INTERNATIONAL FINANCIAL STATEMENT ANALYSIS WORKBOOK

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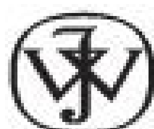

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PART I

LEARNING OUTCOMES, SUMMARY OVERVIEW, AND PROBLEMS

CHAPTER 1

FINANCIAL STATEMENT ANALYSIS: AN INTRODUCTION

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LEARNING OUTCOMES

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

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

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

SUMMARY OVERVIEW

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

- The primary purpose of financial reports is to provide information and data about a company's financial position and performance, including profitability and cash flows. The information presented in financial reports — including the financial statements, financial notes, and management's discussion and analysis — allows the financial analyst to assess a company's financial position and performance and trends in that performance.
- Key financial statements that are a primary focus of analysis include the income statement, balance sheet, cash flow statement, and statement of owners' equity.
- The income statement presents information on the financial results of a company's business activities over a period of time. The income statement communicates how much revenue the company generated during a period and what costs it incurred in connection with generating that revenue. The basic

equation underlying the income statement is 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.

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.

CHAPTER 2

FINANCIAL REPORTING MECHANICS

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LEARNING OUTCOMES

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

- Identify the groups (operating, investing, and financing activities) into which business activities are categorized for financial reporting purposes and classify any business activity in the appropriate group.
- Explain the relationship of financial statement elements and accounts, and classify accounts into the financial statement elements.
- Explain the accounting equation in its basic and expanded forms.

- Explain the process of recording business transactions using an accounting system based on the accounting equations.
- Explain the need for accruals and other adjustments in preparing financial statements.
- Prepare financial statements given account balances and/or other elements in the relevant accounting equation, and explain the relationships among the income statement, balance sheet, statement of cash flows, and statement of owners' equity.
- Describe the flow of information in an accounting system.
- Explain the use of the results of the accounting process in security analysis.

SUMMARY OVERVIEW

The accounting process is a key component of financial reporting. The mechanics of this process convert business transactions into records necessary to create periodic reports on a company. An understanding of these mechanics is useful in evaluating financial statements for credit and equity analysis purposes and in forecasting future financial statements. Key concepts are as follows:

- Business activities can be classified into three groups: operating activities, investing activities, and financing activities.
- Companies classify transactions into common accounts that are components of the five financial statement elements: assets, liabilities, equity, revenue, and expense.
- The core of the accounting process is the basic accounting equation: Assets = Liabilities + Owners' equity.

- The expanded accounting equation is Assets = Liabilities + Contributed capital + Beginning retained earnings + Revenue — Expenses — Dividends.
- Business transactions are recorded in an accounting system that is based on the basic and expanded accounting equations.
- The accounting system tracks and summarizes data used to create financial statements: the balance sheet, income statement, statement of cash flows, and statement of owners’ equity. The statement of retained earnings is a component of the statement of owners’ equity.
- Accruals are a necessary part of the accounting process and are designed to allocate activity to the proper period for financial reporting purposes.
- The results of the accounting process are financial reports that are used by managers, investors, creditors, analysts, and others in making business decisions.
- An analyst uses the financial statements to make judgments on the financial health of a company.
- Company management can manipulate financial statements, and a perceptive analyst can use his or her understanding of financial statements to detect misrepresentations.

PROBLEMS

1. Which of the following items would most likely be classified as an operating activity?
    a. Issuance of debt
    b. Acquisition of a competitor
    c. Sale of automobiles by an automobile dealer
2. Which of the following items would most likely be classified as a financing activity?

a. Issuance of debt
b. Payment of income taxes
c. Investments in the stock of a supplier

3. Which of the following elements represents an economic resource?
a. Asset
b. Liability
c. Owners’ equity

4. Which of the following elements represents a residual claim?
a. Asset
b. Liability
c. Owners’ equity

5. An analyst has projected that a company will have assets of €2,000 at year-end and liabilities of €1,200. The analyst’s projection of total owners’ equity should be closest to
a. €800.
b. €2,000.
c. €3,200.

6. An analyst has collected the following information regarding a company in advance of its year-end earnings announcement (in millions):

Estimated net income	$200
Beginning retained earnings	$1,400
Estimated distributions to owners	$100

The analyst’s estimate of ending retained earnings (in millions) should be closest to
a. $1,300.
b. $1,500.
c. $1,700.

7. An analyst has compiled the following information regarding Rubsam, Inc.

Liabilities at year-end	€1,000
Contributed capital at year-end	€500
Beginning retained earnings	€600
Revenue during the year	€5,000
Expenses during the year	€4,300

There have been no distributions to owners. The analyst's most likely estimate of total assets at year-end should be closest to

a. €2,100.
b. €2,300.
c. €2,800.

8. A group of individuals formed a new company with an investment of $500,000. The most likely effect of this transaction on the company's accounting equation at the time of the formation is an increase in cash and

a. an increase in revenue.
b. an increase in liabilities.
c. an increase in contributed capital.

9. HVG, LLC paid $12,000 of cash to a real estate company upon signing a lease on 31 December 2005. The payment represents a $4,000 security deposit and $4,000 of rent for each of January 2006 and February 2006. Assuming that the correct accounting is to reflect both January and February rent as prepaid, the most likely effect on HVG's accounting equation in December 2005 is

a. no net change in assets.
b. a decrease in assets of $8,000.
c. a decrease in assets of $12,000.

10. TRR Enterprises sold products to customers on 30 June 2006 for a total price of €10,000. The terms of the sale are that payment is due in 30 days. The cost of the products was €8,000. The most likely net change in TRR's total assets on 30 June 2006 related to this transaction is

a. €0.

b. €2,000.
c. €10,000.

11. On 30 April 2006, Pinto Products received a cash payment of $30,000 as a deposit on production of a custom machine to be delivered in August 2006. This transaction would most likely result in which of the following on 30 April 2006?
    a. No effect on liabilities
    b. A decrease in assets of $30,000
    c. An increase in liabilities of $30,000
12. Squires & Johnson, Ltd., recorded €250,000 of depreciation expense in December 2005. The most likely effect on the company's accounting equation is
    a. no effect on assets.
    b. a decrease in assets of €250,000.
    c. an increase in liabilities of €250,000.
13. An analyst who is interested in assessing a company's financial position is most likely to focus on which financial statement?
    a. Balance sheet
    b. Income statement
    c. Statement of cash flows
14. The statement of cash flows presents the flows into which three groups of business activities?
    a. Operating, nonoperating, and financing
    b. Operating, investing, and financing
    c. Operating, nonoperating, and investing
15. Which of the following statements about cash received prior to the recognition of revenue in the financial statements is *most* accurate? The cash is recorded as
    a. deferred revenue, an asset.
    b. accrued revenue, a liability.
    c. deferred revenue, a liability.
16. When, at the end of an accounting period, a revenue has been recognized in the financial statements but

no billing has occurred and no cash has been received, the accrual is to

a. unbilled (accrued) revenue, an asset.
b. deferred revenue, an asset.
c. unbilled (accrued) revenue, a liability.

17. When, at the end of an accounting period, cash has been paid with respect to an expense incurred but not yet recognized in the financial statements, the business should then record

a. an accrued expense, an asset.
b. a prepaid expense, an asset.
c. an accrued expense, a liability.

18. When, at the end of an accounting period, cash has not been paid with respect to an expense that has been incurred but not recognized yet in the financial statements, the business should then record

a. an accrued expense, an asset.
b. a prepaid expense, an asset.
c. an accrued expense, a liability.

19. The collection of all business transactions sorted by account in an accounting system is referred to as

a. a trial balance.
b. a general ledger.
c. a general journal.

20. If a company reported fictitious revenue, it could try to cover up its fraud by

a. decreasing assets.
b. increasing liabilities.
c. creating a fictitious asset.

CHAPTER 3

FINANCIAL REPORTING STANDARDS

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LEARNING OUTCOMES

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

- Explain the objective of financial statements and the importance of reporting standards in security analysis and valuation.
- Explain the role of financial reporting standard-setting bodies (including the International Accounting Standards Board and the U.S. Financial Accounting Standards Board) and regulatory authorities such as the International Organization of Securities Commissions, the U.K. Financial Services Authority,

and the U.S. Securities and Exchange Commission in establishing and enforcing reporting standards.
- Discuss the status of global convergence of accounting standards and the ongoing barriers to developing one universally accepted set of financial reporting standards.
- Describe the International Financial Reporting Standards (IFRS) framework, including the objective of financial statements, their qualitative characteristics, required reporting elements, and the constraints and assumptions in preparing financial statements.
- Explain the general requirements for financial statements.
- Compare and contrast the key concepts of financial reporting standards under IFRS and alternative reporting systems, and discuss the implications for financial analysis of differing financial reporting systems.
- Identify the characteristics of a coherent financial reporting framework and barriers to creating such a framework.
- Discuss the importance of monitoring developments in financial reporting standards and evaluate company disclosures of significant accounting policies.

SUMMARY OVERVIEW

An awareness of the reporting framework underlying financial reports can assist in security valuation and other financial analysis. The framework describes the objectives of financial reporting, desirable characteristics for financial reports, the elements of financial reports, and the underlying assumptions and constraints of financial reporting. An understanding of the framework, broader than knowledge of a particular set of rules, offers an analyst a