Unit 15 Financial Statement Analysis, Part I

I. The Acceptance of Financial Statements

A. **Generally accepted accounting principles (GAAP)**, also called concepts and standards, are needed to assure accounting information is reliable, understandable, and comparable.
   1. Official sources for these principles began with the **American Institute of Certified Public Accountants (AICPA)**, whose **Accounting Principles Board** issued many **formal opinions**.
   2. AICPA has been replaced by the **Financial Accounting Standards Board (FASB)**.
      a. FASB is strongly independent.
      b. It consists of accounting professionals from public accounting, government, industry, and education.
      c. FASB has many **statements of financial accounting standards.**

B. **The Securities and Exchange Commission (SEC)** works closely with the FASB.
   1. The FASB is responsible for accounting rules and standards.
   2. The SEC insures that publicly traded corporations adequately disclose their financial position.

C. **Independent audit procedures** also enhance the acceptance of financial statements.
   1. Independent audits are required by the SEC and some creditors.
   2. Conducted by **certified public accountants (CPA)**, **generally accepted auditing standards (GAAS)** are used by auditors to determine if company financial statements are based on generally accepted accounting principles (GAAP).
   3. Financial statements that are presented fairly receive an **unqualified "clean" opinion.** This is the best opinion a company can receive.
   4. An **adverse opinion** means that GAAP were not followed.

II. Important Financial Reports

A. **There are four financial statements.**
   1. Balance sheet
   2. Income statement
   3. Statement of owners' equity
   4. Statement of cash flows

B. The **annual report** to stockholders contains useful information.
   1. Background information
      a. A business description
      b. Biographies of key company officials
      c. Operation reports from management
   2. Audited financial statements and financial analysis

C. **Form 10-K**, containing specific information not in a company's annual report, must be filed by publicly traded corporations with the SEC and made available when requested by stockholders.

III. Using Financial Reports

A. Financial analysis is used to evaluate the financial performance of a business.
   1. By analyzing important, meaningful relationships depicted by financial statements, financial analysis helps decision makers.
   2. Financial analysis has limitations.
      a. Comparing companies is difficult because of the choices allowed by accrual accounting.
      b. Historical costing makes accounting for inflation difficult.
      c. Some important factors are not quantifiable.

B. Many people use company financial reports.
   1. Owners use them to analyze the value of their investment.
   2. Managers use financial statements to help manage their departments.
      a. Managers rely more on internal reports produced to analyze problems.
      b. Internal reports need not follow the AICPA, SEC, and other guidelines.
      c. These reports are the province of **managerial accounting**.
   3. Creditors use financial reports to determine credit worthiness.
   4. Customers use them to determine business stability.
   5. Regulators use them to determine regulatory compliance.

C. Current and future business environments should be considered when analyzing financial reports.
   1. Economic and political conditions should be studied.
   2. Industry demand should be estimated.
   3. Competitors' activity should be considered.

IV. Types of Financial Analysis

A. **Horizontal Analysis**
   1. Income statement or balance sheet data for relevant periods are placed side by side.
   2. Absolute and relative (percentage) changes between periods are calculated and compared.

$$\% \text{ Change} = \frac{\text{Later Value - Earlier Value}}{\text{Earlier Value}} (100)$$

B. **Vertical Analysis**
   1. The components of an income statement or balance sheet are expressed as a percentage of a key compon
   2. These key components are often net sales for the income statement and total assets for the balance sheet.

C. **Trend Analysis**
   1. This type of horizontal analysis has an extensive time period.
   2. Trend analysis is often done on an absolute and relative (percentage) basis.

D. **Ratio Analysis**
   1. Related financial-statement items are contrasted to better understand their interrelationships.
   2. These interrelationships pertain to liquidity, profitability, leverage, and solvency.
   3. A company compares their ratios over time and to the ratios of similar companies.

V. Horizontal and Vertical Analysis

Quick Company
Balance Sheets
December 31,1998

			Horizontal Analysis		Vertical Analysis	
Assets	**1998**	**1997**	**Change**	**% Change**	**1998**	**1997**
Cash	$ 1,200,000	$ 1,100,000	$ 100,000	9.1%	6.3%	6.2%
Accounts Receivable (Net)	1,400,000	1,000,000	400,000	40.0%	7.3%	5.6%
Prepaid Expenses	105,000	100,000	5,000	5.0%	.5%	.6%
Inventory	1,200,000	800,000	400,000	50.0%	6.3%	4.5%
Land	9,000,000	9,000,000	0	0.0%	46.9%	50.8%
Fixed Assets (Net)	6,270,000	5,700,000	570,000	10.0%	32.7%	32.2%
Total Assets	$19,175,000	$17,700,000	$1,475,000		100.0%	100.0%[1]
Liabilities and Equity						
Accounts Payable	$ 1,307,000	$ 890,000	$ 417,000	46.9%	6.8%	5.0%
Salaries Payable	15,000	10,000	5,000	50.0%	.1%	.1%
Notes Payable	8,500,000	8,500,000	0	0.0%	44.3%	48.0%
Stockholders' Equity	9,353,000	8,300,000	1,053,000	12.7%	48.8%	46.9%
Total Liabilities	$19,175,000	$17,700,000	$1,475,000		100.0%	100.0%

[1] rounded to 100%

Analysis

A. Quick Company is a new company. It began business in January 1997.
B. Accounts receivable increased less than Accounts Payable (40% to 46.9%). This could mean that their marketing policy is not aggressive.
C. The increase in inventory was substantial (50%), but this is consistent with a high-growth company. Carrying inventory is expensive and lowers gross profit margins.
D. An interesting question would concern what the company bought to necessitate an increase in fixed assets of $570,000 (10%). Additional analysis will follow in Unit 16.