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Fourth Edition

International Financial Statement Analysis Workbook

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INTERNATIONAL FINANCIAL STATEMENT ANALYSIS WORKBOOK

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INTERNATIONAL FINANCIAL STATEMENT ANALYSIS WORKBOOK

Fourth Edition

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Cover design: Wiley

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
The First and Second Editions of this book were published by Wiley in 2008 and 2012 respectively.
Published simultaneously in Canada.

ISBN 978-1-119-62809-5 (paper)
ISBN 978-1-119-70523-9 (ePDF)
ISBN 978-1-119-62812-5 (ePub)

Printed in the United States of America.
10 9 8 7 6 5 4 3 2 1

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PART I

LEARNING OBJECTIVES, SUMMARY OVERVIEW, AND PROBLEMS

CHAPTER 1

INTRODUCTION TO FINANCIAL STATEMENT ANALYSIS

LEARNING OUTCOMES

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

- describe the roles of financial reporting and financial statement analysis;
- describe the roles of the statement of financial position, statement of comprehensive income, statement of changes in equity, and statement of cash flows in evaluating a company's performance and financial position;
- describe the importance of financial statement notes and supplementary information—including disclosures of accounting policies, methods, and estimates—and management's commentary;
- describe the objective of audits of financial statements, the types of audit reports, and the importance of effective internal controls;
- identify and describe information sources that analysts use in financial statement analysis besides annual financial statements and supplementary information;
- describe the steps in the financial statement analysis framework.

SUMMARY OVERVIEW

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

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

- The primary purpose of financial reports is to provide information and data about a company's financial position and performance, including profitability and cash flows. The information presented in the reports —including the financial statements and notes and management's commentary or management's discussion and analysis—allows the financial analyst to assess a company's financial position and performance and trends in that performance.
- The primary financial statements are the statement of financial position (i.e., the balance sheet), the statement of comprehensive income (or two statements consisting of an income statement and a statement of comprehensive income), the statement of changes in equity, and the statement of cash flows.
- The balance sheet discloses what resources a company controls (assets) and what it owes (liabilities) at a specific point in time. Owners' equity represents the net assets of the company; it is the owners' residual interest in, or residual claim on, the company's assets after deducting its liabilities. The relationship among the three parts of the balance sheet (assets, liabilities, and owners' equity) may be shown in equation form as follows: Assets = Liabilities + Owners' equity.
- The income statement presents information on the financial results of a company's business activities over a period of time. The income statement communicates how much revenue and other income the company generated during a period and what expenses, including losses, it incurred in connection with generating that revenue and other income. The basic equation underlying the income statement is Revenue + Other income – Expenses = Net income.
- The statement of comprehensive income includes all items that change owners' equity except transactions with owners. Some of these items are included as part of net income, and some are reported as other comprehensive income (OCI).
- The statement of changes in equity provides information about increases or decreases in the various components of owners' equity.
- Although the income statement and balance sheet provide measures of a company's success, cash and cash flow are also vital to a company's long-term success. Disclosing the sources and uses of cash helps creditors, investors, and other statement users evaluate the company's liquidity, solvency, and financial flexibility.
- The notes (also referred to as footnotes) that accompany the financial statements are an integral part of those statements and provide information that is essential to understanding the statements. Analysts should evaluate note disclosures regarding the use of alternative accounting methods, estimates, and assumptions.
- In addition to the financial statements, a company provides other sources of information that are useful to the financial analyst. As part of his or her analysis, the financial analyst should read and assess this additional information, particularly that presented in the management commentary (also called management report[ing], operating and financial review, and management's discussion and analysis [MD&A]).
- A publicly traded company must have an independent audit performed on its annual financial statements. The auditor's report expresses an opinion on the financial statements and

provides some assurance about whether the financial statements fairly present a company's financial position, performance, and cash flows. In addition, for US publicly traded companies, auditors must also express an opinion on the company's internal control systems.
- Information on the economy, industry, and peer companies is useful in putting the company's financial performance and position in perspective and in assessing the company's future. In most cases, information from sources apart from the company are crucial to an analyst's effectiveness.
- The financial statement analysis framework provides steps that can be followed in any financial statement analysis project. These steps are:
  - articulate the purpose and context of the analysis;
  - collect input data;
  - process data;
  - analyze/interpret the processed data;
  - develop and communicate conclusions and recommendations; and
  - follow up.

PROBLEMS

1. Providing information about the performance and financial position of companies so that users can make economic decisions *best* describes the role of:
   A. auditing.
   B. financial reporting.
   C. financial statement analysis.
2. Which of the following *best* describes the role of financial statement analysis?
   A. To provide information about a company's performance.
   B. To provide information about a company's changes in financial position.
   C. To form expectations about a company's future performance and financial position.
3. The role of financial statement analysis is *best* described as:
   A. providing information useful for making investment decisions.
   B. evaluating a company for the purpose of making economic decisions.
   C. using financial reports prepared by analysts to make economic decisions.
4. A company's financial position would *best* be evaluated using the:
   A. balance sheet.
   B. income statement.
   C. statement of cash flows.
5. A company's profitability for a period would *best* be evaluated using the:
   A. balance sheet.
   B. income statement.
   C. statement of cash flows.
6. The financial statement that presents a shareholder's residual claim on assets is the:
   A. balance sheet.
   B. income statement.
   C. cash flow statement.

7. A company's profitability over a period of time is *best* evaluated using the:
   A. balance sheet.
   B. income statement.
   C. cash flow statement.

8. The income statement is *best* used to evaluate a company's:
   A. financial position.
   B. sources of cash flow.
   C. financial results from business activities.

9. Accounting policies, methods, and estimates used in preparing financial statements are *most likely* to be found in the:
   A. auditor's report.
   B. management commentary.
   C. notes to the financial statements.

10. Information about management and director compensation are *least likely* to be found in the:
    A. auditor's report.
    B. proxy statement.
    C. notes to the financial statements.

11. Information about a company's objectives, strategies, and significant risks are *most likely* to be found in the:
    A. auditor's report.
    B. management commentary.
    C. notes to the financial statements.

12. Which of the following *best* describes why the notes that accompany the financial statements are required? The notes:
    A. permit flexibility in statement preparation.
    B. standardize financial reporting across companies.
    C. provide information necessary to understand the financial statements.

13. What type of audit opinion is preferred when analyzing financial statements?
    A. Qualified.
    B. Adverse.
    C. Unqualified.

14. An auditor determines that a company's financial statements are prepared in accordance with applicable accounting standards except with respect to inventory reporting. This exception is *most likely* to result in an audit opinion that is:
    A. adverse.
    B. qualified.
    C. unqualified.

15. An independent audit report is *most likely* to provide:
    A. absolute assurance about the accuracy of the financial statements.
    B. reasonable assurance that the financial statements are fairly presented.
    C. a qualified opinion with respect to the transparency of the financial statements.

16. Interim financial reports released by a company are *most likely* to be:
    A. monthly.
    B. unaudited.
    C. unqualified.

17. Which of the following sources of information used by analysts is found outside a company's annual report?
    A. Auditor's report.
    B. Peer company analysis.
    C. Management's discussion and analysis.

18. Ratios are an input into which step in the financial statement analysis framework?
    A. Process data.
    B. Collect input data.
    C. Analyze/interpret the processed data.

19. Which phase in the financial statement analysis framework is *most likely* to involve producing updated reports and recommendations?
    A. Follow-up.
    B. Analyze/interpret the processed data.
    C. Develop and communicate conclusions and recommendations.

CHAPTER 2

FINANCIAL REPORTING STANDARDS

LEARNING OUTCOMES

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

- describe the objective of financial reporting and the importance of financial reporting standards in security analysis and valuation;
- describe the roles of financial reporting standard-setting bodies and regulatory authorities in establishing and enforcing reporting standards;
- describe the International Accounting Standards Board's conceptual framework, including qualitative characteristics of financial reports, constraints on financial reports, and required reporting elements;
- describe general requirements for financial statements under International Financial Reporting Standards (IFRS);
- describe implications for financial analysis of alternative financial reporting systems and the importance of monitoring developments in financial reporting standards.

SUMMARY OVERVIEW

An awareness of financial reporting and underlying financial reporting standards can assist in security valuation and other financial analysis. This chapter describes the conceptual objectives of financial reporting standards, the parties involved in standard-setting processes, and the implication for analysts in monitoring developments in reporting standards.

Some key points of the chapter are summarized below:

- The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.
- Financial reporting requires policy choices and estimates. These choices and estimates require judgment, which can vary from one preparer to the next. Accordingly, standards are needed to ensure increased consistency in these judgments.

- Private-sector standard-setting bodies and regulatory authorities play significant but different roles in the standard-setting process. In general, standard-setting bodies make the rules, and regulatory authorities enforce the rules. However, regulators typically retain legal authority to establish financial reporting standards in their jurisdiction.
- The IFRS framework sets forth the concepts that underlie the preparation and presentation of financial statements for external users.
- The objective of fair presentation of useful information is the center of the IASB's *Conceptual Framework*. The qualitative characteristics of useful information include fundamental and enhancing characteristics. Information must exhibit the fundamental characteristics of relevance and faithful representation to be useful. The enhancing characteristics identified are comparability, verifiability, timeliness, and understandability.
- *IFRS Financial Statements*: IAS No. 1 prescribes that a complete set of financial statements includes a statement of financial position (balance sheet), a statement of comprehensive income (either two statements—one for net income and one for comprehensive income—or a single statement combining both net income and comprehensive income), a statement of changes in equity, a cash flow statement, and notes. The notes include a summary of significant accounting policies and other explanatory information.
- Financial statements need to reflect certain basic features: fair presentation, going concern, accrual basis, materiality and aggregation, and no offsetting.
- Financial statements must be prepared at least annually, must include comparative information from the previous period, and must be consistent.
- Financial statements must follow certain presentation requirements including a classified statement of financial position (balance sheet) and minimum information on both the face of the financial statements and in the notes.
- A significant number of the world's listed companies report under either IFRS or US GAAP.
- In many cases, a user of financial statements will lack the information necessary to make specific adjustments required to achieve comparability between companies that use IFRS and companies that use US GAAP. Instead, an analyst must maintain general caution in interpreting comparative financial measures produced under different accounting standards and monitor significant developments in financial reporting standards.
- Analysts can remain aware of ongoing developments in financial reporting by monitoring new products or types of transactions; actions of standard setters, regulators, and other groups; and company disclosures regarding critical accounting policies and estimates.

PROBLEMS

1. Which of the following is *most likely* not an objective of financial statements?
   A. To provide information about the performance of an entity.
   B. To provide information about the financial position of an entity.
   C. To provide information about the users of an entity's financial statements.

2. International financial reporting standards are currently developed by which entity?
   A. The IFRS Foundation.
   B. The International Accounting Standards Board.
   C. The International Organization of Securities Commissions.

3. US generally accepted accounting principles are currently developed by which entity?
   A. The Securities and Exchange Commission.
   B. The Financial Accounting Standards Board.
   C. The Public Company Accounting Oversight Board.

4. A core objective of the International Organization of Securities Commissions is to:
   A. eliminate systemic risk.
   B. protect users of financial statements.
   C. ensure that markets are fair, efficient, and transparent.

5. According to the *Conceptual Framework for Financial Reporting*, which of the following is *not* an enhancing qualitative characteristic of information in financial statements?
   A. Accuracy.
   B. Timeliness.
   C. Comparability.

6. Which of the following is *not* a constraint on the financial statements according to the *Conceptual Framework*?
   A. Understandability.
   B. Benefit versus cost.
   C. Balancing of qualitative characteristics.

7. The assumption that an entity will continue to operate for the foreseeable future is called:
   A. accrual basis.
   B. comparability.
   C. going concern.

8. The assumption that the effects of transactions and other events are recognized when they occur, not when the cash flows occur, is called:
   A. relevance.
   B. accrual basis.
   C. going concern.

9. Neutrality of information in the financial statements most closely contributes to which qualitative characteristic?
   A. Relevance.
   B. Understandability.
   C. Faithful representation.

10. Valuing assets at the amount of cash or equivalents paid or the fair value of the consideration given to acquire them at the time of acquisition most closely describes which measurement of financial statement elements?
    A. Current cost.
    B. Historical cost.
    C. Realizable value.

11. The valuation technique under which assets are recorded at the amount that would be received in an orderly disposal is:
    A. current cost.
    B. present value.
    C. realizable value.

12. Which of the following is *not* a required financial statement according to IAS No. 1?
    A. Statement of financial position.
    B. Statement of changes in income.
    C. Statement of comprehensive income.
13. Which of the following elements of financial statements is *most* closely related to measurement of performance?
    A. Assets.
    B. Expenses.
    C. Liabilities.
14. Which of the following elements of financial statements is *most* closely related to measurement of financial position?
    A. Equity.
    B. Income.
    C. Expenses.
15. Which of the following disclosures regarding new accounting standards provides the *most* meaningful information to an analyst?
    A. The impact of adoption is discussed.
    B. The standard will have no material impact.
    C. Management is still evaluating the impact.

CHAPTER 3

UNDERSTANDING INCOME STATEMENTS

LEARNING OUTCOMES

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

- describe the components of the income statement and alternative presentation formats of that statement;
- Describe general principles of revenue recognition and accounting standards for revenue recognition;
- calculate revenue given information that might influence the choice of revenue recognition method;
- describe general principles of expense recognition, specific expense recognition applications, and implications of expense recognition choices for financial analysis;
- describe the financial reporting treatment and analysis of non-recurring items (including discontinued operations, unusual or infrequent items) and changes in accounting policies;
- distinguish between the operating and non-operating components of the income statement;
- describe how earnings per share is calculated and calculate and interpret a company's earnings per share (both basic and diluted earnings per share) for both simple and complex capital structures;
- distinguish between dilutive and antidilutive securities and describe the implications of each for the earnings per share calculation;
- convert income statements to common-size income statements;
- evaluate a company's financial performance using common-size income statements and financial ratios based on the income statement;
- describe, calculate, and interpret comprehensive income;
- describe other comprehensive income and identify major types of items included in it.

SUMMARY OVERVIEW

This chapter has presented the elements of income statement analysis. The income statement presents information on the financial results of a company's business activities over a period of time; it communicates how much revenue the company generated during a period and what costs it incurred in connection with generating that revenue. A company's net income and its components (e.g., gross margin, operating earnings, and pretax earnings) are critical inputs into both the equity and credit analysis processes. Equity analysts are interested in earnings because equity markets often reward relatively high- or low-earnings growth companies with above-average or below-average valuations, respectively. Fixed-income analysts examine the components of income statements, past and projected, for information on companies' abilities to make promised payments on their debt over the course of the business cycle. Corporate financial announcements frequently emphasize income statements more than the other financial statements.

Key points to this chapter include the following:

- The income statement presents revenue, expenses, and net income.
- The components of the income statement include: revenue; cost of sales; sales, general, and administrative expenses; other operating expenses; non-operating income and expenses; gains and losses; non-recurring items; net income; and EPS.
- An income statement that presents a subtotal for gross profit (revenue minus cost of goods sold) is said to be presented in a multi-step format. One that does not present this subtotal is said to be presented in a single-step format.
- Revenue is recognized in the period it is earned, which may or may not be in the same period as the related cash collection. Recognition of revenue when earned is a fundamental principal of accrual accounting.
- An analyst should identify differences in companies' revenue recognition methods and adjust reported revenue where possible to facilitate comparability. Where the available information does not permit adjustment, an analyst can characterize the revenue recognition as more or less conservative and thus qualitatively assess how differences in policies might affect financial ratios and judgments about profitability.
- As of the beginning of 2018, revenue recognition standards have converged. The core principle of the converged standards is that revenue should be recognized to "depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in an exchange for those goods or services."
- To achieve the core principle, the standard describes the application of five steps in recognizing revenue. The standard also specifies the treatment of some related contract costs and disclosure requirements.
- The general principles of expense recognition include a process to match expenses either to revenue (such as, cost of goods sold) or to the time period in which the expenditure occurs (period costs such as administrative salaries) or to the time period of expected benefits of the expenditures (such as depreciation).
- In expense recognition, choice of method (i.e., depreciation method and inventory cost method), as well as estimates (i.e., uncollectible accounts, warranty expenses, assets' useful life, and salvage value) affect a company's reported income. An analyst should identify

differences in companies' expense recognition methods and adjust reported financial statements where possible to facilitate comparability. Where the available information does not permit adjustment, an analyst can characterize the policies and estimates as more or less conservative and thus qualitatively assess how differences in policies might affect financial ratios and judgments about companies' performance.
- To assess a company's future earnings, it is helpful to separate those prior years' items of income and expense that are likely to continue in the future from those items that are less likely to continue.
- Under IFRS, a company should present additional line items, headings, and subtotals beyond those specified when such presentation is relevant to an understanding of the entity's financial performance. Some items from prior years clearly are not expected to continue in future periods and are separately disclosed on a company's income statement. Under US GAAP, unusual and/or infrequently occurring items, which are material, are presented separately within income from continuing operations.
- Non-operating items are reported separately from operating items on the income statement. Under both IFRS and US GAAP, the income statement reports separately the effect of the disposal of a component operation as a "discontinued" operation.
- Basic EPS is the amount of income available to common shareholders divided by the weighted average number of common shares outstanding over a period. The amount of income available to common shareholders is the amount of net income remaining after preferred dividends (if any) have been paid.
- If a company has a simple capital structure (i.e., one with no potentially dilutive securities), then its basic EPS is equal to its diluted EPS. If, however, a company has dilutive securities, its diluted EPS is lower than its basic EPS.
- Diluted EPS is calculated using the if-converted method for convertible securities and the treasury stock method for options.
- Common-size analysis of the income statement involves stating each line item on the income statement as a percentage of sales. Common-size statements facilitate comparison across time periods and across companies of different sizes.
- Two income-statement-based indicators of profitability are net profit margin and gross profit margin.
- Comprehensive income includes *both* net income and other revenue and expense items that are excluded from the net income calculation.

PROBLEMS

1. Expenses on the income statement may be grouped by:
   A. nature, but not by function.
   B. function, but not by nature.
   C. either function or nature.
2. An example of an expense classification by function is:
   A. tax expense.
   B. interest expense.
   C. cost of goods sold.

3. Denali Limited, a manufacturing company, had the following income statement information:

Revenue	$4,000,000
Cost of goods sold	$3,000,000
Other operating expenses	$500,000
Interest expense	$100,000
Tax expense	$120,000

Denali's gross profit is equal to:
A. $280,000.
B. $500,000.
C. $1,000,000.

4. Under IFRS, income includes increases in economic benefits from:
A. increases in liabilities not related to owners' contributions.
B. enhancements of assets not related to owners' contributions.
C. increases in owners' equity related to owners' contributions.

5. Fairplay had the following information related to the sale of its products during 2009, which was its first year of business:

Revenue	$1,000,000
Returns of goods sold	$100,000
Cash collected	$800,000
Cost of goods sold	$700,000

Under the accrual basis of accounting, how much net revenue would be reported on Fairplay's 2009 income statement?
A. $200,000.
B. $900,000.
C. $1,000,000.

6. Apex Consignment sells items over the internet for individuals on a consignment basis. Apex receives the items from the owner, lists them for sale on the internet, and receives a 25 percent commission for any items sold. Apex collects the full amount from the buyer and pays the net amount after commission to the owner. Unsold items are returned to the owner after 90 days. During 2009, Apex had the following information:
• Total sales price of items sold during 2009 on consignment was €2,000,000.
• Total commissions retained by Apex during 2009 for these items was €500,000.
How much revenue should Apex report on its 2009 income statement?
A. €500,000.
B. €2,000,000.
C. €1,500,000.

7. A company previously expensed the incremental costs of obtaining a contract. All else being equal, adopting the May 2014 IASB and FASB converged accounting standards on revenue recognition makes the company's profitability initially appear:
A. lower.
B. unchanged.
C. higher.