CFA Institute

FINANCIAL STATEMENT ANALYSIS

CFA® Program Curriculum

2027 • LEVEL PREREQUISITE READING • VOLUME 2

ISBN 979-8-89559-012-6 (pdf)
ISBN 979-8-89559-051-5 (ebook)
May 2026

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How to Use the CFA Program Curriculum

The CFA® Program exams measure your mastery of the core knowledge, skills, and abilities required to succeed as an investment professional. These core competencies are the basis for the Candidate Body of Knowledge (CBOK™). The CBOK consists of four components:

A broad outline that lists the major CFA Program topic areas (www.cfainstitute.org/programs/cfa/curriculum/cbok/cbok)

Topic area weights that indicate the relative exam weightings of the top-level topic areas (www.cfainstitute.org/en/programs/cfa/curriculum)

Learning outcome statements (LOS) that tell you the specific knowledge, skills, and abilities you should gain from each curriculum topic area. You will find these statements at the start of each learning module and lesson. We encourage you to review the information about the LOS on our website (www.cfainstitute.org/programs/cfa/curriculum/study-sessions), including the descriptions of LOS "command words" on the candidate resources page at www.cfainstitute.org/-/media/documents/support/programs/cfa-and-cipm-los-command-words.ashx.

The CFA Program curriculum that candidates receive access to upon exam registration.

Therefore, the key to your success on the CFA exams is studying and understanding the CBOK. You can learn more about the CBOK on our website: www.cfainstitute.org/programs/cfa/curriculum/cbok.

The curriculum, including the practice questions, is the basis for all exam questions. The curriculum is selected/developed specifically to provide candidates with the knowledge, skills, and abilities reflected in the CBOK.

CFA INSTITUTE LEARNING ECOSYSTEM (LES)

Your exam registration fee includes access to the CFA Institute Learning Ecosystem (LES). This digital learning platform provides access to all the curriculum content and practice questions. The LES is organized as a series of learning modules consisting of short online lessons and associated practice questions. This tool is your source for all study materials, including practice questions and mock exams. The LES is the primary method by which CFA Institute delivers your curriculum experience. Here, you will find additional practice questions to test your knowledge, including some interactive questions.

DESIGNING YOUR PERSONAL STUDY PROGRAM

An orderly, systematic approach to exam preparation is critical. You should dedicate a consistent block of time every week to reading and studying. Review the LOS both before and after you study curriculum content to ensure you can demonstrate the knowledge, skills, and abilities described by the LOS and the assigned learning module. Use the LOS as a self-check to track your progress and highlight areas of weakness for later review.

Successful candidates report an average of more than 300 hours preparing for each exam. Your preparation time will vary based on your prior education and experience, and you will likely spend more time on some topics than on others.

ERRATA

The curriculum development process is rigorous and involves multiple rounds of reviews by content experts. Despite our efforts to produce a curriculum that is free of errors, we must make corrections in some instances. Curriculum errata are periodically updated and posted by exam level and test date on the Curriculum Errata webpage (www.cfainstitute.org/en/programs/submit-errata). If you believe you have found an error in the curriculum, you can submit your concerns through our curriculum errata reporting process found at the bottom of the Curriculum Errata webpage.

OTHER FEEDBACK

Please send any comments or suggestions to info@cfainstitute.org, and we will review your feedback thoughtfully.

Financial Statement Analysis

LEARNING MODULE

1

Introduction to Financial Reporting

by Elaine Henry, PhD, CFA, J. Hennie van Greuning, DCom, CFA, and Thomas R. Robinson, PhD, CFA, CAIA.

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LEARNING OUTCOMES

Mastery	*The candidate should be able to:*
☐	describe the objective of financial reporting and the importance of financial reporting standards in security analysis and valuation
☐	describe the roles of financial reporting standard-setting bodies and regulatory authorities in establishing and enforcing reporting standards
☐	describe the International Accounting Standards Board's conceptual framework, including qualitative characteristics of financial reports, constraints on financial reports, and required reporting elements
☐	describe general requirements for financial statements under International Financial Reporting Standards (IFRS)
☐	describe the roles of the statement of financial position, statement of comprehensive income, statement of changes in equity, and statement of cash flows in evaluating a company's performance and financial position

Note: Changes in accounting standards as well as new rulings and/or pronouncements issued after the publication of the readings on financial reporting and analysis may cause some of the information in these readings to become dated. Candidates are *not* responsible for anything that occurs after the readings were published. In addition, candidates are expected to be familiar with the analytical frameworks contained in the readings, as well as the implications of alternative accounting methods for financial analysis and valuation discussed in the readings. Candidates are also responsible for the content of accounting standards, but not for the actual reference numbers. Finally, candidates should be aware that certain ratios may be defined and calculated differently. When alternative ratio definitions exist and no specific definition is given, candidates should use the ratio definitions emphasized in the readings.

1 INTRODUCTION

Financial reporting standards provide principles for preparing financial reports and determine the types and amounts of information that must be provided to users of financial statements, including investors and creditors, so that they may make informed decisions. An understanding of the underlying framework of financial reporting standards, which is broader than knowledge of specific accounting rules, will allow an analyst to assess the valuation implications of financial statement elements and transactions—including transactions, such as those that represent new developments, which are not specifically addressed by the standards.

This learning module discusses the objective of financial reporting and the importance of financial reporting standards in security analysis and valuation, describes the roles of financial reporting standard-setting bodies and regulatory authorities and several of the financial reporting standard-setting bodies and regulatory authorities, and describes the International Financial Reporting Standards (IFRS) reporting framework[1] and general requirements for financial statements. It also discusses the elements of financial statements and the general requirements for financial statements.

2 THE OBJECTIVE OF FINANCIAL REPORTING

☐ describe the objective of financial reporting and the importance of financial reporting standards in security analysis and valuation

The financial reports of a company include financial statements and other supplemental disclosures necessary to assess a company's financial position and periodic financial performance. Financial reporting is based on a simple premise. The International Accounting Standards Board (IASB), which sets financial reporting standards that have been adopted in many countries, said in its *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) that the objective of financial reporting is to provide financial information that is useful to users in making decisions about providing resources to the reporting entity, where those decisions relate to equity and debt instruments, or loans or other forms of credit, and in influencing management's actions that affect the use of the entity's economic resources.[2]

A fully articulated framework is an essential first step to guide the development of a set of standards. Before the establishment and broad adoption of IFRS, financial reporting standards were primarily developed independently by each country's standard-setting body. This independent standard setting process created a wide range of standards, some of which were quite comprehensive and complex (rules-based standards), and others that were more general (principles-based standards). The globalization of capital flows and various accounting scandals increased awareness of the need for more uniform, high quality global financial reporting standards and provided the impetus for stronger coordination among the major standard-setting bodies. Such coordination is also a natural outgrowth of the increased globalization of capital markets.

1 The body of standards issued by the International Accounting Standards Board (IASB) is referred to as International Financial Reporting Standards.
2 In March 2018, the IASB updated the *Conceptual Framework for Financial Reporting* originally adopted in 2010.

Developing financial reporting standards is complicated because the underlying economic activities are complicated and dynamic. The financial transactions and financial position that companies present in their financial reports are also complex. Furthermore, uncertainty about various aspects of transactions often results in the need for accruals and estimates, both of which necessitate judgment. Judgment varies from one preparer to the next. Accordingly, standards are needed to achieve some amount of consistency in these judgments. Even with such standards, there usually will be no single correct answer to the question of how to reflect economic activity in financial reports. Nevertheless, financial reporting standards try to limit the range of acceptable answers to increase consistency in financial reports.

The IASB and the US-based Financial Accounting Standards Board (FASB) have developed similar financial reporting frameworks which specify the overall objective and qualities of information to be provided. Financial reports are intended to provide information to many users, including investors, creditors, employees, customers, and others. As a result, financial reports are *not* designed solely with asset valuation in mind. However, financial reports provide important inputs into the process of valuing a company or the securities a company issues. Understanding the financial reporting framework—including how and when judgements, estimates, and management policy decisions can affect the numbers reported—enables an analyst to evaluate the information reported and to use the information appropriately when assessing a company's financial performance. Clearly, such an understanding is also important in assessing the financial impact of business decisions by, and in making comparisons across, entities.

ACCOUNTING STANDARDS BOARDS

3

- ☐ describe the objective of financial reporting and the importance of financial reporting standards in security analysis and valuation
- ☐ describe the roles of financial reporting standard-setting bodies and regulatory authorities in establishing and enforcing reporting standards

A distinction must be made between standard-setting bodies and regulatory authorities. Standard-setting bodies, such as the IASB and FASB, are typically private sector, self-regulated organizations with board members who are experienced accountants, auditors, users of financial statements, and academics. The requirement to prepare financial reports in accordance with specified accounting standards is the responsibility of regulatory authorities. Regulatory authorities, such as the Accounting and Corporate Regulatory Authority in Singapore, the Securities and Exchange Commission (SEC) in the United States, and the Securities and Exchange Commission of Brazil, have the legal authority to enforce financial reporting requirements and exert other controls over entities that participate in the capital markets within their jurisdiction.

In other words, *generally*, standard-setting bodies set the standards and regulatory authorities recognise and enforce the standards. Without the recognition of the standards by the regulatory authorities, the private sector standard-setting bodies would have no authority. Note, however, that regulators often retain the legal authority to establish financial reporting standards in their jurisdiction and can overrule the private sector standard-setting bodies.

Accounting Standards Boards

While accounting standards boards exist in virtually every national market, the IASB and FASB are the two most influential because the vast majority of issuers in global financial markets prepare their financial statements under IFRS or US GAAP.

International Accounting Standards Board

The IASB is the independent standard-setting body of the IFRS Foundation, an independent, not-for-profit private sector organization. The Trustees of the IFRS Foundation reflect a diversity of geographical and professional backgrounds. The Trustees appoint the members of the IASB and are accountable to a monitoring board composed of public authorities that include representatives from the European Commission, IOSCO, the Japan Financial Services Agency, and the US SEC, with the chairman of the Basel Committee on Banking Supervision as an observer.

The Trustees of the IFRS Foundation are committed to act in the public interest. The principle objectives of the IFRS Foundation are to develop and promote the use and adoption of a single set of high quality financial standards; to ensure the standards result in transparent, comparable, and decision-useful information while taking into account the needs of a range of sizes and types of entities in diverse economic settings; and to promote the convergence of national accounting standards and IFRS. The Trustees are responsible for ensuring that the IASB acts and is perceived to act independently and in the best interests of users of the financial statements.

The members of the IASB are appointed by the Trustees on the basis of professional competence and practical experience and reflect a diversity of geographical and professional backgrounds. The members deliberate, develop, and issue international financial reporting standards,[3] assisted by advice on the standards, and their application, from advisory bodies whose members represent a wide range of organizations and individuals that are affected by and interested in international financial reporting.

The IASB has a formal, structured process that it goes through when deliberating, developing, and issuing international financial reporting standards. A simplified version of the typical process is as follows. An issue is identified as a priority for consideration and placed on the IASB's agenda. After considering an issue, which may include soliciting advice from others including national standard-setters, the IASB may publish an exposure draft for public comment. After reviewing the comments and input of others, the IASB may issue a new or revised financial reporting standard. These standards are authoritative to the extent that they are recognised and adopted by regulatory authorities.

Financial Accounting Standards Board

The FASB and its predecessor organizations have been issuing financial reporting standards in the United States since the 1930s. The FASB operates within a structure similar to that of the IASB. The Financial Accounting Foundation oversees, administers, and finances the organization. The Foundation ensures the independence of the standard-setting process and appoints members to the FASB and related advisory entities.

The FASB issues new and revised standards to improve standards of financial reporting so that decision-useful information is provided to users of financial reports. This is done through a thorough and independent process that seeks input from stakeholders and is overseen by the Financial Accounting Foundation. The steps in the process are

3 Although the name of the IASB incorporates "Accounting Standards" and early standards were titled International Accounting Standards (IAS), the term "International Financial Reporting Standards" (IFRS) is being used for new standards. The use of the words "financial reporting" recognizes the importance of disclosures outside of the core financial statements, such as management discussion of the business, risks, and future plans.

similar to those described for the IASB. The outputs of the standard-setting process are contained in the FASB Accounting Standards Codification™ (Codification).[4] The Codification, organized by topic, is the source of authoritative US generally accepted accounting principles to be applied to non-governmental entities.

US GAAP, as established by the FASB, is officially recognized as authoritative by the SEC; however the SEC retains the authority to establish accounting standards and financial reporting requirements. Although it has rarely overruled the FASB, the SEC does issue authoritative financial reporting guidance including Staff Accounting Bulletins. These bulletins reflect the SEC's views regarding accounting-related disclosure practices and can be found on the SEC website. Certain portions—but not all portions—of the SEC regulations, releases, interpretations, and guidance are included for reference in the FASB Codification.

4 THE INTERNATIONAL FINANCIAL REPORTING STANDARDS FRAMEWORK

- ☐ describe the objective of financial reporting and the importance of financial reporting standards in security analysis and valuation
- ☐ describe the International Accounting Standards Board's conceptual framework, including qualitative characteristics of financial reports, constraints on financial reports, and required reporting elements

The IASB's *Conceptual Framework for Financial Reporting* sets forth the concepts that underlie the preparation and presentation of financial statements for external users.[5] The framework is designed to: assist standard setters in developing and reviewing standards; assist preparers of financial statements in applying standards and in dealing with issues not specifically covered by existing standards; assist auditors in forming an opinion on financial statements; and assist users in interpreting financial statement information. The objective of financial reporting is to provide financial information that is useful to current and potential economic resource providers in making decisions, and all other aspects of the framework flow from that central objective.

The primary users of financial reports include investors, lenders, and other creditors. Other users may also find the financial information useful for making economic decisions. The types of economic decisions differ by users, so the specific information needed differs as well. However, although users may have unique information needs, some information needs are common across all users. For example, users need information about a company's a) financial position, including its resources and its financial obligations; b) financial performance, including how and why the company's financial position changed in the past, which can be useful in evaluating potential changes in

4 The Codification combines literature issued by various standard setters, including the FASB, the Emerging Issues Task Force (EITF), the Derivative Implementation Group (DIG), and the American Institute of Certified Public Accountants (AICPA).

5 The FASB has a similar conceptual framework which it describes on its website as follows: "The Conceptual Framework (or "Concepts Statements") is a body of interrelated objectives and fundamentals. The objectives identify the goals and purposes of financial reporting and the fundamentals are the underlying concepts that help achieve those objectives. Those concepts provide guidance in selecting transactions, events and circumstances to be accounted for, how they should be recognized and measured, and how they should be summarized and reported." Note that under IFRS, the conceptual framework is considered authoritative guidance, but under US GAAP, the conceptual framework is not authoritative.

the future; and c) cash position, including how the company obtained cash (by selling its products and services, borrowing, and other methods) and how it used cash (by paying expenses, investing in new equipment, paying dividends, and other methods).

Information that is helpful to users in assessing future net cash inflows to the entity includes information about the economic resources of (assets) and claims against (liabilities and equity) the entity, and about how well company management and the governing board utilized the resources of the entity. Financial reports are useful in estimating the economic value of an entity.

Qualitative Characteristics of Financial Reports

Flowing from the central objective of providing information that is *useful* to providers of resources, the *Conceptual Framework* identifies two fundamental qualitative characteristics that make financial information useful: relevance and faithful representation.[6] The concept of materiality is discussed within the context of relevance.

1. *Relevance*: Information is relevant if it would potentially affect or make a difference in users' decisions. The information can have predictive value (useful in making forecasts), confirmatory value (useful to evaluate past decisions or forecasts), or both. In other words, relevant information helps users of financial information to evaluate past, present, and future events, or to confirm or correct their past evaluations in a decision-making context. *Materiality:* Information is considered to be material if omission or misstatement of the information could influence users' decisions. Materiality is a function of the nature and/or magnitude of the information.
2. *Faithful representation*: Information that faithfully represents an economic phenomenon that it purports to represent is ideally complete, neutral, and free from error. Complete means that all information necessary to understand the phenomenon is depicted. Neutral means that information is selected and presented without bias. In other words, the information is not presented in such a manner as to bias the users' decisions. Free from error means that there are no errors of commission or omission in the description of the economic phenomenon, and that an appropriate process to arrive at the reported information was selected and was adhered to without error. Faithful representation maximizes the qualities of complete, neutral, and free from error to the extent possible. Faithful representation is sometimes referred to as "reliability."

Relevance and faithful representation are the fundamental, most critical characteristics of useful financial information. In addition the *Conceptual Framework* identifies four enhancing qualitative characteristics: comparability, verifiability, timeliness, and understandability.

1. *Comparability*: Comparability allows users "to identify and understand similarities and differences of items." Information presented in a consistent manner over time and across entities enables users to make comparisons more easily than information with variations in how similar economic phenomena are represented.
2. *Verifiability*: Verifiability means that different knowledgeable and independent observers would agree that the information presented faithfully represents the economic phenomena it purports to represent.
3. *Timeliness*: Timely information is available to decision makers prior to their making a decision.

6 *Conceptual Framework for Financial Reporting.*

4. *Understandability*: Clear and concise presentation of information enhances understandability. Information should be prepared for and be understandable by users who have a reasonable knowledge of business and economic activities, and who are willing to study the information with diligence. Information that is useful should not be excluded simply because it is difficult to understand, and it may be necessary for users to seek assistance to understand information about complex economic phenomena.

Financial information exhibiting these qualitative characteristics—fundamental and enhancing—should be useful for making economic decisions.

Constraints on Financial Reports

Although it would be ideal for financial statements to exhibit all of these qualitative characteristics and thus achieve maximum usefulness, it may be necessary to make tradeoffs across the enhancing characteristics. The application of the enhancing characteristics follows no set order of priority and each enhancing characteristic may take priority over the others. The aim is an appropriate balance among the enhancing characteristics.

A pervasive constraint on useful financial reporting is the cost of providing and using this information. Optimally, benefits derived from information should exceed the costs of providing and using it. Again, the aim is a balance between costs and benefits.

A limitation of financial reporting involves information that is not included. Financial statements, by necessity, omit information that is non-quantifiable. For example, the creativity, innovation, and competence of a company's work force are not directly captured in the financial statements. Similarly, customer loyalty, a positive corporate culture, environmental responsibility, and many other aspects about a company may not be directly reflected in the financial statements. Of course, to the extent that these items result in superior financial performance, a company's financial reports should reflect the results.

EXAMPLE 1

Balancing Qualitative Characteristics of Useful Information

A tradeoff between enhancing qualitative characteristics often occurs. For example, when a company records sales revenue, it is required to simultaneously estimate and record an expense for potential bad debts (uncollectible accounts) if the sale is made on credit. Including this estimated expense is considered to represent the economic event faithfully and to provide relevant information about the net profits for the accounting period. The information is timely and understandable; but because bad debts may not be known with certainty until a later period, inclusion of this estimated expense involves a sacrifice of verifiability. The bad debt expense is simply an estimate. Accordingly, it is apparent that it is not always possible to simultaneously fulfill all qualitative characteristics.

5 THE ELEMENTS OF FINANCIAL STATEMENTS

- ☐ describe the International Accounting Standards Board's conceptual framework, including qualitative characteristics of financial reports, constraints on financial reports, and required reporting elements
- ☐ describe general requirements for financial statements under International Financial Reporting Standards (IFRS)

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes (elements) according to their economic characteristics. Three elements of financial statements are directly related to the measurement of financial position: assets, liabilities, and equity.

- **Assets**: A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. Assets are what a company owns (e.g., inventory and equipment).
- **Liabilities**: A present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty or responsibility that the entity has no practical ability to avoid. Liabilities are what a company owes (e.g., bank borrowings).
- **Equity**: Assets less liabilities. Equity is the residual interest in the assets after subtracting the liabilities.

The elements of financial statements directly related to the measurement of performance (profit and related measures) are income and expenses.

- **Income**: Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims. Income includes both revenues and gains. Revenues represent income from the ordinary operating activities of the enterprise (e.g., the sale of products or provision of services). Gains may result from ordinary activities or other activities (the sale of surplus equipment).
- **Expenses**: Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims. Expenses include cost of goods sold (which may include wages and rent) and selling and administrative expenses. Losses are also considered expenses and can result from the sale of assets at less than their carrying values, impairments of asset values and a variety of other items.

Underlying Assumptions in Financial Statements

Two important assumptions underlie financial statements: accrual accounting and going concern. These assumptions determine how financial statement elements are recognized and measured.

The use of "accrual accounting" assumes that financial statements should reflect transactions in the period when they actually occur, not necessarily when cash movements occur. For example, a company reports revenues *when they are earned (when the performance obligations have been satisfied)*, regardless of whether the company received cash before or after delivering the product, at the time of delivery. Accrual accounting helps ensure related revenues and expenses are recognized in the same reporting period, resulting in a more meaningful measure of net income.

"Going concern" refers to the assumption that the company will continue in business for the foreseeable future. To illustrate, consider the value of a company's inventory if it is assumed that the inventory can be sold over a normal period of time versus the value of that same inventory if it is assumed that the inventory must all be sold in a day (or a week). Companies with the intent to liquidate or materially curtail operations would require different information for a fair presentation.

Recognition of Financial Statement Elements

Recognition means that an item is included in the balance sheet or income statement. Recognition occurs if the item meets the definition of an element and satisfies the criteria for recognition. Recognition is appropriate if it results in both relevant information about assets, liabilities, equity, income and expenses and a faithful representation of those items, because the aim is to provide information that is useful to investors, lenders and other creditors.

Measurement of Financial Statement Elements

Measurement is the process of determining the monetary amount at which the elements of the financial statements are recognized and carried in the balance sheet and income statement. The following alternative bases of measurement are used to different degrees and in varying combinations to measure assets and liabilities:

- **Historical cost**: Historical cost is simply the amount of cash or cash equivalents paid to purchase an asset, including any costs of acquisition and/or preparation, such as transportation expense or sales tax. If the asset was not bought for cash, historical cost is the fair value of whatever was given in order to buy the asset. When referring to liabilities, historical cost means the amount of proceeds received in exchange for the obligation.
- **Amortised cost**: Historical cost adjusted for amortisation, depreciation, or depletion and/or impairment.
- **Current cost**: In reference to assets, current cost is the amount of cash or cash equivalents that would have to be paid to buy the same or an equivalent asset today (i.e., replacement cost). In reference to liabilities, the current cost basis of measurement means the undiscounted amount of cash or cash equivalents that would be required to settle the obligation today.
- **Realizable (settlement) value**: In reference to assets, realizable value is the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. For liabilities, the equivalent to realizable value is called "settlement value"—that is, settlement value is the undiscounted amount of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.
- **Present value (PV)**: For assets, present value is the net present value of the future expected cash inflows that the asset is expected to generate in the normal course of business, discounted at an appropriate interest rate. For liabilities, present value is the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business, discounted at an appropriate interest rate.

- **Fair value**: Fair value is defined as an exit price, the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This may involve either market measures or present value measures depending on the availability of information.

6 MAJOR FINANCIAL STATEMENTS

☐ describe the roles of the statement of financial position, statement of comprehensive income, statement of changes in equity, and statement of cash flows in evaluating a company's performance and financial position

In performing an equity or credit analysis of a company, an analyst collects a great deal of information. The nature of the information collected will vary on the basis of the individual decision to be made (or the specific purpose of the analysis) but will typically include information about the economy, industry, and company, as well as information about comparable peer companies. Information from outside the company will likely include economic statistics, industry reports, trade publications, and databases containing information on competitors. The company itself provides core information for analysis on its website and in its financial reports, press releases, investor conference calls, and webcasts.

Companies prepare financial reports at regular intervals (annually, semiannually, and/or quarterly depending on the applicable regulatory requirements). Financial reports include financial statements along with supplemental disclosures necessary to assess the company's financial position and periodic performance.

Financial statements are the result of an accounting process that records a company's economic transactions, following the applicable accounting standards and principles. These statements summarize the accounting information, mainly for users outside the company (such as investors, creditors, analysts, and others) because insiders have direct access to the underlying financial data summarized in the financial statements and to other information that is not included in the financial reporting process.

Financial statements of public companies and large, privately owned companies are typically audited by independent public accountants, who provide an opinion on whether the financial statements present fairly the company's performance and financial position, in accordance with a specified, applicable set of accounting standards and principles.

Financial Statements and Supplementary Information

A complete set of financial statements includes a statement of financial position (i.e., a balance sheet), a statement of comprehensive income (i.e., a single statement of comprehensive income or an income statement and a statement of comprehensive income), a statement of changes in equity, and a statement of cash flows.

The balance sheet portrays the company's financial position at a given point in time. The statement of comprehensive income and statement of cash flows present different aspects of a company's performance over a period of time. The statement of changes in equity provides additional information regarding the changes in a company's financial position over a period of time. In addition, the accompanying required notes, or footnotes, are an integral part of a complete set of financial statements. The financial statements are reported on a consolidated basis, meaning that they include the relevant account balances of subsidiary companies under the control of the parent (reporting) company.

Along with the required financial statements, a company typically provides additional information in its financial reports. In many jurisdictions, some or all of this additional information is mandated by regulators or accounting standards boards. The additional information provided may include a letter from the chairman of the company, a report from management discussing the results (typically called management discussion and analysis [MD&A]), an external auditor's report providing assurances that the financial statements comply with applicable accounting standards and that internal controls over financial reporting are functioning, a governance report describing the structure of the company's board of directors, and a corporate responsibility report. As part of his or her analysis, the financial analyst should read and assess this additional information along with the financial statements. The following sections describe and illustrate each financial statement and some of the additional information.

BALANCE SHEET (STATEMENT OF FINANCIAL POSITION) 7

☐ describe the roles of the statement of financial position, statement of comprehensive income, statement of changes in equity, and statement of cash flows in evaluating a company's performance and financial position

The **balance sheet** (also called the **statement of financial position** or **statement of financial condition**) presents a company's financial position by disclosing the resources the company controls (assets) and its obligations to lenders and other creditors (liabilities) at a specific point in time. **Owners' equity** (sometimes called "net assets") represents the excess of assets over liabilities. This amount is attributable to the company's owners or shareholders. Owners' equity is the owners' residual interest in (i.e., residual claim on) the company's assets after deducting its liabilities. The total amount of owner's equity is also known as the "book value" of a company.

The relationship among the three parts of the balance sheet (assets, liabilities, and owners' equity) can be expressed in the following equation form: Assets = Liabilities + Owners' equity. This equation (sometimes called the accounting equation or the balance sheet equation) shows that the total amount of assets must equal or *balance* with the combined total amounts of liabilities and owners' equity. Alternatively, the equation may be rearranged as follows: Assets – Liabilities = Owners' equity. This formulation emphasizes the residual claim aspect of owners' equity. Depending on the form of the organization, owners' equity may be referred to as "partners' capital" or "shareholders' equity" or "shareholders' funds."

Exhibit 1 presents the balance sheet of the Volkswagen Group from its Annual Report 2017.

Exhibit 1: Balance Sheet of the Volkswagen Group (Excerpt)

€ million	31 Dec. 2017	31 Dec. 2016
Assets		
Noncurrent assets		
Intangible assets	63,419	62,599
Property, plant and equipment	55,243	54,033
Lease assets	39,254	38,439
Investment property	468	512
Equity-accounted investments	8,205	8,616
Other equity investments	1,318	996
Financial services receivables	73,249	68,402
Other financial assets	8,455	8,256
Other receivables	2,252	2,009
Tax receivables	407	392
Deferred tax assets	9,810	9,756
	262,081	**254,010**
Current assets		
Inventories	40,415	38,978
Trade receivables	13,357	12,187
Financial services receivables	53,145	49,673
Other financial assets	11,998	11,844
Other receivables	5,346	5,130
Tax receivables	1,339	1,126
Marketable securities	15,939	17,520
Cash, cash equivalents and time deposits	18,457	19,265
Assets held for sale	115	—
	160,112	**155,722**
Total assets	**422,193**	**409,732**
Equity and Liabilities		
Equity		
Subscribed capital	1,283	1,283
Capital reserves	14,551	14,551
Retained earnings	81,367	70,446
Other reserves	560	(1,158)
Equity attributable to Volkswagen AG hybrid capital investors	11,088	7,567
Equity attributable to Volkswagen AG shareholders and hybrid capital investors	108,849	92,689
Noncontrolling interests	229	221
	109,077	**92,910**
Noncurrent liabilities		
Financial liabilities	81,628	66,358
Other financial liabilities	2,665	4,488
Other liabilities	6,199	5,664

€ million	31 Dec. 2017	31 Dec. 2016
Deferred tax liabilities	5,636	4,745
Provisions for pensions	32,730	33,012
Provisions for taxes	3,030	3,556
Other provisions	20,839	21,482
	152,726	**139,306**
Current liabilities		
Put options and compensation rights granted to noncontrolling interest shareholders	3,795	3,849
Financial liabilities	81,844	88,461
Trade payables	23,046	22,794
Tax payables	430	500
Other financial liabilities	8,570	9,438
Other liabilities	15,961	15,461
Provisions for taxes	1,397	1,301
Other provisions	25,347	35,711
	160,389	**177,515**
Total equity and liabilities	**422,193**	**409,732**

Note: Numbers are as shown in the annual report and may not precisely add because of rounding.
Source: Volkswagen 2017 annual report

In Exhibit 1, the balance sheet is presented with the most recent year in the left column and the immediately preceeding year in the right column. Although this is a common presentation, analysts should be careful when reading financial statements. In some cases, the ordering may be reversed, with the earlier year(s) on the left and the most recent year on the far right.

At 31 December 2017, Volkswagen's total resources or assets were €422 billion. This number is the sum of non-current assets of €262 billion and current assets of €160 billion.[7] Total equity was €109 billion. Although Volkswagen does not give a total amount for all the balance sheet liabilities, it can be determined by adding the non-current and current liabilities, €153 billion + €160 billion = €313 billion.[8]

Referring back to the basic accounting equation, Assets = Liabilities + Equity, we have €422 billion = €313 billion + €109 billion. In other words, Volkswagen has assets of €422 billion, owes €313 billion, and thus has equity of €109 billion. Using the balance sheet and analyzing the financial statements and the changes in reported account balances, the analyst can answer such questions as

- Has the company's liquidity (ability to meet short-term obligations) improved?
- Is the company solvent (does it have sufficient resources to cover its obligations)?
- What is the company's financial position relative to other companies in the industry?

7 Current assets are defined, in general, as those assets that are cash or cash equivalents; are held for trading; or are expected to be converted to cash (realized), sold, or consumed within 12 months or the company's normal operating cycle. All other assets are classified as non-current.

8 Current liabilities are defined, in general, as those that are expected to be settled within 12 months or the company's normal operating cycle. All other liabilities are classified as non-current.

Volkswagen, a German-based automobile manufacturer, prepares its financial statements in accordance with International Financial Reporting Standards (IFRS). IFRS require companies to present balance sheets that show current and non-current assets and current and non-current liabilities as separate classifications. However, IFRS do not prescribe a particular ordering or format, and the order in which companies present their balance sheet items is largely a function of tradition.

As shown, Volkswagen presents non-current assets before current assets, owners' equity before liabilities, and non-current liabilities before current liabilities. This method generally reflects a presentation from least liquid to most liquid. In other countries, the typical order of presentation may differ. For example, in the United States, Australia, and Canada, companies usually present their assets and liabilities from most liquid to least liquid. Accordingly, "Cash" or "Cash and Equivalents" is typically the first asset shown, and equity is presented after liabilities.

As a basis for comparison, Exhibit 2 presents the balance sheet of Walmart, Inc. (Walmart) from its 2018 annual report, with a fiscal year end of 31 January, which is prepared in accordance with US GAAP.

Exhibit 2: Walmart Consolidated Balance Sheet

	As of 31 January	
(Amounts in $ millions)	**2018**	**2017**
ASSETS		
Current assets:		
Cash and cash equivalents	6,756	6,867
Receivables, net	5,614	5,835
Inventories	43,783	43,046
Prepaid expenses and other	3,511	1,941
Total current assets	59,664	57,689
Property and equipment:		
Property and equipment	185,154	179,492
Less accumulated depreciation	(77,479)	(71,782)
Property and equipment, net	107,675	107,710
Property under capital lease and financing obligations:		
Property under capital lease and financing obligations	12,703	11,637
Less accumulated amortization	(5,560)	(5,169)
Property under capital lease and financing obligations, net	7,143	6,468
Goodwill	18,242	17,037
Other assets and deferred charges	11,798	9,921
Total assets	204,522	198,825
LIABILITIES AND EQUITY		
Current liabilities:		
Short-term borrowings	5,257	1,099
Accounts payable	46,092	41,433
Accrued liabilities	22,122	20,654
Accrued income taxes	645	921

	As of 31 January	
(Amounts in $ millions)	**2018**	**2017**
Long-term debt due within one year	3,738	2,256
Capital lease and financing obligations due within one year	667	565
Total current liabilities	78,521	66,928
Long-term debt	30,045	36,015
Long-term capital lease and financing obligations	6,780	6,003
Deferred income taxes and other	8,354	9,344
Commitments and contingencies		
Equity:		
Common stock	295	305
Capital in excess of par value	2,648	2,371
Retained earnings	85,107	89,354
Accumulated other comprehensive loss	(10,181)	(14,232)
Total Walmart shareholders' equity	77,869	77,798
Noncontrolling interest	2,953	2,737
Total equity	80,822	80,535
Total liabilities and equity	204,522	198,825

Source: Walmart 2018 annual report.

As of 31 January 2018, Walmart has total assets of $205 billion. Liabilities and other non-equity claims total $124 billion, and equity is $81 billion.

STATEMENT OF COMPREHENSIVE INCOME

8

☐ describe the roles of the statement of financial position, statement of comprehensive income, statement of changes in equity, and statement of cash flows in evaluating a company's performance and financial position

The statement of comprehensive income can be presented as a single statement of comprehensive income or as two statements, (1) an income statement and (2) a statement of comprehensive income that begins with profit or loss from the income statement.

Income Statement

The income statement presents information on the financial performance of a company's business activities over a period of time. It communicates how much **revenue** and other income the company generated during a period and the expenses it incurred to generate that revenue and other income. Revenue typically refers to amounts charged for the delivery of goods or services in the ordinary activities of a business. Other income typically includes gains or losses that do not arise from the ordinary activities of the business, such as profit on a business disposal. **Expenses** reflect outflows, depletions of assets, and incurrences of liabilities that decrease equity. Expenses typically include such items as cost of sales (cost of goods sold), selling and administrative expenses, and income tax expenses and may be defined to include losses. Net income (revenue plus other income minus expenses) on the income statement is often referred to as the "bottom line" because of its proximity to the bottom of the income statement. Net income may also be referred to as "net earnings," "net profit," and "profit or loss." In the event that expenses exceed revenues and other income, the result is referred to as "net loss."

The income statement is sometimes referred to as a **statement of operations** or **profit and loss (P&L) statement**. The basic format of the income statement is Revenue – Expenses = Net income.

In general terms, when one company (the parent) controls another company (the subsidiary), the parent presents its own financial statement information consolidated with that of the subsidiary. (When a parent company owns more than 50 percent of the voting shares of a subsidiary company, it is presumed to control the subsidiary and thus presents consolidated financial statements.) Each line item of the consolidated income statement includes the entire amount from the relevant line item on the subsidiary's income statement (after removing any intercompany transactions). However, if the parent does not own 100 percent of the subsidiary, it is necessary for the parent to present an allocation of net income to the minority interests. Minority interests, also called non-controlling interests, refer to owners of the remaining shares of the subsidiary that are not owned by the parent. The share of consolidated net income attributable to minority interests is shown at the bottom of the income statement along with the net income attributable to shareholders of the parent company. Exhibit 3 presents the income statements of the Volkswagen Group from its 2017 annual report.

Exhibit 3: Income Statement of the Volkswagen Group (Excerpt)

€ million	2017	2016
Sales revenue	**230,682**	**217,267**
Cost of sales	(188,140)	(176,270)
Gross result	**42,542**	**40,997**
Distribution expenses	(22,710)	(22,700)
Administrative expenses	(8,254)	(7,336)
Other operating income	14,500	13,049
Other operating expenses	(12,259)	(16,907)
Operating result	**13,818**	**7,103**
Share of the result of equity-accounted investments	3,482	3,497
Interest income	951	1,285
Interest expenses	(2,317)	(2,955)
Other financial result	(2,022)	(1,638)
Financial result	**94**	**189**
Earnings before tax	**13,913**	**7,292**
Income tax income/expense	(2,275)	(1,912)
Current	(3,205)	(3,273)
Deferred	930	1,361
Earnings after tax	**11,638**	**5,379**
of which attributable to		

€ million	2017	2016
Noncontrolling interests	10	10
Volkswagen AG hybrid capital investors	274	225
Volkswagen AG shareholders	11,354	5,144
Basic earnings per ordinary share in €	**22.63**	**10.24**
Diluted earnings per preferred share in €	**22.69**	**10.30**

Note: The numbers are as shown in the annual report and may not add because of rounding.
Source: 2017 Volkswagen annual report.

Exhibit 3 shows that Volkswagen's sales revenue for the year ended 31 December 2017 was €231 billion. Subtracting cost of sales from revenue gives gross profit (called "gross results" by Volkswagen and "gross margin" by other companies) of €43 billion. After subtracting operating costs and expenses and adding other operating income, the company's operating profit (called "operating result" by Volkswaen) totals €14 billion. Operating profit represents the results of the company's usual business activities before deducting interest expense or taxes. Operating profit (also called operating income in addition to operating result) is thus often referred to as earnings before interest and taxes (EBIT).

Next, operating profit is increased by Volkswagen's share of the profits generated by certain of its investments (€3.5 billion) plus interest income of €1.0 billion, and decreased by losses from its other financial activities (€2.0 billion) and by interest expense of €2.3 billion, resulting in profit (earnings) before tax of €13.9 billion. Total income tax expense for 2017 was €2.3 billion, resulting in profit after tax (net income) of €11.6 billion. After allocating the profits attributable to minority interest ownership in Volkswagen subsidiary companies, the profit attributable to shareholders of Volkswagen for 2017 was €11.4 billion.

Companies present both basic and diluted earnings per share on the face of the income statement. Earnings per share numbers represent net income attributable to the class of shareholders divided by the relevant number of shares outstanding during the period. Basic earnings per share is calculated using the weighted-average number of common (ordinary) shares that were actually outstanding during the period and the profit or loss attributable to the common shareowners. Diluted earnings per share uses **diluted shares**—the number of shares that would hypothetically be outstanding if potentially dilutive claims on common shares (e.g., stock options or convertible bonds) were exercised or converted by their holders—and an appropriately adjusted profit or loss attributable to the common shareowners.

Volkswagen has two types of shareholders, ordinary and preferred, and presents earnings per share information for both, although there is no requirement to present earnings per share information for preferred shareowners. Volkswagen's basic earnings per ordinary share was €22.63. A note to the company's financial statements explains that this number was calculated as follows: €11.4 billion profit attributable to shareholders of Volkswagen, of which €6.8 billion is attributable to ordinary shareholders and the balance is attributable to preferred shareholders. The €6.8 billion attributable to ordinary shareholders divided by the weighted-average number of ordinary shares of 0.295 billion shares equals basic earnings per share of €22.63. Similar detail is provided in the notes for each of the earnings per share numbers.

An analyst examining the income statement might note that Volkswagen was profitable in both years. The company's profits increased substantially in 2017, primarily because of higher sales and lower other operating expenses (footnotes reveal this was largely due to $4 billion less in litigation expenses in 2017). The analyst might formulate questions related to profitability, such as the following:

- Is the change in revenue related to an increase in units sold, an increase in prices, or some combination?
- If the company has multiple business segments (for example, Volkswagen's segments include passenger cars, light commercial vehicles, and financial services, among others), how are the segments' revenue and profits changing?
- How does the company compare with other companies in the industry?

Answering such questions requires the analyst to gather, analyze, and interpret information from a number of sources, including, but not limited to, the income statement, corresponding notes and the management's discussion and analysis.

Other Comprehensive Income

Comprehensive income includes all items that impact owners' equity but which are not the result of transactions with shareowners. Some of these items are included in the calculation of net income, and some are included in other comprehensive income (OCI). When comprehensive income is presented in two statements, the statement of comprehensive income begins with the profit or loss from the income statement and then presents the components of OCI.

Exhibit 4 presents an excerpt from the statement of comprehensive income of the Volkswagen Group from its 2017 annual report.

Exhibit 4: Statement of Comprehensive Income of the Volkswagen Group (Excerpt)

€ million	Fiscal Year Ended 31 December 2017
Earnings after tax	**11,638**
Pension plan remeasurements recognized in other comprehensive income	
Pension plan remeasurements recognized in other comprehensive income, before tax	785
Deferred taxes relating to pension plan remeasurements recognized in other comprehensive income	(198)
Pension plan remeasurements recognized in other comprehensive income, net of tax	587
Share of other comprehensive income of equity-accounted investments that will not be reclassified to profit or loss, net of tax	96
Items that will not be reclassified to profit or loss	**683**
Exchange differences on translating foreign operations	
Unrealized currency translation gains/losses	(2,095)
Transferred to profit or loss	(4)
Exchange differences on translating foreign operations, before tax	(2,099)
Deferred taxes relating to exchange differences on translating foreign operations	(8)
Exchange differences on translating foreign operations, net of tax	(2,107)
Cash flow hedges	
Fair value changes recognized in other comprehensive income	6,137

€ million	Fiscal Year Ended 31 December 2017
Transferred to profit or loss	(558)
Cash flow hedges, before tax	5,579
Deferred taxes relating to cash flow hedges	(1,597)
Cash flow hedges, net of tax	3,982
Available-for-sale financial assets	
Fair value changes recognized in other comprehensive income	56
Transferred to profit or loss	62
Available-for-sale financial assets, before tax	118
Deferred taxes relating to available-for-sale financial assets	(25)
Available-for-sale financial assets, net of tax	93
Share of other comprehensive income of equity-accounted investments that may be reclassified subsequently to profit or loss, net of tax	(346)
Items that may be reclassified subsequently to profit or loss	**1,622**
Other comprehensive income, before tax	4,133
Deferred taxes relating to other comprehensive income	(1,828)
Other comprehensive income, net of tax	**2,305**
Total comprehensive income	**13,943**

Source: Volkswagen 2017 annual report.

Exhibit 4 shows total comprehensive income for 2017 was €13.9 billion, which is the sum of earnings after tax of €11.6 billion, reported on the income statement, and other comprehensive income of €2.3 billion. The items in OCI reflect changes in the company's equity that are not considered to be profit or loss, some of which may be reclassified as such in the future such as unrealized currency translation gains and losses.

STATEMENT OF CHANGES IN EQUITY AND CASH FLOW STATEMENT

9

☐ describe the roles of the statement of financial position, statement of comprehensive income, statement of changes in equity, and statement of cash flows in evaluating a company's performance and financial position

The statement of changes in equity, sometimes called the "statement of changes in owners' equity" or "statement of changes in shareholders' equity," primarily serves to report changes in the owners' investment in the business over time. The basic components of owners' equity are paid-in capital and retained earnings. Retained earnings include the cumulative amount of the company's profits that have been retained in the company. In addition, non-controlling or minority interests and reserves that represent accumulated OCI items are included in equity. The latter items may be shown separately or included in retained earnings. Volkswagen includes reserves as components of retained earnings.

The statement of changes in equity is organized to present, for each component of equity, the beginning balance, any increases during the period, any decreases during the period, and the ending balance. For paid-in capital, an example of an increase is a new issuance of equity and an example of a decrease is a repurchase of previously issued stock. For retained earnings, income (both net income as reported on the income statement and OCI) is the most common increase and a dividend payment is the most common decrease.

Volkswagen's balance sheet in Exhibit 1 shows that equity at the end of 2017 totaled €109 billion, compared with €93 billion at the end of 2016. The company's statement of changes in equity presents additional detail on the change in each line item. Exhibit 5 presents an excerpt of the statement of changes in equity of the Volkswagen Group from its 2017 annual report. For purposes of brevity, several interim columns were excluded from the presentation.

Exhibit 5: Statement of Changes in Equity of the Volkswagen Group (Excerpt)

€ million	Subscribed capital	Capital reserves	Retained earnings	Total equity
Balance at 1 January 2017	1,283	14,551	70,446	92,910
Earnings after tax	—	—	11,354	11,638
Other comprehensive income, net of tax	—	—	586	2,305
Total comprehensive income	—	—	11,940	13,943
Capital increases	—	—	—	3,481
Dividends payment	—	—	−1,015	−1,332
Capital transactions involving a change in ownership interest	—	—	—	—
Other changes	—	—	−4	75
Balance at 31 December 2017	1,283	14,551	81,367	109,077

Note: Numbers are as shown in the annual report and may not add and cross-add because of the exclusion of columns and due to rounding.

In Exhibit 5, as shown in the far right column, total equity is increased during the year by total comprehensive income of €13.9 billion and by capital infusions of €3.5 billion; it is decreased by dividends of €1.3 billion and finally, slightly increased by €75 million of other changes. Explanatory notes on equity are included in the notes to the consolidated financial statements.

Cash Flow Statement

Although the income statement and balance sheet provide measures of a company's success in terms of performance and financial position, cash flow is also vital to a company's long-term success. Net income may be influenced by accrual accounting and policy choices management makes in preparing its financial statements. However, the cash flow statements show how a company's cash balance changed over the course of the reporting period. Disclosing the sources and uses of cash helps creditors, investors, and other statement users evaluate the company's liquidity, solvency, and financial flexibility. **Financial flexibility** is the ability of the company to react and adapt to financial adversity and opportunities.

The cash flow statement classifies all cash flows of the company into three categories: operating, investing, and financing. Cash flows from **operating activities** generally involve the cash effects of transactions involved in the determination of net income and, hence, comprise the day-to-day operations of the company. Cash flows from **investing activities** are associated with the acquisition and disposal of long-term assets, such as property and equipment. Cash flows from **financing activities** relate to obtaining or repaying capital to be used in the business. IFRS permit more flexibility than US generally accepted accounting principles (GAAP) in classifying dividend and interest receipts and payments within these categories.

Exhibit 6 presents Volkswagen's statement of cash flows for the fiscal years ended 31 December 2017 and 2016.

Exhibit 6: Cash Flow Statement of the Volkswagen Group: 1 January to 31 December

€ million	2017	2016
Cash and cash equivalents at beginning of period	**18,833**	**20,462**
Earnings before tax	13,913	7,292
Income taxes paid	(3,664)	(3,315)
Depreciation and amortization of, and impairment losses on, intangible assets, property, plant and equipment, and investment property	10,562	10,100
Amortization of and impairment losses on capitalized development costs	3,734	3,586
Impairment losses on equity investments	136	130
Depreciation of and impairment losses on lease assets	7,734	7,107
Gain/loss on disposal of noncurrent assets and equity investments	(25)	(222)
Share of the result of equity-accounted investments	274	377
Other noncash expense/income	(480)	716
Change in inventories	(4,198)	(3,637)
Change in receivables (excluding financial services)	(1,660)	(2,155)
Change in liabilities (excluding financial liabilities)	5,302	5,048
Change in provisions	(9,443)	5,966
Change in lease assets	(11,478)	(12,074)
Change in financial services receivables	(11,891)	(9,490)
Cash flows from operating activities	**(1,185)**	**9,430**
Investments in intangible assets (excluding development costs), property, plant and equipment, and investment property	(13,052)	(13,152)
Additions to capitalized development costs	(5,260)	(5,750)
Acquisition of subsidiaries	(277)	(119)
Acquisition of other equity investments	(561)	(309)
Disposal of subsidiaries	496	(7)
Disposal of other equity investments	24	2,190
Proceeds from disposal of intangible assets, property, plant and equipment, and investment property	411	351
Change in investments in securities	1,376	(1,245)
Change in loans and time deposits	335	(2,638)
Cash flows from investing activities	**(16,508)**	**(20,679)**
Capital contributions	3,473	—
Dividends paid	(1,332)	(364)
Capital transactions with noncontrolling interest shareholders	—	(3)
Proceeds from issuance of bonds	30,279	14,262
Repayments of bonds	(17,877)	(23,601)

€ million	2017	2016
Changes in other financial liabilities	3,109	19,455
Lease payments	(28)	(36)
Cash flows from financing activities	**17,625**	**9,712**
Effect of exchange rate changes on cash and cash equivalents	(727)	(91)
Net change in cash and cash equivalents	**(796)**	**(1,628)**
Cash and cash equivalents at end of period	**18,038**	**18,833**

After showing the beginning cash balance, the operating activities section starts with profit before tax,[9] €13.9 billion for 2017, subtracts actual income tax payments, and then adjusts for the effects of non-cash transactions, accruals and deferrals, and transactions of an investing and financing nature to arrive at the amount of cash generated from operating activities: negative €1.2 billion (a net use of cash). This approach to reporting cash flow from operating activities is termed the indirect method. The direct method of reporting cash flows from operating activities discloses major classes of gross cash receipts and gross cash payments. Examples are cash received from customers and cash paid to suppliers and employees. However, very few companies use the direct method when reporting their cash flow statement.

The indirect method emphasizes the different perspectives of the income statement and cash flow statement. On the income statement, income is reported when earned, not necessarily when cash is received, and expenses are reported when incurred, not necessarily when paid. The cash flow statement presents another aspect of performance: the ability of a company to generate cash flow from running its business. Ideally, for an established company, the analyst would like to see that the primary source of cash flow is from operating activities as opposed to investing or financing activities.

The sum of the net cash flows from operating, investing, and financing activities and the effect of exchange rates on cash equals the net change in cash during the fiscal year. For Volkswagen, the sum of these four items was negative €796 million in 2017, decreasing the company's cash and cash equivalents from €18.8 billion at the beginning of the period to €18.0 billion at the end of the period.

SUMMARY

An awareness of financial reporting and underlying financial reporting standards can assist in security valuation and other financial analysis. This module describes the conceptual objectives of financial reporting standards, the parties involved in standard-setting processes, and the implication for analysts in monitoring developments in reporting standards.

Key points of this module are summarized below:

- The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.
- Financial reporting requires management to make policy choices and estimates. These choices and estimates require judgment, which can vary from one preparer to the next. Accordingly, standards are needed to ensure increased consistency in these judgments.

9 Other companies may choose to begin with net income.

- Private sector standard setting bodies and regulatory authorities play significant but different roles in the standard setting process. In general, standard setting bodies make the rules, and regulatory authorities enforce the rules. However, regulators typically retain legal authority to establish financial reporting standards in their jurisdiction.
- The IFRS framework sets forth the concepts that underlie the preparation and presentation of financial statements for external users.
- The objective of fair presentation of useful information is the center of the IASB's *Conceptual Framework*. The qualitative characteristics of useful information include fundamental and enhancing characteristics. Information must exhibit the fundamental characteristics of relevance and faithful representation to be useful. The enhancing characteristics identified are comparability, verifiability, timeliness, and understandability.
- *IFRS Financial Statements*: A complete set of financial statements includes a statement of financial position (balance sheet), a statement of comprehensive income (either two statements—one for net income and one for comprehensive income—or a single statement combining both net income and comprehensive income), a statement of changes in equity, a cash flow statement, and notes. The notes include a summary of significant accounting policies and other explanatory information.
- Financial statements need to reflect certain basic features: fair presentation, going concern, accrual basis, materiality and aggregation, and no offsetting.
- Financial statements must be prepared at least annually, must include comparative information from the previous period, and must be consistent.
- Financial statements must follow certain presentation requirements including a classified statement of financial position (balance sheet) and minimum information on both the face of the financial statements and in the notes.
- The primary purpose of financial reports is to provide information and data about a company's financial position and performance, including profitability and cash flows. The information presented in the reports—including the financial statements and notes and management's commentary or management's discussion and analysis—allows the financial analyst to assess a company's financial position and performance and trends in that performance.
- The primary financial statements are the statement of financial position (i.e., the balance sheet), the statement of comprehensive income (or two statements consisting of an income statement and a statement of comprehensive income), the statement of changes in equity, and the statement of cash flows.
- The balance sheet discloses what resources a company controls (assets) and what it owes (liabilities) at a specific point in time. Owners' equity represents the net assets of the company; it is the owners' residual interest in, or residual claim on, the company's assets after deducting its liabilities. The relationship among the three parts of the balance sheet (assets, liabilities, and owners' equity) may be shown in equation form as follows: Assets = Liabilities + Owners' equity.
- The income statement presents information on the financial results of a company's business activities over a period of time. The income statement communicates how much revenue and other income the company generated during a period and what expenses, including losses, it incurred in connection with generating that revenue and other income. The basic equation underlying the income statement is Revenue + Other income – Expenses = Net income.

- The statement of comprehensive income includes all items that change owners' equity except transactions with owners. Some of these items are included as part of net income, and some are reported as other comprehensive income (OCI).
- The statement of changes in equity provides information about increases or decreases in the various components of owners' equity.
- Although the income statement and balance sheet provide measures of a company's success, cash and cash flow are also vital to a company's long-term success. Disclosing the sources and uses of cash helps creditors, investors, and other statement users evaluate the company's liquidity, solvency, and financial flexibility.

PRACTICE PROBLEMS

1. Which of the following is *most likely* not an objective of financial statements?

   A. To provide information about the performance of an entity

   B. To provide information about the financial position of an entity

   C. To provide information about the users of an entity's financial statements

2. According to the *Conceptual Framework for Financial Reporting*, which of the following is *not* an enhancing qualitative characteristic of information in financial statements?

   A. Accuracy.

   B. Timeliness.

   C. Comparability.

3. Which of the following is *not* a constraint on the financial statements according to the *Conceptual Framework*?

   A. Understandability.

   B. Benefit versus cost.

   C. Balancing of qualitative characteristics.

4. The assumption that an entity will continue to operate for the foreseeable future is called:

   A. accrual basis.

   B. comparability.

   C. going concern.

5. The assumption that the effects of transactions and other events are recognized when they occur, not when the cash flows occur, is called:

   A. relevance.

   B. accrual basis.

   C. going concern.

6. Neutrality of information in the financial statements most closely contributes to which qualitative characteristic?

   A. Relevance.

   B. Understandability.

   C. Faithful representation.

7. Valuing assets at the amount of cash or equivalents paid or the fair value of the consideration given to acquire them at the time of acquisition most closely de-

scribes which measurement of financial statement elements?

A. Current cost.

B. Historical cost.

C. Realizable value.

8. The valuation technique under which assets are recorded at the amount that would be received in an orderly disposal is:

   A. current cost.

   B. present value.

   C. realizable value.

9. Which of the following elements of financial statements is *most* closely related to measurement of performance?

   A. Assets.

   B. Expenses.

   C. Liabilities.

10. Which of the following elements of financial statements is *most* closely related to measurement of financial position?

    A. Equity.

    B. Income.

    C. Expenses.

11. Providing information about the performance and financial position of companies so that users can make economic decisions *best* describes the role of:

    A. auditing.

    B. financial reporting.

    C. financial statement analysis.

12. A company's financial position would *best* be evaluated using the:

    A. balance sheet.

    B. income statement.

    C. statement of cash flows.

13. A company's profitability for a period would *best* be evaluated using the:

    A. balance sheet.

    B. income statement.

    C. statement of cash flows.

14. The financial statement that presents a shareholder's residual claim on assets is

the:

A. balance sheet.

B. income statement.

C. cash flow statement.

15. A company's profitability over a period of time is *best* evaluated using the:

A. balance sheet.

B. income statement.

C. cash flow statement.

16. The income statement is *best* used to evaluate a company's:

A. financial position.

B. sources of cash flow.

C. financial results from business activities.

SOLUTIONS

1. C is correct. Financial statements provide information, including information about the entity's financial position, performance, and changes in financial position, to users. They do not typically provide information about users.

2. A is correct. Accuracy is not an enhancing qualitative characteristic. Faithful representation, not accuracy, is a fundamental qualitative characteristic.

3. A is correct. Understandability is an enhancing qualitative characteristic of financial information—not a constraint.

4. C is correct. The *Conceptual Framework* identifies two important underlying assumptions of financial statements: accrual basis and going concern. Going concern is the assumption that the entity will continue to operate for the foreseeable future. Enterprises with the intent to liquidate or materially curtail operations would require different information for a fair presentation.

5. B is correct. Accrual basis reflects the effects of transactions and other events being recognized when they occur, not when the cash flows. These effects are recorded and reported in the financial statements of the periods to which they relate.

6. C is correct. The fundamental qualitative characteristic of faithful representation is contributed to by completeness, neutrality, and freedom from error.

7. B is correct. Historical cost is the consideration paid to acquire an asset.

8. C is correct. The amount that would be received in an orderly disposal is realizable value.

9. B is correct. The elements of financial statements related to the measure of performance are income and expenses.

10. A is correct. The elements of financial statements related to the measurement of financial position are assets, liabilities, and equity.

11. B is correct. This is the role of financial reporting. The role of financial statement analysis is to evaluate the financial reports.

12. A is correct. The balance sheet portrays the company's financial position on a specified date. The income statement and statement of cash flows present different aspects of performance during the period.

13. B is correct. Profitability is the performance aspect measured by the income statement. The balance sheet portrays the financial position. The statement of cash flows presents a different aspect of performance.

14. A is correct. Owners' equity is the owners' residual interest in (i.e., residual claim on) the company's assets after deducting its liabilities, which is information presented on the balance sheet.

15. B is correct. A company's profitability is best evaluated using the income statement. The income statement presents information on the financial results of a company's business activities over a period of time by communicating how much revenue was generated and the expenses incurred to generate that revenue.

16. C is correct. A company's revenues and expenses are presented on the income statement, which is used to evaluate a company's financial results (or profitability) from business activities over a period of time. A company's financial position is best evaluated by using the balance sheet. A company's sources of cash flow are best evaluated using the cash flow statement.