

Chapter 1-financial statements



Chapter 1 Financial Statements Map Helps its user reach a desired destination through clarity of representation. Maze attempts to confuse its user by purposefully introducing conflicting elements and complexities that prevent reaching the desired goal. Financial Statements as a Map • Form the basis for understanding the financial position of a firm

- Allow users to assess historical and prospective financial performance
 - Present clear representations of a firm's financial health
- Financial Statements as a Maze • Overwhelming amount of information
- Unreliable auditing
 - Constantly changing and complex policies and reporting requirements
 - Considerable discretion given to management
 - Key information hidden or omitted
- Main objectives of the book • Ensure that financial statements serve as a map, not a maze,
- Demonstrate how to read and evaluate financial statements,
 - Provide the tools and techniques needed to complete a comprehensive financial statement analysis, and
 - Encourage intelligent decision making. Usefulness of information
- Financial position
- Success of operations
 - Policies and strategies of management
 - Insight into future performance
- Volume of information • Financial statements
- Notes to the financial statements
 - Auditor's report
 - Five-year summary of key financial data
 - High and low stock prices
 - Management's discussion and analysis of operations

- Other material Acronyms
- Generally accepted accounting principles (GAAP)
- Securities and Exchange Commission (SEC)
- Financial Accounting Standards Board (FASB)
- International Accounting Standards Board (IASB)
- Issues Statements of Financial Accounting Standards (SFASs) Form 10-K-
Filed annually with the SEC
- Same order for all filing companies
- Electronic Data Gathering, Analysis, and Retrieval (EDGAR) Where to find
annual report-Financial statements
- Public relations material
- Sent to shareholders and prospective investors
- Most companies just post it on their corporate website What does the
balance sheet consist of?
- Balance sheet (or statement of financial position)
- Income statement (or earnings statement)
- Statement of stockholders' equity
- Statement of cash flows Notes in the financial statement
- Integral part of the
statements
- Summary of the firm's accounting policies
- Details about particular accounts
- Other supplementary information What does the notes to financial
statement include?
- Inventory
- Property, plant, and equipment
- Investments
- Long-term debt
- Equity accounts Other information included in the notes to financial
statement
- Any major acquisitions or divestitures that have occurred during

the accounting period

- Officer and employee retirement, pension, and stock option plans
- Leasing arrangements
- The term, cost, and maturity of debt
- Pending legal proceedings
- Income taxes
- Contingencies and commitments
- Quarterly results of operations

• Operating segments Auditor's report • Attests to the fairness of the presentation of financial statements

• Sarbanes-Oxley (SOX) Act of 2002 Types of auditor's reports • Unqualified reports

• Qualified reports

• Adverse opinion

• Disclaimer of opinion

• Unqualified opinion with explanatory language Auditor's Unqualified

Report States that the financial statements present fairly, in all material respects, the financial position, the results of operations, and the cash flows

for the accounting period, in conformity with GAAP Auditor's Qualified

Report A departure from GAAP resulting in a qualified opinion, Auditors will

use a language in the opinion sentence " In our opinion, except for the

(nature of departure explained), the financial statements present fairly."

Auditor's Adverse Opinion If the departure from GAAP affects numerous

accounts and financial statement relationships, then this will be rendered,

which states that the financial statements have not been presented fairly in

accordance with GAAP. Auditor's Disclaimer of Opinion Means the auditor

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cannot evaluate the fairness of the statements and therefore expresses no opinion on them. Lack of independence will result in this. Auditor's Unqualified Opinion with Explanatory Language These will result in additional paragraphs to the standard report.

- Many circumstances warrant these such as:
 - Consistency departure due to a change in accounting principle
 - Uncertainty caused by future events such as contract disputes and lawsuits
 - Or events that the auditor wished to describe because they may present business risk and going-concern problems
- Financial reporting reforms
- SOX Title I - Public Company Accounting Oversight Board (PCAOB)
- SOX Title II - prohibits nonaudit services during an external audit
- SOX Titles III and IV - corporate responsibility
- SOX Title IX - harsh penalties for violations
- Management Discussion and Analysis
- Sometimes labeled financial review
- Coverage of favorable or unfavorable trends, events, and/or uncertainties in areas of liquidity
- Capital resources
- Results of operations
- Companies do a good job of describing historical events.
- Very few firms provide accurate and meaningful forecasts
- What does the Management Discussion and Analysis Consist of?
- Internal and external sources of liquidity
- Material deficiencies in liquidity and how they will be rendered

- Commitments for capital expenditures, the purpose of such commitments, and expected sources of funding
- Anticipated changes in the mix and cost of financing resources
- Unusual or infrequent transactions that affect income from continuing operations
- Events that cause material changes in the relationship between costs and revenues
- Breakdown of sales increases into price and volume components
- Five-year summary of selected financial data and market data
- Net sales or operating revenues
- Income or loss from continuing operations per common share
- Total assets
- Long-term obligations and redeemable preferred stock
- Cash dividends per common share
- Two years of high and low common stock price by quarter
- Pandora (a. k. a. "PR Fluff")
- Colored photographs
- Charts
- Shareholders' letter from the CEO
- Other items to make the report attractive
- Proxy Statement
- Used to solicit shareholder votes
- Important in assessing:
 - Who manages the firm
 - How management is paid
 - Conflict of interest issues
 - Missing and hard-to-find information
 - Employee relations with management
- Morale and efficiency of employees

- Reputation of the firm
- Firm's prestige in the community
- Effectiveness of management
- Provisions for management succession
- Potential exposure to regulation changes
- Publicity in the media
- Companies operating in several lines of unrelated businessComplexities-
Accounting Choices•Management discretion in application of regulations
- Differing accounting methods
- Financial data appropriated to particular time periodsComplexities-
Anticipated changes due to FASB/IASB joint projects•Lease accounting
- Classification of financial instruments
- Inventory accounting
- Revenue recognition
- Reformatting of financial statementsQuality of financial reporting•Many
opportunities for management to affect quality
- Timing of revenue and expense recognition
- Discretionary items ONCHAPTER 1-FINANCIAL STATEMENTS SPECIFICALLY
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