

Interpretation of Financial Statements

Steven M. Bragg

Table of Contents

Chapter 1 – Overview of the Financial Statements	1
Learning Objectives	1
Introduction.....	1
The General Ledger.....	1
The Accrual Basis of Accounting	2
Costs versus Expenses.....	3
The Balance Sheet.....	3
The Income Statement.....	6
The Statement of Cash Flows	8
Interactions between the Financial Statements.....	10
Financial Statement Footnotes.....	10
Interpretation Tools	12
Ratio Analysis.....	12
Horizontal Analysis	13
Experience	14
Summary	15
Review Questions	16
Review Answers	17
 Chapter 2 – Interpretation of Cash and Investments	 18
Learning Objectives	18
Introduction.....	18
The Interpretation of Cash and Investments	18
Natural Cash Balance.....	19
Relevance of a Low Cash Figure	19
Restricted Cash	20
Events Triggering Changes in Cash.....	20
Sources of Cash.....	21
The Impact of Sales Growth on Cash.....	22
Sufficiency of the Cash and Investment Balance	22
The Liquidity of Investments	22
The Return on Investment	23
Analysis Conclusions	23
Review Questions	24
Review Answers	25
 Chapter 3 – Interpretation of Receivables.....	 26
Learning Objectives	26
Introduction.....	26
The Interpretation of Accounts Receivable	26
Inherent Profit Margin	27
Age of the Trade Receivables.....	28
Age of the Other Accounts Receivable.....	30
No Allowance for Doubtful Accounts	30
Reliability of the Allowance for Doubtful Accounts	30
No Allowance for Other Accounts Receivable	31
Amount of Bad Debts Recognized	31
Analysis Conclusions	31
Review Questions	33
Review Answers	34
 Chapter 4 – Interpretation of Inventory	 35
Learning Objectives	35
Introduction.....	35

Table of Contents

The Interpretation of Inventory.....	35
Relative Importance of Inventory.....	36
Age of the Inventory.....	37
Reality of the Ending Balance	40
Type of Costing System Used.....	40
Ownership of the Inventory	41
Reliability of the Reserve for Obsolete Inventory	41
Amount of Obsolete Inventory and Inventory Adjustments Recognized	41
Analysis Conclusions	42
Review Questions	43
Review Answers	44
Chapter 5 – Interpretation of Fixed Assets.....	45
Learning Objectives	45
Introduction.....	45
The Interpretation of Fixed Assets	45
Depreciation Method.....	47
Existence of Depreciation	49
Sufficiency of Depreciation.....	50
What is Being Capitalized	51
What is Being Derecognized.....	51
Proportion of Sales to Fixed Assets	51
Cash Flow Support of Fixed Assets	52
Proportion of Repairs to Fixed Assets	53
Analysis Conclusions	54
Review Questions	55
Review Answers	56
Chapter 6 – Interpretation of Other Assets	57
Learning Objectives	57
Introduction.....	57
The Interpretation of Prepaid Expenses.....	57
Nature of the Account Contents	58
The Increasing Account Balance.....	59
The Impact of Sales Growth on Prepaid Expenses.....	59
The Interpretation of Goodwill	59
Goodwill Impairment.....	60
Goodwill Amortization.....	60
Analysis Conclusions	61
Review Questions	62
Review Answers	63
Chapter 7 – Interpretation of Current Liabilities.....	64
Learning Objectives	64
Introduction.....	64
The Interpretation of Current Liabilities	64
Days Payables Outstanding.....	65
Changes in Payable Days.....	66
Sales Tax Payables Issues.....	67
Dividends Payable Issues.....	67
Wages Payable Issues	67
Income Taxes Payable Issues	67
Warranty Liability Issues	68
Unearned Revenues.....	68
Analysis Conclusions	68
Review Questions	69
Review Answers	70

Table of Contents

Chapter 8 – Interpretation of Debt	71
Learning Objectives	71
Introduction.....	71
The Interpretation of Debt	71
Financial Leverage	72
Debt-Equity Ratio	72
Interest Coverage Ratio.....	73
Relative Size of Debt	74
Seasonal Borrowings.....	74
Line of Credit Usage.....	74
Shifts from Long-term to Short-term Debt.....	75
Conversions from Payables to Debt.....	75
Conversions from Debt to Equity.....	75
Debt Forgiveness	75
Permanent Debt	75
Offshore Cash	76
Analysis Conclusions	76
Review Questions	77
Review Answers	78
Chapter 9 – Interpretation of Equity	79
Learning Objectives	79
Introduction.....	79
The Interpretation of Equity	79
The Book Value Concept.....	80
Tangible Book Value.....	80
Book Value per Share.....	81
Changes in Retained Earnings.....	82
Negative Retained Earnings	82
Appropriated Retained Earnings	83
Treasury Stock Usage	83
Number of Shares Authorized and Outstanding	84
Analysis Conclusions	84
Review Questions	85
Review Answers	86
Chapter 10 – Interpretation of Sales	87
Learning Objectives	87
Introduction.....	87
The Interpretation of Sales	87
The Trend of Sales	88
The Quality of Sales	88
The Reliability of Sales	89
The Timing of Revenue Recognition	89
Revenue at Gross or Net	89
Orders versus Sales	91
The Presence of Sales Discounts	91
The Trend of Sales Returns.....	92
Analysis Conclusions	92
Review Questions	93
Review Answers	94
Chapter 11 – Interpretation of the Cost of Sales and Gross Margin.....	95
Learning Objectives	95
Introduction.....	95
The Interpretation of the Cost of Sales and Gross Margin.....	95
Gross Margin Analysis.....	96

Table of Contents

Contribution Margin Analysis	97
The Inventory Build Concept.....	98
Direct Materials Changes.....	98
Obsolete Inventory Changes.....	99
Scrap Changes.....	99
Direct Labor Changes.....	99
Factory Overhead Changes.....	100
Freight In Changes.....	100
Analysis Conclusions	100
Review Questions	102
Review Answers	103
Chapter 12 – Interpretation of Operating Expenses.....	104
Learning Objectives	104
Introduction.....	104
The Interpretation of Operating Expenses	104
Horizontal Analysis.....	106
Strategy Impact on Operating Expenses	107
Research and Development Costs.....	107
Payroll Tax Wage Cap Issues.....	107
Commission Fluctuations.....	108
Non-Cash Operating Expenses.....	108
Rent Subleases	108
Supplies Expense and the Capitalization Limit	108
The Fixed Nature of Compensation in Operating Expenses	108
The Public Company Impact on Operating Expenses.....	109
Analysis Conclusions	109
Review Questions	110
Review Answers	111
Chapter 13 – Interpretation of Other Income, Taxes, and Profits.....	112
Learning Objectives	112
Introduction.....	112
The Interpretation of Other Income, Taxes, and Profits.....	112
Implications of Interest and Dividend Income	113
Implications of Gains/Losses on Asset Sales	113
Effects of Interest Expense	113
Implications of Taxable Income.....	114
Effective Tax Rate	114
Net Profit Margin.....	115
Deflated Profit Growth	115
Core Earnings Ratio	116
Earnings per Share.....	117
Manipulation of Earnings per Share	118
Analysis Conclusions	119
Review Questions	120
Review Answers	121
Chapter 14 – Interpretation of Cash Flows.....	122
Learning Objectives	122
Introduction.....	122
The Interpretation of the Statement of Cash Flows	122
Overview of the Statement of Cash Flows.....	122
The Direct Method	123
The Indirect Method.....	124
Examination of Cash Flows from Operating Activities.....	125
Examination of Cash Flows from Investing Activities	126

Table of Contents

Examination of Cash Flows from Financing Activities	127
Cash Flow Return on Sales	128
Analysis Conclusions	128
Review Questions	130
Review Answers	131
Chapter 15 – Other Analysis Topics	132
Learning Objectives	132
Introduction	132
Financial Statement Audits, Reviews, and Compilations	132
Audit Opinions	132
Working Capital Analysis	133
Quick Ratio	134
Working Capital Productivity	135
Breakeven and the Margin of Safety	136
Dividend Performance	138
Dividend Payout Ratio	138
Dividend Yield Ratio	139
Analysis Conclusions	140
Review Questions	141
Review Answers	142
Chapter 16 – Additional Public Company Information	143
Learning Objectives	143
Introduction	143
The Form 10-K	143
Item 1. Business	145
Item 1A. Risk Factors	147
Item 1B. Unresolved Staff Comments	149
Item 2. Properties	149
Item 3. Legal Proceedings	150
Item 4. Mine Safety Disclosures	150
Item 5. Market for Company Stock	151
Item 6. Selected Financial Data	153
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A)	154
Item 7A. Quantitative and Qualitative Disclosures about Market Risk	156
Item 8. Financial Statements and Supplementary Data	158
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	159
Item 9A. Controls and Procedures	159
Item 10. Directors, Executive Officers and Corporate Governance	161
Item 11. Executive Compensation	162
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	168
Item 13. Certain Relationships and Related Transactions, and Director Independence	169
Item 14. Principal Accountant Fees and Services	170
Analysis Conclusions	171
Review Questions	173
Review Answers	174
Glossary	175
Index	179