

Reading 21: Financial Statement Analysis: An Introduction

Question #1 of 24

Question ID: 413991

Which of the following *best* describes financial reporting and financial statement analysis?

- ☐ A) Financial reports assess a company's past performance in order to draw conclusions about the company's ability to generate cash and profits in the future.
- ☐ B) The objective of financial analysis is to provide information about the financial position of an entity that is useful to a wide range of users.
- ☒ C) 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.

References

Question From: Session 6 > Reading 21 > LOS a

Related Material:

- Key Concepts by LOS

Question #2 of 24

Question ID: 414001

Which of the following would NOT require an explanatory paragraph added to the auditors' report?

- ☒ A) Statements that the financial information was prepared according to GAAP.
- ☐ B) Doubt regarding the "going concern" assumption.
- ☐ C) Uncertainty due to litigation.

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.

References

Question From: Session 6 > Reading 21 > LOS d

Related Material:

- Key Concepts by LOS

Question #3 of 24

Question ID: 713757

Which of the following statements regarding footnotes to the financial statements is *least* accurate? Financial statement footnotes:

- X **A)** may contain information regarding contingent losses.
- X **B)** provide information about assumptions and estimates used by management.
- ✓ **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.

References

Question From: Session 6 > Reading 21 > LOS c

Related Material:

- Key Concepts by LOS
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Question #4 of 24

Question ID: 413997

Which of the following statements concerning the notes to the audited financial statements of a company is *least* accurate? Financial statement notes:

- ✓ **A)** include management's assessment of the company's operating performance and financial results.
- X **B)** are audited.
- X **C)** contain information about contingent losses that may occur.

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.

References

Question From: Session 6 > Reading 21 > LOS c

Related Material:

- Key Concepts by LOS
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Question #5 of 24

Question ID: 413995

Which of the following statements represents information at a specific point in time?

- X **A)** The income statement and the balance sheet.

- X **B)** The income statement.
- ✓ **C)** The balance sheet.

Explanation

The balance sheet represents information at a specific point in time. The income statement represents information over a period of time.

References

Question From: Session 6 > Reading 21 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #6 of 24

Question ID: 413994

A company's operating revenues for a reporting period are *most likely* to be shown on its:

- X **A)** balance sheet.
- X **B)** cash flow statement.
- ✓ **C)** income statement.

Explanation

Revenues for a reporting period are presented on a company's income statement. They can be, but are not required to be, classified as operating and nonoperating revenues. Cash from operating activities is presented on the company's statement of cash flows, but this is not necessarily equal to operating revenues because revenue might be recognized in a different period than cash is collected. The balance sheet displays a company's financial position at a fixed point in time.

References

Question From: Session 6 > Reading 21 > LOS b

Related Material:

- Key Concepts by LOS
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Question #7 of 24

Question ID: 414005

Which of the following is *least likely* to be available on EDGAR (Electronic Data Gathering, Analysis, and Retrieval System)?

- X **A)** SEC filings.
- X **B)** Form 10Q.
- ✓ **C)** 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).

References

Question From: Session 6 > Reading 21 > LOS e

Related Material:

- Key Concepts by LOS
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Question #8 of 24

Question ID: 414002

Which of the following is an independent auditor *least likely* to do with respect to a company's financial statements?

- ☐ A) Provide an opinion concerning their fairness and reliability.
- ☒ B) Prepare and accept responsibility for them.
- ☐ C) Confirm assets and liabilities contained in 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.

References

Question From: Session 6 > Reading 21 > LOS d

Related Material:

- Key Concepts by LOS
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Question #9 of 24

Question ID: 492015

A firm's internal controls are *most accurately* described as:

- ☐ A) outside the scope of an audit report under IFRS and U.S. GAAP.
- ☐ B) a responsibility of the firm's board of directors.
- ☒ C) 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.

References

Question From: Session 6 > Reading 21 > LOS d

Related Material:

- Key Concepts by LOS
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Question #10 of 24

Question ID: 460643

Information about a company's financial position at a point in time is *most likely* found in the:

- X **A)** income statement.
- ✓ **B)** balance sheet.
- X **C)** cash flow statement.

Explanation

The balance sheet reports the company's financial position at a point in time. In contrast, the income statement reports on financial performance over a period of time and the cash flow statement reports a company's cash receipts and payments over a period of time.

References

Question From: Session 6 > Reading 21 > LOS b

Related Material:

- Key Concepts by LOS
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Question #11 of 24

Question ID: 413990

Which of the following statements about financial statement analysis and reporting is *least* accurate?

- X **A)** Providing information about changes in a company's financial position is a role of financial reporting.
- X **B)** Deciding whether to recommend a company's securities to investors is a role of financial statement analysis.
- ✓ **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.

References

Question From: Session 6 > Reading 21 > LOS a

Related Material:

- Key Concepts by LOS
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Question #12 of 24

Question ID: 414004

Which of the following is an analyst *least likely* to rely on as objective information to include in a company analysis?

- X **A)** Government agency statistical data on the economy and the company's industry.
- X **B)** Proxy statements.
- ✓ **C)** 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.

References

Question From: Session 6 > Reading 21 > LOS e

Related Material:

- Key Concepts by LOS

Question #13 of 24

Question ID: 414009

In the financial statement analysis framework, using the data to address the objectives of the analysis and deciding what conclusions or recommendations the information supports is *best* described as:

- X **A)** reporting the conclusions.
- ✓ **B)** analyzing and interpreting the data.
- X **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.

References

Question From: Session 6 > Reading 21 > LOS f

Related Material:

- Key Concepts by LOS
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Question #14 of 24

Question ID: 414006

Which of the following is the *best* description of the financial statement analysis framework?

- ☐ A) Gather data, analyze and interpret the data, determine the context, report the conclusions, update the analysis.
- ☒ B) State the objective and context, gather data, process the data, analyze and interpret the data, report the conclusions or recommendations, update the analysis.
- ☐ C) Gather data, analyze and interpret the data, process the conclusions, assess the context, report the 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.*

References

Question From: Session 6 > Reading 21 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #15 of 24

Question ID: 414007

The step in the financial statement analysis framework that includes making any appropriate adjustments to the financial statements and calculating ratios is *best* described as:

- ☐ A) analyzing and interpreting the data.
- ☐ B) gathering the data.
- ☒ 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.

References

Question From: Session 6 > Reading 21 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #16 of 24

Question ID: 414003

Which of the following statements about proxy statements is *least* accurate? Proxy statements are:

- X **A)** available on the EDGAR web site.
- X **B)** a good source of information about the qualifications of board members and management.
- ✓ **C)** 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.

References

Question From: Session 6 > Reading 21 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #17 of 24

Question ID: 413993

According to the IASB, which of the following *least* accurately describes financial reporting? Financial reporting:

- X **A)** is useful to a wide range of users.
- ✓ **B)** uses the information in a company's financial statements to make economic decisions.
- X **C)** provides information about changes in financial position of an entity.

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.

References

Question From: Session 6 > Reading 21 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #18 of 24

Question ID: 413992

Which of the following is *least likely* to be considered a role of financial statement analysis?

- ☐ A) To make economic decisions.
- ☒ B) Assessing the management skill of the company's executives.
- ☐ C) Determining whether to invest in the company's securities.

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.

References

Question From: Session 6 > Reading 21 > LOS a

Related Material:

- Key Concepts by LOS
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Question #19 of 24

Question ID: 414008

The step in the financial statement analysis framework of "processing the data" is *least likely* to include which activity?

- ☒ A) Acquiring the company's financial statements.
- ☐ B) Making appropriate adjustments to the financial statements.
- ☐ C) Preparing exhibits such as graphs.

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.

References

Question From: Session 6 > Reading 21 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #20 of 24

Question ID: 765489

For publicly traded firms in the United States, the Management Discussion and Analysis (MD&A) portion of the financial disclosure is *least likely* required to discuss:

- X **A)** results of operations.
- X **B)** capital resources and liquidity.
- ✓ **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.

References

Question From: Session 6 > Reading 21 > LOS c

Related Material:

- Key Concepts by LOS
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Question #21 of 24

Question ID: 492014

An analyst who wants to examine a firm's financing transactions during the most recent period is *most likely* to evaluate the firm's statement of:

- X **A)** comprehensive income.
- ✓ **B)** cash flows.
- X **C)** financial position.

Explanation

The statement of cash flows describes a firm's inflows and outflows of cash during a reporting period from operating, investing, and financing activities. Financing transactions such as issuance of debt or stock are shown on the statement of cash flows. The statement of financial position (balance sheet) presents the firm's assets, liabilities, and equity at a point in time. The statement of comprehensive income (income statement) does not directly reflect a firm's financing transactions. Cash raised is not included in a firm's revenues and dividends paid and debt principal repaid are not included in its expenses.

References

Question From: Session 6 > Reading 21 > LOS b

Related Material:

- Key Concepts by LOS
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Question #22 of 24

Question ID: 414000

The standard auditor's report is *most likely* required to:

- ☐ A) provide reasonable assurance that management is reliable.
- ☐ B) provide an "unqualified" opinion if material uncertainties exist.
- ☒ 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.

References

Question From: Session 6 > Reading 21 > LOS d

Related Material:

- Key Concepts by LOS
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Question #23 of 24

Question ID: 485769

In addition to the audited financial statements included in a firm's annual report, which of the following sources of information is *most likely* to contain audited data?

- ☐ A) Interim financial statements filed with the SEC.
- ☐ B) Management's commentary.
- ☒ C) 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.

References

Question From: Session 6 > Reading 21 > LOS e

Related Material:

- Key Concepts by LOS
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Question #24 of 24

Question ID: 765490

According to IFRS guidance for management's commentary, addressing the company's key relationships is:

- ☐ A) neither recommended nor required.
- ☒ B) recommended.
- ☐ C) required.

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.

References

Question From: Session 6 > Reading 21 > LOS c

Related Material:

- Key Concepts by LOS