LEVEL 1:

FINANCIAL REPORTING & ANALYSIS

Reading 15 (1st out of 12): INTRO TO FINANCIAL REPORTING

Difficulty: **easy**   Benchmark Study Time: **2h**

2022

INTENTIONALLY EMPTY

THIS E-BOOK:

- is a selective summary of the corresponding Reading in your CFA® Program Curriculum,
- provides place for your own notes,
- helps you structure your study and revision time!

How to use this e-book to maximize your knowledge retention:

1. **Print** the e-book in duplex and bind it to keep **all** important info for this Reading **in one place.**
2. **Read** this e-book, best twice, to grasp the idea of what this Reading is about.
3. **Study** the Reading from your curriculum. **Here add** your notes, examples, formulas, definitions, etc.
4. **Review** the Reading using this e-book, e.g. write your summary of key concepts or revise the formulas at the end of this e-book (if applicable).
5. **Done?** Go to your study plan and change the Reading's status to **green**:
   (it will make your Chance-to-Pass-Score™ grow ☺).
6. **Come back** to this e-book from time to time to **regularly review for knowledge retention!**

NOTE: While studying or reviewing this Reading, you can use the tables at the end of this e-book and mark your study/review sessions to hold yourself accountable.

FINANCIAL REPORTING & FINANCIAL STATEMENT ANALYSIS

Role of financial reporting

The role of financial reporting is to provide reliable, fair and true information about a company's performance and its financial position.

This information can be then analyzed by different market participants (e.g. analysts, investors, customers, management, etc.) and used to make / help make some economic decisions.

In other words, the purpose of financial reporting is to give information about:

- the company's performance,
- the company's financial situation,
- changes in the company's financial situation and performance.

Financial statement analysis

Financial statement analysis is aimed at evaluating the past, current, and potential performance of a company and its past, current, and potential financial position.

Financial statement analysis helps to make some economic decisions and answer questions related to a company analyzed, e.g.:

- Are we going to add this company's shares to our portfolio?
- What is this company's intrinsic value? Is the company overvalued? Well-priced? Undervalued?
- Should we acquire this company?
- Will this company meet its long-term obligations?
- Is this company able to meet its short-term obligations?
- Should a bank lend some money to this company?
- How should we evaluate this company's credit rating?
- What cash flows is this company going to generate in the future?
- What is this company's current financial position? What are the growth prospects?
- How does the company perform in comparison to other companies from the same industry?
- etc.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

FINANCIAL STATEMENTS

Financial statements provide information about the company's:

- assets,
- liabilities,
- equity,
- income and expenses,
- contributions by and distributions to owners,
- cash flows.

Financial statements include:

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

BALANCE SHEET

The balance sheet gives information about the company's financial position **at a given point in time**.

balance sheet = statement of financial position = statement of financial condition

asset = a resource controlled by the company as a result of past events and which is expected to bring future economic benefits to the company

Examples of assets:

- inventories; accounts receivable; cash and cash equivalents; property, plant and equipment; investment properties; intangible assets; financial assets.

liability = a present obligation of the company arising from past events, the settlement of which is expected to result in an outflow from the company of resources embodying economic benefits

Examples of liabilities:

- long-term debt, accounts payable, accrued income taxes.

Basic accounting equation

assets = liabilities + owners' equity

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STATEMENT OF COMPREHENSIVE INCOME

In accordance with the IFRS, a comprehensive income statement may be presented:

- as a single statement of comprehensive income, **OR**
- in two statements:
    a. the income statement, and
    b. the statement of comprehensive income that begins with profit or loss from the income statement.

Income statement

income statement = statement of operations = profit and loss (P&L) statement

The income statement:

- shows items that are used to calculate net income,
- contains information about the financial performance of the company over a period of time,
- indicates how much revenue and other income the company earned,
- indicates what expenses the company incurred.

Other comprehensive income

Other comprehensive income includes items that affect owners' equity but are not included in net income and don't result from transactions with shareowners.

total comprehensive income = net income from the income statement +

+ other comprehensive income

Definitions

revenue = the amount received for the supply of goods or services in the ordinary course of business

expenses = depletions of assets, outflows, and incurrences of liabilities that reduce owners' equity

other income = includes both gains that may or may not occur in the ordinary course of business

expenses > revenue + other income

↓

company incurred a net loss

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Basic equation for the income statement

net income = income – expenses = revenue + other income – expenses

Net income is also known as: net earnings, net profit, profit or loss, or bottom line.

Earnings per share

At the bottom of the income statement, you will find two types of earnings per share:

- basic earnings per share, and
- diluted earnings per share.

Earnings per share (EPS) is the ratio of net income attributable to shareholders and the number of ordinary shares outstanding during the period.

For basic earnings per share, in the nominator we use profit or loss attributable to ordinary shareholders, and in the denominator – the weighted average number of ordinary shares outstanding during the period.

For diluted earnings per share, we use the diluted number of shares in the denominator. This means that we take into account the number of shares that would be outstanding if all hypothetical claims to ordinary shares resulting in the dilution, for example stock options or warrants, were exercised or converted into shares. Note that the net profit or loss attributable to ordinary shareholders which is the nominator should be also properly adjusted.

$$\text{basic EPS} = \frac{\text{net income} - \text{preferred dividends}}{\text{weighted average number of common shares outstanding}}$$

$$\text{diluted EPS} = \frac{\text{adjusted net income (taking into account potentially dilutive securities)}}{\text{weighted average number of common \& potentially common shares outstanding}}$$

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CASH FLOW STATEMENT

Cash flows are divided into cash flows from:

- operating activities,
- investing activities,
- financing activities.

Cash flows from **investing activities** are cash flows from operations related to the acquisition or disposal of long-term assets.

Cash flows from **financing activities** are cash flows from the activities related to the acquisition or repayment of capital used to finance the company's operations.

Cash flows from **operating activities** are:

- the cash flows not included in investing or financing activities,
- related to everyday business operations.

Role of the statement of cash flows

The role of the statement of cash flows is to determine the sources of money and exact amounts that come from every category of activities.

Liquidity & Solvency & Financial flexibility

Based on the cash flow statement, analysts are able to assess the company's:

- liquidity,
- solvency,
- financial flexibility.

liquidity = the company's ability to meet short-term obligations

solvency = the company's ability to meet long-term obligations

financial flexibility = the company's ability to exploit the opportunities arising for the company and the ability to react to financial adversities

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Cash flow patterns

The best cash flow pattern for a growing company (but not a startup):

- cash flow from operating activities is positive (**the company earns**),
- cash flow from investing activities is negative (**the company invests**),
- cash flow from financing activities is positive (**the company raises capital**).

Direct method vs Indirect method

Methods of preparing the cash flow statement from **operating activities**:

- direct method,
- indirect method.

The direct method is about listing all inflows and outflows of cash and summing them up.

The indirect method assumes starting with net income and adjusting it by all relevant flows that are either:

- included (if they were not present in net income), or
- removed (if they were noncash items).

For investing and financing activities only the direct method is used.

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STATEMENT OF CHANGES IN EQUITY

The statement of changes in equity shows how equity has changed over some period of time.

Components of equity

- paid-in capital (common shares, preferred shares, treasury shares),
- retained earnings,
- accumulated other comprehensive income,
- non-controlling (minority) interests.

paid-in capital = money raised from the issuance of equity

retained earnings = company's profits that were not distributed by the company

For each component of equity, the statement of changes in owners' equity includes:

- beginning balance,
- changes during the period (decreases and increases),
- ending balance.

Dividends vs Retained earnings

Profit earned over the period can be either:

- paid out as dividends, or
- retained.

Events affecting equity

Event	Change in equity
issuance of new shares	increase
redemption of shares	decrease
company has a profit	increase
company incurs a loss	decrease
company pays dividends	decrease

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FINANCIAL NOTES & SUPPLEMENTAL SCHEDULES

Any additional notes (aka. footnotes) provided in a financial report constitute an essential and integral part of a complete set of financial statements and are the source of important and detailed information left out from the core statements for the sake of clarity.

Note: The financial statements themselves are only sets of numbers. It is crucial to understand where these numbers come from and to know their source. This is the information you can find in the footnotes.

Footnotes:

- describe and explain the items of the financial statements,
- are a required and integral part of a complete set of financial statements,
- provide information necessary to understand the information contained in the financial statements.

Examples of information included and described in footnotes:

- the dates of the fiscal year,
- units of measure in which numbers are given,
- financial standards on which the financial statements are based,
- methods and estimates used to prepare the financial statements,
- accounting policies,
- relevant country laws and regulations,
- related-parties transactions,
- business acquisitions,
- etc.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

MANAGEMENT COMMENTARY (aka. MANAGEMENT DISCUSSION AND ANALYSIS)

Public companies are very often required (depending on the country) to include in the annual financial report a section with management commentary about the company, its performance, future prospects, etc.

Different countries and jurisdictions may require different disclosures in the management commentary.

According to the Securities and Exchange Commission (**SEC**), management commentary should at least include and disclose:

- favorable and unfavorable trends and significant events and uncertainties affecting the company,
- effect of inflation,
- other material events that might affect future operating results and financial condition of the company in comparison to the company's current situation,
- off-balance-sheet obligations,
- contractual commitments,
- accounting policies that require the management to make a subjective judgment materially affecting presented financial results.

AUDITOR REPORT

It is required that the annual financial report of a company be audited by an independent auditor.

The role of an audit report is to provide a **reasonable** assurance that financial statements are fairly presented and the financial condition of the company, its performance, and cash flows are prepared in accordance with an applicable set of accounting standards.

After conducting the audit, the auditor prepares a written opinion on the company's financial statements. The opinion is one of the three generally required paragraphs of an audit report:

- **Introductory paragraph:** describes the financial statements and responsibilities of both the company's management and the auditor itself.
- **Scope paragraph:** describes the nature of an audit process and gives the basis for reasonable assurance that the financial statements are fairly presented.
- **Opinion paragraph:** includes the auditor's opinion on the fairness of the financial statements.

In the USA (under the Sarbanes-Oxley Act), auditors are also obliged to express an opinion about the company's internal control systems.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Auditor: types of opinion

There are 3 types of opinions that an auditor can give:

- **Unqualified audit opinion** means that the financial statements give a true and fair view of the company and are prepared in accordance with accounting standards.
- **Qualified audit opinion** means that there are some limitations and exceptions to accounting standards in the company's financial statements. These limitations and exceptions are then described in detail to help analysts, etc. evaluate them and their impact.
- **Adverse audit opinion** means that the financial statements don't give a true and fair view of the company and materially depart from accounting standards.

There is also a possibility that for some rational reasons no opinion will be expressed by the auditor. In such a case, we talk about a **disclaimer of opinion**.

ADDITIONAL SOURCES OF INFORMATION USED BY ANALYSTS (apart from annual report)

Apart from the annual report, analysts use lots of different sources of information to prepare their analyses:

1. Company's internal sources:
    a. proxy statements – provided to investors before shareholder meetings and including information about things that will be discussed and voted on,
    b. interim reports (provided semiannually or quarterly) – usually not audited,
    c. company website,
    d. press releases,
    e. periodic earnings announcements,
    f. conference calls with analysts and portfolio managers,
    g. etc.
2. External sources:
    a. about the economy,
    b. about the industry,
    c. peer companies,
    d. etc.

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ANALYSIS FRAMEWORK FOR FINANCIAL STATEMENTS

Basic information

One common analysis framework ensures that the process of analysis is coherent and consistent regardless of:

- the purpose of the analysis,
- the company analyzed,
- the securities or investments under scrutiny, etc.

The framework provides a sequence of stages to be always covered when conducting an analysis.

Stages of analysis

Stages of analysis:

1. State the purpose of analysis.
2. Gather input data.
3. Process data.
4. Interpret and analyze the processed data.
5. State findings and recommendations.
6. Review findings periodically (follow-up).

Stage 1: State the purpose of analysis

The source of information is determined by:

- the nature of the analyst's task and responsibilities,
- the client's or supervisor's needs and expectations,
- norms and guidelines developed to regulate the specific product of the analysis.

The output:

- defining the purpose,
- wording specific questions to be answered by the analysis,
- schedule and resources for carrying out the analysis.

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Stage 2: Gather input data

The sources of information:

- financial statements and other financial data,
- results of conversations with management, suppliers, customers, and competitors,
- results of visits to the company site.

The output:

- financial statements in an organized form,
- tabulated data.

Stage 3: Process data

The source of information:

- the data from the previous phase.

The output:

- adjusted financial statements,
- common-size financial statements,
- ratios and rates,
- graphs and charts,
- forecasts.

Stage 4: Interpret and analyze the processed data

The source of information:

- the input data,
- the processed data.

The output:

- analytical results.

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Stage 5: State findings and recommendations

The source of information:

- obtained analytical results,
- guidelines and regulations for publishing reports.

The output:

- a report giving answers to the earlier posed questions,
- the recommendation relating to the previously defined purpose of analysis.

Stage 6: Review findings periodically (follow-up)

The source of information:

- information obtained as a result of periodic reviews.

The output:

- updated reports,
- updated recommendations.

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Summarizing key concepts:

☐ Roles of financial reporting & financial statement analysis

My summary:

☐ Balance sheet

My summary:

☐ Statement of comprehensive income

My summary:

☐ Cash flow statement

My summary:

☐ Statement of changes in equity

My summary:

☐ Financial notes

My summary:

☐ Management commentary

My summary:

☐ Auditor report

My summary:

☐ Additional sources of information used by analysts

My summary:

☐ Analysis framework for financial statements

My summary:

Keeping myself accountable:

TABLE 1 | STUDY

When you sit down to study, you may want to **try the Pomodoro Technique** to handle your study sessions: study for 25 minutes, then take a 5-minute break. Repeat this 25+5 study-break sequence all throughout your daily study session.

✔ Tick off as you proceed.

POMODORO TIMETABLE: study-break sequences (25′ + 5′)													
date		date		date		date		date		date		date	
25′		25′		25′		25′		25′		25′		25′	
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25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	

TABLE 2 | REVIEW

Never ever neglect revision! Though it's not the most popular thing among CFA candidates, regular revision is what makes the difference. If you want to pass your exam, **schedule & do your review sessions.**

REVIEW TIMETABLE: When did I review this Reading?													
date		date		date		date		date		date		date	
date		date		date		date		date		date		date	