Reading 29

INTRODUCTION TO FINANCIAL STATEMENT ANALYSIS

1. (C) **Financial statement analysis focuses on the way companies show their financial performance to investors by preparing and presenting financial statements.**

Explanation

Financial reporting refers to the way companies show their financial performance to investors, creditors, and other interested parties by preparing and presenting financial statements, including information about changes in a company's financial position. The role of financial statement analysis is to use the information in a company's financial statements, along with other relevant information, to make economic decisions, such as whether to invest in the company's securities or recommend them to other investors. Analysts use financial statement data to evaluate a company's past performance and current financial position in order to form opinions about the company's ability to earn profits and generate cash flow in the future.

(Module 29.1, LOS 29.b)

2. (A) **recommended.**

Explanation

IFRS recommends that management commentary address the company's key relationships, resources, and risks, as well as the nature of the business, management's objectives, the company's past performance, and the performance measures used. Securities regulators may impose requirements for publicly traded firms to address certain topics in management's commentary, but accounting standards do not.

(Module 29.1, LOS 29.c)

3. (C) **typically include a discussion of the firm's past performance and future outlook.**

Explanation

Discussion of a firm's past performance and future outlook is most likely to be found in management's commentary.

(Module 29.1, LOS 29.c)

4. (C) **unusual or infrequent items.**

Explanation

For publicly traded U.S. firms, the MD&A portion of the financial disclosure is required to discuss results of operations, capital resources and liquidity and a general business overview based on known trends. A discussion of unusual or infrequent items may be included in the MD&A, but is not required.

(Module 29.1, LOS 29.c)

5. (A) **Financial reporting refers to how companies show their financial performance and financial analysis refers to using the information to make economic decisions.**

Explanation

Financial reporting refers to the way companies show their financial performance to investors, creditors, and other interested parties by preparing and presenting financial statements. The objective of financial statements, not analysis, is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. The role of financial statement analysis, not reporting, is to use the information in a company's financial statements, along with other relevant information, to assess a company's past performance in order to draw conclusions about the company's ability to generate cash and profits in the future.

(Module 29.1, LOS 29.b)

6. (B) **Prepare and accept responsibility for them.**

Explanation

Auditors make an independent review of financial statements, which are prepared by company management and are management's responsibility. It is the responsibility of auditors to confirm the assets, liabilities, and other items included in the statements and then issue an opinion concerning their fairness and reliability.

(Module 29.1, LOS 29.c)

7. (B) **uses the information in a company's financial statements to make economic decisions.**

Explanation

The role of financial reporting is described by the International Accounting Standards Board (IASB) in its "Framework for the Preparation and Presentation of Financial Statements":

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

Using the information in a company's financial statements to make economic decisions is financial analysis, not financial reporting.

(Module 29.1, LOS 29.b)

8. (C) **the use of information from a company's financial statements along with other information to make economic decisions regarding that company.**

Explanation

Financial statement analysis refers to the use of information from a company's financial statements along with other information to make economic decisions regarding that company. Financial reporting refers to the reports and presentations that a company uses to show its financial performance to investors, creditors, and other interested parties. Financial reporting is a requirement for companies that are listed on public exchanges.

(Module 29.1, LOS 29.b)

9. (B) **State the objective and context, gather data, process the data, analyze and interpret the data, report the conclusions or recommendations, update the analysis.**

Explanation

The financial statement analysis framework consists of six steps:

1. State the objective and context.
2. Gather data.
3. Process the data.
4. Analyze and interpret the data.
5. Report the conclusions or recommendations.
6. Update the analysis.

(Module 29.1, LOS 29.a).

10. (B) **Statements that the financial information was prepared according to GAAP.**

Explanation

The statements that the financial information was prepared according to GAAP should be included in the regular part of the auditors' report and not as an explanatory paragraph. The other information would be contained in explanatory paragraphs added to the auditors' report.

(Module 29.1, LOS 29.c)

11. (A) **Footnotes to the annual financial statements.**

Explanation

The footnotes are an integral part of the audited financial statements in a firm's annual report and are included in the audit opinion.

(Module 29.1, LOS 29.e)

12. (A) **management has not explained its business purpose.**

Explanation

New types of transactions may emerge that are not covered by existing accounting standards or regulations. Analysts should obtain information from a firm's management about the economic substance of such transactions to ensure that they serve a business purpose and have not been created primarily to manipulate the firm's financial statements.

(Module 29.1, LOS 29.d)

13. (C) **processing the data.**

Explanation

The financial statement analysis framework consists of six steps:

1. State the objective and context. Determine what questions the analysis is meant to answer, the form in which it needs to be presented, and what resources and how much time are available to perform the analysis.
2. Gather data. Acquire the company's financial statements and other relevant data on its industry and the economy. Ask questions of the company's management, suppliers, and customers, and visit company sites.
3. Process the data. Make any appropriate adjustments to the financial statements. Calculate ratios. Prepare exhibits such as graphs and common-size balance sheets.
4. Analyze and interpret the data. Use the data to answer the questions stated in the first step. Decide what conclusions or recommendations the information supports.
5. Report the conclusions or recommendations. Prepare a report and communicate it to its intended audience. Be sure the report and its dissemination comply with the Code and Standards that relate to investment analysis and recommendations.
6. Update the analysis. Repeat these steps periodically and change the conclusions or recommendations when necessary.

(Module 29.1, LOS 29.a)

14. (B) **not filed with the SEC.**

Explanation

Proxy statements are issued to shareholders when there are matters that require a shareholder vote. These statements, which are also filed with the SEC and available from EDGAR, are a good source of information about the election of (and qualifications of) board members, compensation, management qualifications, and the issuance of stock options.

(Module 29.1, LOS 29.e)

15. (B) **directly affecting the firm's financial reporting quality.**

Explanation

Weak internal controls provide an opportunity for low-quality or even fraudulent financial reporting. A firm's management, not its board of directors, is responsible for ensuring the effectiveness of a firm's internal controls. Under U.S. GAAP, auditors are required to state an opinion on a firm's internal controls.

(Module 29.1, LOS 29.c)

16. (A) **Corporate press releases.**

Explanation

Securities and Exchange Commission (SEC) filings are available from EDGAR (Electronic Data Gathering, Analysis, and Retrieval System, www.sec.gov). Companies' annual and quarterly financial statements are also filed with the SEC (Form 10-K and Form 10-Q, respectively).

(Module 29.1, LOS 29.e)

17. (A) **Assessing the management skill of the company's executives.**

Explanation

The role of financial statement analysis is to use the information in a company's financial statements, along with other relevant information, to make economic decisions. Examples of such decisions include whether to invest in the company's securities or recommend them to other investors, or whether to extend trade or bank credit to the company. Although the financial statements might provide indirect evidence about the management skill of the company's executives, that is not generally considered the role of financial statement analysis.

(Module 29.1, LOS 29.b)

18. (C) **provide reasonable assurance that the financial statements contain no material errors.**

Explanation

The standard auditor's report contains three parts:

1. The financial statements are prepared by management and are their responsibility and the auditor has performed an independent review.
2. The audit was conducted using generally accepted auditing standards, which provides reasonable assurance that there are no material errors in the financial statements.
3. The auditor is satisfied the statements were prepared in accordance with accepted accounting principles, and the principles chosen and estimates are reasonable.

Under U.S. GAAP, the auditor is required to state an opinion on the company's internal controls. The auditor may add this opinion as a fourth element of the auditor's report or provide it separately.

(Module 29.1, LOS 29.c)

19. (A) **Acquiring the company's financial statements.**

Explanation

The financial statement analysis framework consists of six steps. Step 2: "Gather data" includes acquiring the company's financial statements and other relevant data on its industry and the economy. Step 3. "Process the data" includes activities such as making any appropriate adjustments to the financial statements and preparing exhibits such as graphs and common-size balance sheets.

(Module 29.1, LOS 29.a)

20. (A) **Corporate press releases.**

Explanation

Corporate reports and press releases are written by management and are often viewed as public relations or sales materials. An analyst should review information on the economy and the company's industry and compare the company to its competitors. This information can be acquired from sources such as trade journals, statistical reporting services, and government agencies. Securities and Exchange Commission (SEC) filings include Form 8-K, which a company must file to report events such as acquisitions and disposals of major assets or changes in its management or corporate governance and proxy statements, which are a good source of information about the election of (and qualifications of) board members, compensation, management qualifications, and the issuance of stock options.

(Module 29.1, LOS 29.e)

21. (B) **include management's assessment of the company's operating performance and financial results.**

Explanation

Management's perspective on the company's results is provided in the Management's Discussion and Analysis supplement to the financial statements. Financial statement notes (footnotes) provide information about matters such as the company's accounting methods and assumptions, contingencies, and acquisitions and disposals. Footnotes to the financial statements are audited.

(Module 29.1, LOS 29.c)

22. (A) **analysing and interpreting the data.**

Explanation

The financial statement analysis framework consists of six steps:

1. State the objective and context. Determine what questions the analysis is meant to answer, the form in which it needs to be presented, and what resources and how much time are available to perform the analysis.
2. Gather data. Acquire the company's financial statements and other relevant data on its industry and the economy. Ask questions of the company's management, suppliers, and customers, and visit company sites.
3. Process the data. Make any appropriate adjustments to the financial statements. Calculate ratios. Prepare exhibits such as graphs and common-size balance sheets.
4. Analyze and interpret the data. Use the data to answer the questions stated in the first step. Decide what conclusions or recommendations the information supports.
5. Report the conclusions or recommendations. Prepare a report and communicate it to its intended audience. Be sure the report and its dissemination comply with the Code and Standards that relate to investment analysis and recommendations.
6. Update the analysis. Repeat these steps periodically and change the conclusions or recommendations when necessary.

(Module 29.1, LOS 29.a)