlled by the company in relation to the claims against those resources. An example of a resource is cash. In Example 1-1, if no other transactions occur, the company should have cash on 31 December 2006 of €250,000.

EXHIBIT 1-1 An Earnings Release and Analyst Reaction

Panel A. Excerpt from Apple Earnings Release

Apple Reports Third-Quarter Results
Posts Second-Highest Quarterly Revenue and Earnings in Company's History

CUPERTINO, California—July 19, 2006—Apple® today announced financial results for its fiscal 2006 third quarter ended July 1, 2006. The Company posted revenue of $4.37 billion and a net quarterly profit of $472 million, or $0.54 per diluted share. These results compare to revenue of $3.52 billion and a net profit of $320 million, or $0.37 per diluted share, in the year-ago quarter. Gross margin was 30.3 percent, up from 29.7 percent in the year-ago quarter. International sales accounted for 39 percent of the quarter's revenue.

Apple shipped 1,327,000 Macintosh® computers and 8,111,000 iPods during the quarter, representing 12 percent growth in Macs and 32 percent growth in iPods over the year-ago quarter. . . .

Panel B. Excerpt from CNET News.com Report

"Mac Sales Up 12 Percent as Apple Profits Soar" by Tom Krazit

Apple Computer's third-quarter revenue fell a little short of expectations, but profitability was far higher than expected and Mac sales increased at a healthy clip.

. . . Net income was $472 million, or 54 cents per share, an improvement of 48 percent compared with last year's results of $320 million in net income and 37 cents per share. Analysts surveyed by Thomson First Call had been expecting Apple to report $4.4 billion in revenue and earn 44 cents per share.

. . . The outlook for the next period will probably disappoint some investors. The company predicted fourth-quarter revenue would be about $4.5 billion to $4.6 billion, less than the $4.9 billion analysts had been expecting. Apple executives will hold a conference call later Wednesday to discuss results.

Sources: www.apple.com/pr/library/2006/jul/19results.html, http://news.com.com/Mac+sales+up+12+percent+as+Apple+profits+soar/2100-1047_3-6096116.html.

EXHIBIT 1-2 Grupo Imsa Press Release Dated 18 January 2005

Standard & Poor's and Fitch Upgrade Grupo Imsa's Credit Rating

MONTERREY, Mexico: Grupo Imsa (NYSE: IMY) (BMV: IMSA) announces that Standard & Poor's has recently upgraded the Company's local currency corporate credit rating from BBB– to BBB and its national scale rating from mxAA to mxAA+. Fitch Mexico also increased Grupo Imsa's domestic rating from AA(mex) to AA+(mex). These rating upgrades reflect the positive results of Grupo Imsa's main businesses and the strengthening of its financial position, combined with the Company's geographic diversification, market leadership, state-of-the-art technology and high operational efficiency.

Mr. Marcelo Canales, Grupo Imsa's CFO, explained: "Grupo Imsa follows a policy of maintaining a solid financial position that ensures the Company's continuity for the benefit of our employees, shareholders and creditors. We take our financial commitments very seriously, as can be seen from the fact that during our 70 years of existence we have always complied with our financial obligations. The change in rating also reflects the strength of our business model and its capacity to generate cash." Mr. Canales added: "These upgrades in credit rating should translate into a better valuation of our debt to reflect Grupo Imsa's new financial reality."

Grupo Imsa, a holding company, dates back to 1936 and is today one of Mexico's leading diversified industrial companies, operating in three core businesses: steel processed products; steel and plastic construction products; and aluminum and other related products. With manufacturing and distribution facilities in Mexico, the United States, Europe and throughout Central and South America, Grupo Imsa currently exports to all five continents. Grupo Imsa's shares trade on the Mexican Stock Exchange (IMSA) and, in the United States, on the NYSE (IMY).

This document contains forward-looking statements relating to Grupo Imsa's future performance or its current expectations or beliefs, including statements regarding the intent, belief or current expectations of the Company and its management. Investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties pertaining to the industries in which the Company participates. Grupo Imsa does not intend, and does not assume any obligation, to update these forward-looking statements.

Source: Business Wire, 18 January 2005.

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This cash can be used by the company to pay the obligation to the supplier (a claim against the company) and may also be used to make distributions to the owner (who also has a claim against the company for any profits that have been earned). Financial position is particularly important in credit analysis, as depicted in Exhibit 1-2.

In conducting a financial analysis of a company, the analyst will regularly refer to the company's financial statements, financial notes and supplementary schedules, and a variety of other information sources. The next section introduces the major financial statements and most commonly used information sources.

3. MAJOR FINANCIAL STATEMENTS AND OTHER INFORMATION SOURCES

In order to perform an equity or credit analysis of a company, an analyst must collect a great deal of information. The nature of the information will vary based on the individual task but will typically include information about the economy, industry, and company as well as information about comparable peer companies. Much of this information will come from outside

the company, such as economic statistics, industry reports, trade publications, and databases containing information on competitors. The company itself provides some of the core information for analysis in its financial reports, press releases, and conference calls and webcasts.

Companies prepare financial reports to report to investors and creditors on financial performance and financial strength at regular intervals (annually, semiannually, and/or quarterly). Financial reports include financial statements and supplemental information necessary to assess the performance and financial position of the company. Financial statements are the end results of an accounting record-keeping process that records the economic activities of a company. They summarize this information for use by investors, creditors, analysts, and others interested in a company's performance and financial position. In order to provide some assurances as to the information provided in the financial statements and related notes, the financial statements are audited by independent accountants, who express an opinion on whether the financial statements fairly portray the company's performance and financial position.

3.1. Financial Statements and Supplementary Information

The key financial statements that are the focus of analysis are the income statement, balance sheet, statement of cash flows, and statement of changes in owners' equity. The income statement and statement of cash flows portray different aspects of a company's performance over a period of time. The balance sheet portrays the company's financial position at a given point in time. The statement of changes in owners' equity provides additional information regarding the changes in a company's financial position. In addition to the financial statements, a company provides other information in its financial reports that is useful to the financial analyst. As part of his or her analysis, the financial analyst should read and assess this additional information, which includes:

- Notes to the financial statements (also known as footnotes) and supplementary schedules.
- Management's discussion and analysis (MD&A).
- The external auditor's report(s).

The following sections illustrate the major financial statements.

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3.1.1. Income Statement

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. Net income (revenue minus all costs) on the income statement is often referred to as the "bottom line" because of its proximity to the bottom of the income statement.[2] Income statements are reported on a consolidated basis, meaning that they include the revenues and expenses of affiliated companies under the control of the parent (reporting) company. 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 − Expenses = Net income.

In Exhibit 1-3, the income statement is presented with the most recent year in the first column and the earliest year in the last column. Although this is a common presentation,

[2]Net income is also referred to as net earnings or net profit. In the event that costs exceed revenues, it is referred to as net loss.

EXHIBIT 1-3 Wal-Mart Consolidated Statements of Income (in millions except per share data)

Fiscal years ended 31 January	**2005**	**2004**	**2003**
Revenues			
Net sales	$285,222	$256,329	$229,616
Other income, net	2,767	2,352	1,961
	287,989	258,681	231,577
Costs and Expenses			
Cost of sales	219,793	198,747	178,299
Operating, selling, general, and administrative expenses	51,105	44,909	39,983
Operating Income	17,091	15,025	13,295
Interest			
Debt	934	729	799
Capital lease	253	267	260
Interest income	(201)	(164)	(132)
Interest, net	986	832	927
Income from continuing operations before income taxes and minority interest	16,105	14,193	12,368
Provision for Income Taxes			
Current	5,326	4,941	3,883
Deferred	263	177	474
Total	5,589	5,118	4,357
Income from continuing operations before minority interest	10,516	9,075	8,011
Minority interest	(249)	(214)	(193)
Income from continuing operations	10,267	8,861	7,818
Income from discontinued operations, net of tax	—	193	137
Net Income	$ 10,267	$ 9,054	$ 7,955
Basic Net Income per Common Share			
Income from continuing operations	$ 2.41	$ 2.03	$ 1.77
Income from discontinued operations	—	0.05	0.03
Basic net income per common share	$ 2.41	$ 2.08	$ 1.80
Diluted Net Income per Common Share			
Income from continuing operations	$ 2.41	$ 2.03	$ 1.76
Income from discontinued operations	—	0.04	0.03
Diluted net income per common share	$ 2.41	$ 2.07	$ 1.79
Weighted Average Number of Common Shares			
Basic	4,259	4,363	4,430
Diluted	4,266	4,373	4,446
Dividends per Common Share	$ 0.52	$ 0.36	$ 0.30

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analysts should be careful when reading an income statement because in other cases, the years may be listed from most distant to most recent.

Exhibit 1-3 shows that Wal-Mart's total revenue for the fiscal year ended 31 January 2005 was (in millions) $287,989. Wal-Mart then subtracted its operating costs and expenses to arrive at an operating income (profit) of $17,091. Operating income reflects a company's profits from its usual business activities, before deducting interest expense or taxes. Operating income is thus often referred to as EBIT, or earnings before interest and taxes. Operating income reflects the company's underlying performance independent of the use of financial leverage. Wal-Mart's total interest cost (net of the interest income that was earned from investments) for 2005 was $986; its earnings before taxes was, therefore, $16,105. Total income tax expense for 2005 was $5,589, and the minority interest expense (income earned by the minority shareholders from Wal-Mart subsidiary companies) was $249. After deducting these final expenses, Wal-Mart's net income for fiscal 2005 was $10,267.

Companies present their basic and diluted earnings per share on the face of the income statement. Earnings per share represents the net income divided by the number of shares of stock outstanding during the period. Basic earnings per share uses the weighted average number of common shares that were actually outstanding during the period, whereas diluted earnings per share uses **diluted shares**—the number of shares that would be outstanding if potentially dilutive claims on common shares (e.g., stock options) were exercised by their holders. Wal-Mart's basic earning per share for 2005 was $2.41 ($10,267 net income ÷ 4,259 basic shares outstanding). Likewise, Wal-Mart's diluted earnings per share for 2005 was also $2.41 ($10,267 net income ÷ 4,266 diluted shares).

An analyst examining the income statement might note that Wal-Mart was profitable in each year and that revenue, operating income, net income, and earnings per share—all measures of profitability—increased over the three-year period. The analyst might formulate questions related to profitability, such as the following:

- Is the growth in revenue related to an increase in units sold, an increase in prices, or some combination?
- After adjusting for growth in the number of stores, is the company still more profitable over time?
- How does the company compare with other companies in the industry?

Answering such questions requires the analyst to gather, analyze, and interpret facts from a number of sources, including the income statement. The chapter on understanding the income statement will explain the income statement in greater detail. The next section illustrates the balance sheet, the second major financial statement.

3.1.2. Balance Sheet

The **balance sheet** (also known as the **statement of financial position** or **statement of financial condition**) presents a company's current financial position by disclosing resources the company controls (assets) and what it owes (liabilities) at a specific point in time. **Owners' equity** represents the excess of assets over liabilities. This amount is attributable 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 an accounting relationship known as the accounting equation: Assets = Liabilities + Owners' equity (that is, the total amount for assets must *balance* to the combined total amounts for liabilities and owners' equity). Alternatively, the three parts of the balance sheet

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of the accounting relationship may be formulated as Assets − Liabilities = Owners' equity. Depending on the form of the organization, owners' equity also goes by several alternative titles, such as "partners' capital" or "shareholders' equity."

Exhibit 1-4 presents Wal-Mart's consolidated balance sheets for the fiscal years ended 31 January 2004 and 2005.

EXHIBIT 1-4 Wal-Mart Consolidated Balance Sheets (in millions except per-share data)

Fiscal Years Ended 31 January	**2005**	**2004**
Assets		
Current assets:		
Cash and cash equivalents	$ 5,488	$ 5,199
Receivables	1,715	1,254
Inventories	29,447	26,612
Prepaid expenses and other	1,841	1,356
Total current assets	38,491	34,421
Property and equipment, at cost:		
Land	14,472	12,699
Buildings and improvements	46,582	40,192
Fixtures and equipment	21,461	17,934
Transportation equipment	1,530	1,269
Property and equipment, at cost	84,045	72,094
Less accumulated depreciation	18,637	15,684
Property and equipment, net	65,408	56,410
Property under capital lease:		
Property under capital lease	4,997	4,286
Less accumulated amortization	1,838	1,673
Property under capital lease, net	3,159	2,613
Goodwill	10,803	9,882
Other assets and deferred charges	2,362	2,079
Total assets	$120,223	$105,405
Liabilities and shareholders' equity		
Current liabilities:		
Commercial paper	$ 3,812	$ 3,267
Accounts payable	21,671	19,425
Accrued liabilities	12,155	10,671
Accrued income taxes	1,281	1,377
Long-term debt due within one year	3,759	2,904
Obligations under capital leases due within one year	210	196
Total current liabilities	42,888	37,840

(*Continued*)

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EXHIBIT 1-4 *Continued*

Fiscal Years Ended 31 January	2005	2004
Long-term debt:	$20,087	$17,102
Long-term obligations under capital leases	3,582	2,997
Deferred income taxes and other	2,947	2,359
Minority interest	1,323	1,484
Shareholders' equity:		
Preferred stock ($0.10 par value; 100 shares authorized, none issued)	—	—
Common stock ($0.10 par value; 11,000 shares authorized, 4,234 and 4,311 issued and outstanding in 2005 and 2004, respectively)	423	431
Capital in excess of par value	2,425	2,135
Other accumulated comprehensive income	2,694	851
Retained earnings	43,854	40,206
Total shareholders' equity	49,396	43,623
Total Liabilities and Shareholders' Equity	$120,223	$105,405

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On 31 January 2005, Wal-Mart's total resources or assets were $120,223 (in millions). Shareholders' equity (in millions) was $49,396. Although Wal-Mart does not give a total amount for all the balance sheet liabilities, it may be determined from the accounting relationship as Total assets − Total shareholders' equity or $120,223 − $49,396 = $70,827.[3] Using the balance sheet and applying financial statement analysis, the analyst will be able to answer such questions as:

- Has the company's liquidity (ability to meet short-term obligations) improved?
- Is the company solvent (does it have sufficient resources to cover its obligations)?
- What is the company's financial position relative to the industry?

The chapter on understanding the balance sheet will cover the analysis of the balance sheet in more depth. The next section illustrates the cash flow statement.

3.1.3. Cash Flow Statement

Although the income statement and balance sheet provide a measure of a company's success in terms of performance and financial position, cash flow is 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. **Financial flexibility** is the ability to react and adapt to financial adversities and opportunities. The cash flow statement classifies all company cash flows into operating, investing,

[3]Note that this computation includes an amount labeled "minority interest in liabilities." Minority interest represents ownership in a subsidiary company by others (not the parent company). Accounting rule makers are currently considering reclassifying this amount as part of owners' equity.

and financing activity cash flows. **Operating activities** involve transactions that enter into the determination of net income and are primarily activities that comprise the day-to-day business functions of a company. **Investing activities** are those activities associated with the acquisition and disposal of long-term assets, such as equipment. **Financing activities** are those activities related to obtaining or repaying capital to be used in the business.

Exhibit 1-5 presents Wal-Mart's consolidated statement of cash flows for the fiscal years ended 31 January 2003, 2004, and 2005.

EXHIBIT 1-5 Wal-Mart Consolidated Statements of Cash Flows (in millions)

Fiscal Years Ended 31 January	**2005**	**2004**	**2003**
Cash Flows from Operating Activities			
Income from continuing operations	$ 10,267	$ 8,861	$ 7,818
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	4,405	3,852	3,364
Deferred income taxes	263	177	474
Other operating activities	378	173	685
Changes in certain assets and liabilities, net of effects of acquisitions:			
Decrease (increase) in accounts receivable	(304)	373	(159)
Increase in inventories	(2,635)	(1,973)	(2,219)
Increase in accounts payable	1,694	2,587	1,748
Increase in accrued liabilities	976	1,896	1,212
Net cash provided by operating activities of continuing operations	15,044	15,946	12,923
Net cash provided by operating activities of discontinued operations	—	50	82
Net cash provided by operating activities	15,044	15,996	13,005
Cash Flows from Investing Activities			
Payments for property and equipment	(12,893)	(10,308)	(9,245)
Investment in international operations	(315)	(38)	(749)
Proceeds from the disposal of fixed assets	953	481	311
Proceeds from the sale of McLane	—	1,500	—
Other investing activities	(96)	78	(73)
Net cash used in investing activities of continuing operations	(12,351)	(8,287)	(9,756)
Net cash used in investing activities discontinued operations	—	(25)	(83)
Net cash used in investing activities	(12,351)	(8,312)	(9,839)
Cash Flows from Financing Activities			
Increase in commercial paper	544	688	1,836
Proceeds from issuance of long-term debt	5,832	4,099	2,044

(*Continued*)

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EXHIBIT 1-5 *Continued*

Fiscal Years Ended 31 January	**2005**	**2004**	**2003**
Purchase of company stock	(4,549)	(5,046)	(3,383)
Dividends paid	(2,214)	(1,569)	(1,328)
Payment of long-term debt	(2,131)	(3,541)	(1,261)
Payment of capital lease obligations	(204)	(305)	(216)
Other financing activities	113	111	(62)
Net cash used in financing activities	(2,609)	(5,563)	(2,370)
Effect of exchange rate changes on cash	205	320	(199)
Net increase in cash and cash equivalents	289	2,441	597
Cash and cash equivalents at beginning of year	5,199	2,758	2,161
Cash and cash equivalents at end of year	$ 5,488	$ 5,199	$ 2,758
Supplemental Disclosure of Cash Flow Information			
Income tax paid	$ 5,593	$ 4,358	$ 4,539
Interest paid	1,163	1,024	1,085
Capital lease obligations incurred	377	252	381

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In the cash flows from operating activities section of Wal-Mart's cash flow statement, the company reconciles its net income to net cash provided by operating activities. This emphasizes the different perspectives of the income statement and cash flow statement. Income is reported when earned, not necessarily when cash is received. The cash flow statement presents another aspect of performance: the ability of a company to generate cash flow from running its business. Ideally, the analyst would like to see that the primary source of cash flow is from operating activities (as opposed to investing or financing activities). Note that Wal-Mart had a large amount of operating cash flow, which increased from 2003 to 2004 but decreased slightly in 2005. Although operating cash flow was high, an analyst might question why net income increased but operating cash flow decreased in 2005.

The summation 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. For Wal-Mart, the summation of these four cash flow activities in 2005 was $289, which thus increased the company's cash from $5,199 on 31 January 2004 (beginning cash balance) to $5,488 on 31 January 2005 (ending cash balance). Note that these beginning and ending cash balances agree with the cash reported on Wal-Mart's balance sheets in Exhibit 1-4.

The cash flow statement will be treated in more depth in the chapter on understanding the cash flow statement.

3.1.4. Statement of Changes in Owners' Equity

The income statement, balance sheet, and cash flow statements represent the primary financial statements used to assess a company's performance and financial position. A fourth financial statement is also available, variously called a "statement of changes in owners' equity," "statement of shareholders' equity," or "statement of retained earnings." This statement primarily serves to report changes in the owners' investment in the business over time and assists the analyst in understanding the changes in financial position reflected on the balance sheet.

3.1.5. Financial Notes and Supplementary Schedules

Financial notes and supplementary schedules are an integral part of the financial statements. By way of example, the financial notes and supplemental schedules provide explanatory information about the following:

- Business acquisitions and disposals
- Commitments and contingencies
- Legal proceedings
- Stock option and other employee benefit plans
- Related-party transactions
- Significant customers
- Subsequent events
- Business and geographic segments
- Quarterly financial data

Additionally, the footnotes contain information about the methods and assumptions used to prepare the financial statements. Comparability of financial statements is a critical requirement for objective financial analysis. Financial statement comparability occurs when information is measured and reported in a similar manner over time and for different companies. Comparability allows the analyst to identify and analyze the real economic substance differences and similarities between companies. The International Accounting Standards Board based in London sets forth standards under which international financial statements should be prepared. These are referred to as International Financial Reporting Standards (IFRS). Similarly, the Financial Accounting Standards Board (FASB) in the United States sets forth standards (called statements of financial accounting standards) that constitute the key part of the body of principles known as generally accepted accounting principles (U.S. GAAP). These two organizations are working to make their standards similar, but there are key differences. When comparing a U.S. company with a European company, an analyst must understand differences in these standards, which can relate, for example, to the period in which to report revenue.

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Even within each of these sets of standards there can be choices for management to make that can reduce comparability between companies. Both IFRS and U.S. GAAP allow the use of alternative accounting methods to measure company financial performance and financial condition where there are differences in economic environments between companies. Additionally, some principles require the use of estimates and assumptions in measuring performance and financial condition. This flexibility is necessary because, ideally, a company will select those methods, estimates, and assumptions within the principles that fairly reflect the unique economic environment of the company's business and industry. Although this flexibility in accounting principles ostensibly meets the divergent needs of many businesses, it creates a problem for the analyst because comparability is lost when flexibility occurs. For example, if a company acquires a piece of equipment to use in its operations, accounting standards require that the cost of the asset be reported as an expense in a systematic manner over the life of the equipment (estimating the process of the equipment's wearing out). This allocation of the cost is known as **depreciation**. The standards permit a great deal of flexibility, however, in determining the manner in which each year's expense is determined. Two companies may acquire similar equipment but use different methods and assumptions to record the expense over time. Comparing the companies' performance directly is then impaired by this difference.

A company's accounting policies (methods, estimates, and assumptions) are generally presented in the notes to the financial statements. A note containing a summary of significant accounting policies reveals, for example, how the company recognizes its revenues and depreciates its capital assets. Analysts must be aware of the methods, estimates, and assumptions used by a company to determine if they are similar to those of other companies that are being used as benchmarks. If they are not similar, the analyst who understands accounting techniques can make adjustments to make the financial statements more comparable.

3.1.6. Management's Discussion and Analysis

Publicly held companies are often required to include in their financial reports a section called Management's Discussion and Analysis (MD&A). In it, management must highlight any favorable or unfavorable trends and identify significant events and uncertainties that affect the company's liquidity, capital resources, and results of operations. The MD&A must also provide information about the effects of inflation, changing prices, or other material events and uncertainties that may cause the future operating results and financial condition to materially depart from the current reported financial information. Companies should also provide disclosure in the MD&A that discusses the critical accounting policies that require management to make subjective judgments and that have a significant impact on reported financial results. The MD&A section of a company's report provides a good starting place for understanding what is going on in the financial statements. Nevertheless, it is only one input for the analyst in seeking an objective and independent perspective on a company's performance and prospects.

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3.1.7. Auditor's Reports

Financial statements presented in company annual financial reports are often required to be audited (examined) by an independent accounting firm that then expresses an opinion on the financial statements. Audits may be required by contractual arrangement, law, or regulation. Just as there are standards for preparing financial statements, there are standards for auditing and for expressing the resulting auditor's opinion. International standards for auditing have been developed by the International Auditing and Assurance Standards Board of the International Federation of Accountants. These standards have been adopted by many countries. Other countries, such as the United States, have developed their own standards. With the enactment of the Sarbanes–Oxley Act in the United States, auditing standards are being promulgated by the Public Company Accounting Oversight Board (PCAOB). Under International Standard on Auditing 200:

> *The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.*[4]

Publicly traded companies may also have requirements set by regulators or stock exchanges, such as appointing an independent audit committee of the board of directors to oversee the audit process. The audit process provides a basis for the independent auditor to express an audit opinion on the fairness of the financial statements that were audited. Because audits are designed and conducted by using audit sampling techniques, independent auditors cannot express an opinion that provides absolute assurance about the accuracy or precision of the financial statements. Instead, the independent audit report provides

[4]International Federation of Accountants, *Handbook of International Auditing, Assurance, and Ethics Pronouncements*, 2006 edition, p. 230, available at www.ifac.org.

reasonable assurance that the financial statements are *fairly presented*, meaning that there is a high degree of probability that the audited financial statements are free from *material* error, fraud, or illegal acts that have a direct effect on the financial statements.

The standard independent audit report for a publicly traded company normally has several paragraphs under both the international and U.S. auditing standards. The first or "introductory" paragraph describes the financial statements that were audited and the responsibilities of both management and the independent auditor. The second or "scope" paragraph describes the nature of the audit process and provides the basis for the auditor's expression about reasonable assurance on the fairness of the financial statements. The third or "opinion" paragraph expresses the auditor's opinion on the fairness of the audited financial statements. An *unqualified* audit opinion states that the financial statements give a "true and fair view" (international) or are "fairly presented" (international and U.S.) in accordance with applicable accounting standards. This is often referred to as a "clean" opinion and is the one that analysts would like to see in a financial report. There are several other types of opinions. A *qualified* audit opinion is one in which there is some limitation or exception to accounting standards. Exceptions are described in the audit report with additional explanatory paragraphs so that the analyst can determine the importance of the exception. An *adverse* audit opinion occurs when the financial statements materially depart from accounting standards and are not fairly presented. An adverse opinion makes analysis of the financial statements easy: Don't bother, because the company's financial statements cannot be relied upon. Finally, a *disclaimer of opinion* occurs when, for some reason, the auditors are unable to issue an opinion. Exhibit 1-6 presents the independent auditor's report for Wal-Mart. Note that Wal-Mart received a "clean" or unqualified audit opinion from Ernst & Young LLP for the company's fiscal year ended 31 January 2005.

In the United States, under the Sarbanes-Oxley Act, the auditors must also express an opinion on the company's internal control systems. This information may be provided in a separate opinion or incorporated as a fourth paragraph in the opinion related to the financial statements. The internal control system is the company's internal system that is designed, among other things, to ensure that the company's process for generating financial reports is sound.

Although management has always been responsible for maintaining effective internal control, the Sarbanes-Oxley Act greatly increases management's responsibility for demonstrating that the company's internal controls are effective. Publicly traded companies in the United States are now required by securities regulators to:

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- Accept responsibility for the effectiveness of internal control.
- Evaluate the effectiveness of internal control using suitable control criteria.
- Support the evaluation with sufficient competent evidence.
- Provide a report on internal control.

The Sarbanes-Oxley Act specifically requires management's report on internal control to:

- State that it is management's responsibility to establish and maintain adequate internal control.
- Identify management's framework for evaluating internal control.
- Include management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent year, including a statement as to whether internal control over financial reporting is effective.
- Include a statement that the company's auditors have issued an attestation report on management's assessment.
- Certify that the company's financial statements are fairly presented.

EXHIBIT 1-6 Wal-Mart's Independent Audit Report

Report of Independent Registered Accounting Firm

WAL-MART
The Board of Directors and Shareholders,
Wal-Mart Stores, Inc.

We have audited the accompanying consolidated balance sheets of Wal-Mart Stores, Inc. as of January 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended January 31, 2005. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Wal-Mart Stores, Inc. at January 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Accounting Oversight Board (United States), the effectiveness of Wal-Mart Stores, Inc.'s internal control over financial reporting as of January 31, 2005, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Committee and our report dated March 25, 2005 expressed an unqualified opinion thereon.

Ernst & Young LLP
Rogers, Arkansas
March 25, 2005

Source: 2005 Wal-Mart Stores, Inc. annual report.

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Exhibit 1-7 presents Wal-Mart management's report on internal control to its company's shareholders. Note that Wal-Mart has fully complied with each of the reporting criterion that were discussed in the preceding paragraph.

Although these reports provide some assurances to analysts, they are not infallible. The analyst must always use a degree of healthy skepticism when analyzing financial statements.

3.2. Other Sources of Information

The information described in the previous section is generally provided to shareholders on an annual basis. Interim reports are also provided by the company either semiannually or quarterly. Interim reports generally present the four key financial statements and footnotes but are not audited. These interim reports provide updated information on a company's performance and financial position since the last annual period. Companies also prepare proxy statements for distribution to shareholders on matters that are to be put to a vote at the company's annual (or special) meeting of shareholders. The proxy statement typically provides useful information regarding management and director compensation and company stock performance and discloses any potential conflicts of interest that may exist between management,

EXHIBIT 1-7 Wal-Mart's Report to Shareholders on Corporate Governance and Internal Control

Management's Report to Our Shareholders

WAL-MART

Management of Wal-Mart Stores, Inc. ("Wal-Mart") is responsible for the preparation, integrity and objectivity of Wal-Mart's consolidated financial statements and other financial information contained in this Annual Report to Shareholders. Those consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States. In preparing those consolidated financial statements, Management was required to make certain estimates and judgments, which are based upon currently available information and Management's view of current conditions and circumstances.

The Audit Committee of the Board of Directors, which consists solely of independent directors, oversees our process of reporting financial information and the audit of our consolidated financial statements. The Audit Committee stays informed of the financial condition of Wal-Mart and regularly reviews Management's financial policies and procedures, the independence of our independent auditors, our internal control and the objectivity of our financial reporting. Both the independent financial auditors and the internal auditors have free access to the Audit Committee and meet with the Audit Committee periodically, both with and without Management present.

We have retained Ernst & Young LLP, an independent registered public accounting firm, to audit our consolidated financial statements found in this annual report. We have made available to Ernst & Young LLP all of our financial records and related data in connection with their audit of our consolidated financial statements.

We have filed with the Securities and Exchange Commission the required certifications related to our consolidated financial statements as of and for the year ended January 31, 2005. These certifications are attached as exhibits to our Annual Report on Form 10-K for the year ended January 31, 2005. Additionally, we have also provided to the New York Stock Exchange the required annual certification of our Chief Executive Officer regarding our compliance with the New York Stock Exchange's corporate governance listing standards.

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Report on Internal Control over Financial Reporting

Management has responsibility for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with accounting principles generally accepted in the United States. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Management has assessed the effectiveness of the company's internal control over financial reporting as of January 31, 2005. In making its assessment, Management has utilized the criteria set forth by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission in *Internal Control–Integrated Framework*. Management concluded that based on its assessment, Wal-Mart's internal control over financial reporting was effective as of January 31, 2005. Management's assessment of the effectiveness of the company's internal control over financial reporting as of January 31, 2005 has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report which appears in this Annual Report to Shareholders.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures designed to provide reasonable assurance that information, which is required to be timely disclosed, is accumulated and communicated to Management in a timely fashion. Management has assessed the effectiveness of these disclosure controls and procedures as of January 31, 2005 and determined that they were effective as of that date to provide reasonable assurance that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934, as amended, is accumulated and communicated to Management, as appropriate, to allow timely decisions regarding required disclosure and are effective to provide reasonable assurance that such information is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms.

(*Continued*)

EXHIBIT 1-7 *Continued*

Report on Ethical Standards

Our company was founded on the belief that open communications and the highest standard of ethics are necessary to be successful. Our long-standing "Open Door" communication policy helps Management be aware of and address issues in a timely and effective manner. Through the open door policy all associates are encouraged to inform Management at the appropriate level when they are concerned about any matter pertaining to Wal-Mart.

Wal-Mart has adopted a Statement of Ethics to guide our associates in the continued observance of high ethical standards such as honesty, integrity and compliance with the law in the conduct of Wal-Mart's business. Familiarity and compliance with the Statement of Ethics is required of all associates who are part of Management. The company also maintains a separate Code of Ethics for our senior financial officers. Wal-Mart also has in place a Related-Party Transaction Policy. This policy applies to all of Wal-Mart's Officers and Directors and requires material related-party transactions to be reviewed by the Audit Committee. The Officers and Directors are required to report material related-party transactions to Wal-Mart. We maintain an ethics office which oversees and administers an ethics hotline. The ethics hotline provides a channel for associates to make confidential and anonymous complaints regarding potential violations of our statement of ethics, including violations related to financial or accounting matters.

H. Lee Scott
President and Chief Executive Officer
Thomas M. Schoewe
Executive Vice President and Chief Financial Officer

Source: 2005 Wal-Mart Stores, Inc. annual report.

the board, and shareholders. Companies also provide relevant current information on their web sites and in press releases and as part of conference calls. When performing financial statement analysis, analysts should review all these company sources of information as well as information from external sources regarding the economy, the industry, the company, and peer (comparable) companies. 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. The next section presents a framework for using all this information in financial statement analysis.

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4. FINANCIAL STATEMENT ANALYSIS FRAMEWORK

Analysts work in a variety of positions. Some are equity analysts whose main objective is to evaluate potential equity (share) investments to determine whether a prospective investment is attractive and what an appropriate purchase price might be. Others are credit analysts who evaluate the creditworthiness of a company to decide whether (and with what terms) a loan should be made or what credit rating should be assigned. Analysts may also be involved in a variety of other tasks, such as evaluating the performance of a subsidiary company, evaluating a private equity investment, or finding stocks that are overvalued for purposes of taking a short position. This section presents a generic framework for financial statement analysis that can be used in these various tasks. The framework is summarized in Exhibit 1-8.[5]

[5]Components of this framework have been adapted from van Greuning and Bratanovic (2003, p. 300) and from Benninga and Sarig (1997, pp. 134–156).

EXHIBIT 1-8 Financial Statement Analysis Framework

Phase	Sources of Information	Output
1. Articulate the purpose and context of the analysis.	The nature of the analyst's function, such as evaluating an equity or debt investment or issuing a credit rating. Communication with client or supervisor on needs and concerns. Institutional guidelines related to developing specific work product.	Statement of the purpose or objective of analysis. A list (written or unwritten) of specific questions to be answered by the analysis. Nature and content of report to be provided. Timetable and budgeted resources for completion.
2. Collect data.	Financial statements, other financial data, questionnaires, and industry/economic data. Discussions with management, suppliers, customers, and competitors. Company site visits (e.g., to production facilities or retail stores).	Organized financial statements. Financial data tables. Completed questionnaires, if applicable.
3. Process data.	Data from the previous phase.	Adjusted financial statements. Common-size statements. Ratios and graphs. Forecasts.
4. Analyze/interpret the processed data.	Input data as well as processed data.	Analytical results.
5. Develop and communicate conclusions and recommendations (e.g., with an analysis report).	Analytical results and previous reports. Institutional guidelines for published reports.	Analytical report answering questions posed in Phase 1. Recommendation regarding the purpose of the analysis, such as whether to make an investment or grant credit.
6. Follow up.	Information gathered by periodically repeating above steps as necessary to determine whether changes to holdings or recommendations are necessary.	Updated reports and recommendations.

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The following sections discuss the individual phases of financial statement analysis.

4.1. Articulate the Purpose and Context of Analysis

Prior to undertaking any analysis, it is essential to understand the purpose of the analysis. An understanding of the purpose is particularly important in financial statement analysis because of the numerous available techniques and the substantial amount of data.

Some analytical tasks are well defined, in which case articulating the purpose of the analysis requires little decision making by the analyst. For example, a periodic credit review of an

investment-grade debt portfolio or an equity analyst's report on a particular company may be guided by institutional norms such that the purpose of the analysis is given. Furthermore, the format, procedures, and/or sources of information may also be given.

For other analytical tasks, articulating the purpose of the analysis requires the analyst to make decisions. The purpose of an analysis guides further decisions about the approach, the tools, the data sources, the format in which to report results of the analysis, and the relative importance of different aspects of the analysis.

When facing a substantial amount of data, a less experienced analyst may be tempted to just start crunching numbers and creating output. It is generally advisable to resist the temptation and thus avoid the black hole of pointless number crunching. Consider the questions: If you could wave a magic wand and have all the numbers crunched, what conclusion would you be able to draw? What question would you be able to answer? What decision would your answer support?

The analyst should also define the context at this stage. Who is the intended audience? What is the end product—for example, a final report explaining conclusions and recommendations? What is the time frame (i.e., when is the report due)? What resources and resource constraints are relevant to completion of the analysis? Again, the context may be predefined (i.e., standard and guided by institutional norms).

Having clarified the purpose and context of the financial statement analysis, the analyst should next compile the specific questions to be answered by the analysis. For example, if the purpose of the financial statement analysis (or, more likely, the particular stage of a larger analysis) is to compare the historical performance of three companies operating in a particular industry, specific questions would include: What has been the relative growth rate of the companies and what has been the relative profitability of the companies?

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4.2. Collect Data

Next, the analyst obtains the data required to answer the specific questions. A key part of this step is obtaining an understanding of the company's business, financial performance, and financial position (including trends over time and in comparison with peer companies). For historical analyses, financial statement data alone are adequate in some cases. For example, to screen a large number of alternative companies for those with a minimum level of profitability, financial statement data alone would be adequate. But to address more in-depth questions, such as why and how one company performed better or worse than its competitors, additional information would be required. As another example, to compare the historical performance of two companies in a particular industry, the historical financial statements would be sufficient to determine which had faster-growing sales or earnings and which was more profitable; however, a broader comparison with overall industry growth and profitability would obviously require industry data.

Furthermore, information on the economy and industry is necessary to understand the environment in which the company operates. Analysts often take a top-down approach whereby they (1) gain an understanding of the macroeconomic environment, such as prospects for growth in the economy and inflation, (2) analyze the prospects of the industry in which the subject company operates based on the expected macroeconomic environment, and (3) determine the prospects for the company in the expected industry and macroeconomic environments. For example, an analyst may need to forecast future growth in earnings for a company. To project future growth, past company data provide one basis for statistical

forecasting; however, an understanding of economic and industry conditions can improve the analyst's ability to forecast a company's earnings based on forecasts of overall economic and industry activity.

4.3. Process Data

After obtaining the requisite financial statement and other information, the analyst processes this data using appropriate analytical tools. For example, processing the data may involve computing ratios or growth rates; preparing common-size financial statements; creating charts; performing statistical analyses, such as regressions or Monte Carlo simulations; performing equity valuation; performing sensitivity analyses; or using any other analytical tools or combination of tools that are available and appropriate to the task. A comprehensive financial analysis at this stage would include the following:

- Reading and evaluating financial statements for each company subject to analysis. This includes reading the footnotes and understanding what accounting standards have been used (e.g., IFRS or U.S. GAAP), what accounting choices have been made (e.g., when to report revenue on the income statement), and what operating decisions have been made that affect reported financial statements (e.g., leasing versus purchasing equipment).
- Making any needed adjustments to the financial statements to facilitate comparison, when the unadjusted statements of the subject companies reflect differences in accounting standards, accounting choices, or operating decisions. Note that commonly used databases do not make such analyst adjustments.
- Preparing or collecting common-size financial statement data (which scale data to directly reflect percentages [e.g., of sales] or changes [e.g., from the prior year]) and financial ratios (which are measures of various aspects of corporate performance based on financial statement elements). On the basis of common-size financial statements and financial ratios, analysts can evaluate a company's relative profitability, liquidity, leverage, efficiency, and valuation in relation to past results and/or peers' results.

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4.4. Analyze/Interpret the Processed Data

Once the data have been processed, the next step—critical to any analysis—is to interpret the output. The answer to a specific financial analysis question is seldom the numerical answer alone; the answer to the analytical question relies on the interpretation of the output and the use of this interpreted output to support a conclusion or recommendation. The answers to the specific analytical questions may themselves achieve the underlying purpose of the analysis, but usually, a conclusion or recommendation is required. For example, an equity analysis may require a buy, hold, or sell decision or a conclusion about the value of a share of stock. In support of the decision, the analysis would cite such information as target value, relative performance, expected future performance given a company's strategic position, quality of management, and whatever other information was important in reaching the decision.

4.5. Develop and Communicate Conclusions/Recommendations

Communicating the conclusion or recommendation in an appropriate format is the next step in an analysis. The appropriate format will vary by analytical task, by institution, and/or

by audience. For example, an equity analyst report would typically include the following components:[6]

- Summary and investment conclusion
- Business summary
- Risks
- Valuation
- Historical and pro forma tables

The contents of reports many also be specified by regulatory agencies or professional standards. For example, the CFA Institute *Standards of Practice Handbook* (SOPH) dictates standards that must be followed in communicating recommendations. The SOPH provides, in part:

> *Standard V(B) states the responsibility of members and candidates to include in their communications those key factors that are instrumental to the investment recommendation presented. A critical part of this requirement is to distinguish clearly between opinions and facts. In preparing a research report, the member or candidate must present the basic characteristics of the security being analyzed, which will allow the reader to evaluate the report and incorporate information the reader deems relevant to his or her investment decision making process.*[7]

The SOPH requires that limitations to the analysis and any risks inherent to the investment be disclosed. Furthermore, the SOPH requires that any report include elements important to the analysis and conclusions so that readers can evaluate the conclusions themselves.

4.6. Follow Up

The process does not end with the report. If an equity investment is made or a credit rating assigned, periodic review is required to determine if the original conclusions and recommendations are still valid. In the case of a rejected investment, follow-up may not be necessary but may be appropriate to determine if the analysis process should be refined (e.g., if a rejected investment turns out to be successful in the market). Follow-up may involve repeating all the above steps in the process on a periodic basis.

5. SUMMARY

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.

[6]Stowe, Robinson, Pinto, and McLeavey (2002, p. 27).
[7]*Standards of Practice Handbook* (2006, p. 105).

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- 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 Revenue − Expense = 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 Assets = Liabilities + 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.

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PRACTICE 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.

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