Hi and welcome,

This is a brief sample to provide you with an idea of what my CFA study notes look like.

The style is to provide key content coverage followed by working examples.

Mixed in you will see my ***"Professor's Comments"*** and ***"Exam Tips"***, I've included these to give you my thoughts on how I believe something will show up on the exam or how best to approach learning a concept….or even if I believe you should just skip something altogether.

If you have written the exam before, you can use my materials to get back up to speed very quickly.

If you are a first time writer, you can use my materials to help focus your study efforts and build your knowledge base.

If you have any questions, please do not hesitate to reach out to me by email.

All the best,

Prof Brian Gordon, CFA, CFP, CIM, MBA, FCSI
Director of Learning
Exam Success

Level 1

Study Sessions 6 and 7

Financial Statement Analysis (FSA)

READINGS:

1. Financial Statement Analysis: An Introduction
2. Financial Reporting Mechanics (From Preliminary Readings)
3. Financial Reporting Standards
4. Understanding Income Statements
5. Understanding Balance Sheets
6. Financial Analysis Techniques

- Expect to see 36 questions that relate to FSA SS 6, SS 7, SS 8, SS 9

If you can handle the following items from SS 6 and SS 7, you should be in good shape for the exam.

1. Understand the concept of accounting time periods and the need for adjusting entries.

2. Be able to link the Balance Sheet, Income Statement, Cash Flow Statement and Statement of Owners' Equity.

3. Be able to use the basic and expanded accounting equation.

4. Explain the effects of various revenue recognition methods on reported values and ratios.

5. Explain the effects of various inventory costing methods on reported values and ratios.

6. Explain the effects of various depreciation methods on reported values and ratios.

7. Know how to correctly account for nonrecurring items.

8. Be able to calculate basic and diluted EPS.

9. Be able to calculate comprehensive income.

10. Be ready to construct a statement of cash flows using the direct and indirect methods.

11. Be able to calculate free cash flow.

12. Be ready for a possible trivial question related to audits, or objectives of IFRS

Study Session 6

Financial Statement Analysis: An Introduction

There are 6 learning outcome statements associated with this reading. Only trivial qualitative questions could come from this reading so make sure you are familiar with the role of financial reporting, the key financial statements, other sources of information and the various types of audit reports

Roles of Financial Reporting and Financial Statement Analysis

Financial Reporting is a method by which companies present financial performance to investors, creditors and other interested parties.

Financial Statement Analysis is a method of analyzing financial statements of companies to make investment decisions, lending decisions and in general, business decisions.

Roles of key financial statements

The **Income Statement** shows the financial performance of a company over a period of time. The general category of entries include: revenues, expenses, gains and losses.

The **Balance Sheet** shows the financial performance of the company at a particular point of time. The general account categories include: assets, liabilities and owners' equity.

The **Cash Flow Statement** shows actual cash receipts and cash payments. There are three cash flow categories on the statement, namely **CFO (Cash Flows from Operating Activities), CFI (Cash Flows from Investing Activities)** and **CFF (Cash Flows from Financing Activities)**.

Importance of financial statement notes, supplementary information and management commentary

The **Financial Statement Notes** contain detailed disclosure of items reported on the income statement, balance sheet and cash flow statements. It also contains other details about acquisitions, contingencies and commitments, segments of firm and related party transactions. Financial statement notes are audited.

Supplementary Schedules contain additional information such as hedging activities, reserves for oil & gas companies etc.

Management Discussion and Analysis provides management's perspective on performance of the company. In the U.S., publicly listed companies are required to discuss details about operations including trends in revenues and expenditures, cash flows and capital resources and liquidity.

Objective of audits of financial statement

An audit is done to check the fairness and reliability of financial statements. The audit is done by independent third parties.

Standard Auditor's opinion contains three parts:

1. Auditor has done an independent review of financial statements prepared by the management.

2. If GAAP (Generally Accepted Accounting Practices) were followed, it can be reasonably said that the financial statements will not have any material errors.

3. Statement that the auditor is satisfied with the financial statements. Auditors should provide additional explanation when there is inconsistency between periods.

Three types of Opinions of Auditors

1. **Unqualified –** Auditor believes that financial statements are free from material errors and omissions.

2. **Qualified –** If there are exceptions to accounting standards then Auditor gives qualified opinion and provides opinion on these exceptions.

3. **Adverse –** If statements don't conform to accounting standards or if there are material errors then auditors give adverse opinion.

Internal Controls are the processes by which a company ensures that reported financial statements are accurate. As per Sarbanes Oxley Act, management is required to present a report on internal controls which includes the following:

a) A statement that firm's management is responsible for implementing and maintaining effective internal controls.
b) A description of how the management evaluates internal control system.
c) An assessment of management effectiveness over recent year of internal control implementation.
d) A statement that auditors have accessed management's report on internal controls.
e) A statement certifying that firm's financial statements are presented fairly.

Information sources that analyst use in financial statement analysis

In addition to the annual report and quarterly report data available, the analyst should look into public and non-public sources to get a detailed view about company's operations, competition and overall outlook about the industry.

The analyst should examine press releases by the management and other public information about the company as well as information about the industry in which company operates and overall macroeconomic data from public sources.

For trivial purposes you should know that Form 8K provides details about acquisition and divestments, the 10K is the annual report and the 10Q is the quarterly report.

Steps in financial statement analysis framework

1. State the objective and context of statement analysis.
2. Gather necessary data.
3. Process collected data
4. Analyze and Interpret Data
5. Report the conclusions or Recommendations
6. Update the Analysis (if required)

Quick Summary

The Purpose of Financial Reporting
To provide information about a company's financial position and performance, including profitability and cash flows, allowing a financial analyst to assess financial position and performance and trends.

Key Financial Statements
1) Statement of Financial Position
2) Statement of Comprehensive Income
3) Statement of Changes in Equity
4) Statement of Cash flows

Notes and Supplementary Information
Provide details on management's accounting choices that can be useful in assessing the financial position of a company.

Auditor's Reports
Provide reasonable assurance that the financial statements are fairly presented, free from material error

- **First paragraph (introduction)**, describes the statements that were audited
- **Second paragraph (scope)**, describes the audit process
- **Third paragraph (opinion)**, states the auditor's opinion about the fairness of the statements

Opinions

1) **Unqualified –** clean report
2) **Qualified –** some limitation or exception exists
3) **Adverse –** material violation of accounting standards
4) **Disclaimer of opinion –** auditor is unable to give an opinion

Steps in the Financial Statement Analysis Framework

1) State the purpose and context of the analysis
2) Collect data
3) Process the data
4) Analyze/interpret the data
5) Develop/state recommendations
6) Follow up

Financial Reporting Mechanics

Business activities can be classified into three groups: 1) operating activities, 2) investing activities, and 3) financing activities

Financial Statement Elements and Accounts

Financial Statement Elements refer to the major categories found on the financial statements. These include assets, liabilities, equity, contributed capital, revenues, expenses, distributions, net income, gains and losses.

Accounts are sub-classifications of the financial statement elements. For example, cash and cash equivalents, inventory, prepaid expenses, interest expense, etc.

Accounting Statement equation in basic and extended form

Basic form:

Assets = Liabilities + Owner's Equity

Extended form:

Assets = Liabilities + Beginning Retained Earnings + Revenue – Expenses – Dividends

Process of recording business transactions

Double entry book keeping requires two entries for every transaction. For example, if a company purchases some Land and pays in Cash, the accounting entries would be to increase one asset account (Land) and decrease another asset account (Cash).

Need for accruals and other adjustments in preparing financial statement

Accruals and Adjustments
Accountants divide the economic life of a business into time periods to measure the financial performance. Accruals are designed to allocate business activity to the proper time period for financial reporting purposes.

	Time Period 1		Time Period 2	
BEG B/S	**I/S** **Revenues** **- Expenses** **= Net Income**	**END B/S**	**I/S** **Revenues** **- Expenses** **= Net Income**	**END B/S**

In **accrual based accounting**, **revenue** is recorded when firm **earns it** and **expense** is recorded when firm **incurs it**.

Prepaid Expenses – When an expense is paid in advance of using or deriving any benefit, it is recorded as “prepaid expenses” (on asset side of the balance sheet). When the expense is actually incurred, the prepaid expenses account is decreased and the expense is recorded on the income statement.

Unearned Revenue – When revenue is received before it is earned, it is recorded in an account called “unearned revenue” (on the liability side of the balance sheet). When the revenue is eventually earned, then the unearned revenue account is decreased and the revenue is recorded on the income statement.

Accrued Expenses – Are expenses which have been incurred but not yet paid. They are recorded in an account called “accrued expenses” (on liability side of the balance sheet).

Accrued Revenue – Is revenue that is earned but not yet received. It is recorded in an account called “accrued revenue” (on the asset side of the balance sheet).

Accruals and Adjustments Quick Summary

Prepaid expenses – expenses paid in cash, recorded as assets before they are used
Adjustment: decrease assets and increase expenses

Unearned revenue – cash received, recorded as a liability before it is earned
Adjustment: decrease liabilities and increase revenues

Accrued expense – expense incurred but not yet paid in cash or recorded as a transaction
Adjustment: increase liabilities and increase expenses

Accrued revenue – revenue earned but not yet received in cash or recorded as a transaction
Adjustment: increase assets and increase revenues

Relationship between income statement, balance sheet, Statement of cash flows and statement of owner’s equity

The balance sheet shows account totals as of a specific date. The income statement, statement of cash flows and statement of owner’s equity show the account totals over a period of time.

The net income (or loss) generated by the firm is recorded on the income statement. At the end of each year, a part of this net income may be paid out to shareholders as dividends and the remaining amount is recorded in the “retained earnings” account on the balance sheet in the owners’ equity section.