

Interpretation of Financial Statements

4th Edition

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	7
Interactions between the Financial Statements	9
Financial Statement Footnotes	10
Interpretation Tools	11
Ratio Analysis	11
Horizontal Analysis	12
Experience	14
Summary	14
Review Questions	15
Review Answers	16
 Chapter 2 – Interpretation of Cash and Investments	 17
Learning Objectives	17
Introduction	17
The Interpretation of Cash and Investments	17
Natural Cash Balance	18
Relevance of a Low Cash Figure	18
Restricted Cash	19
Events Triggering Changes in Cash	19
Sources of Cash	20
The Impact of Sales Growth on Cash	21
Sufficiency of the Cash and Investment Balance	21
The Liquidity of Investments	22
The Return on Investment	22
Analysis Conclusions	22
Review Questions	23
Review Answers	24
 Chapter 3 – Interpretation of Receivables	 25
Learning Objectives	25
Introduction	25
The Interpretation of Accounts Receivable	25
Inherent Profit Margin	26
Age of the Trade Receivables	27
Age of the Other Accounts Receivable	29
No Allowance for Doubtful Accounts	29
Reliability of the Allowance for Doubtful Accounts	29
No Allowance for Other Accounts Receivable	30
Amount of Bad Debts Recognized	30
Analysis Conclusions	30
Review Questions	32
Review Answers	33
 Chapter 4 – Interpretation of Inventory	 35
Learning Objectives	35
Introduction	35
The Interpretation of Inventory	35

Table of Contents

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
What is a Hidden Reserve?	42
Analysis Conclusions	42
Review Questions	44
Review Answers	45
Chapter 5 – Interpretation of Fixed Assets.....	47
Learning Objectives	47
Introduction	47
The Interpretation of Fixed Assets	47
Depreciation Method.....	49
Existence of Depreciation	51
Sufficiency of Depreciation.....	51
What is Being Capitalized	53
What is Being Derecognized	53
Proportion of Sales to Fixed Assets	53
Cash Flow Support of Fixed Assets	54
Proportion of Repairs to Fixed Assets	55
Analysis Conclusions	56
Review Questions	57
Review Answers	58
Chapter 6 – Interpretation of Other Assets	59
Learning Objectives	59
Introduction	59
The Interpretation of Prepaid Expenses.....	59
Nature of the Account Contents	60
The Increasing Account Balance.....	61
The Impact of Sales Growth on Prepaid Expenses.....	61
The Interpretation of Goodwill	61
Goodwill Impairment	62
Goodwill Amortization	62
Analysis Conclusions	62
Review Questions	63
Review Answers	64
Chapter 7 – Interpretation of Current Liabilities.....	65
Learning Objectives	65
Introduction	65
The Interpretation of Current Liabilities	65
Days Payables Outstanding	66
Changes in Payable Days.....	67
Sales Tax Payables Issues.....	68
Dividends Payable Issues	68
Wages Payable Issues	68
Income Taxes Payable Issues	68
Warranty Liability Issues	69
Unearned Revenues	69
Analysis Conclusions	69
Review Questions	70
Review Answers	71

Table of Contents

Chapter 8 – Interpretation of Debt	73
Learning Objectives	73
Introduction	73
The Interpretation of Debt	73
Financial Leverage	74
Debt-Equity Ratio	74
Interest Coverage Ratio	75
Relative Size of Debt	75
Seasonal Borrowings	76
Line of Credit Usage	76
Shifts from Long-term to Short-term Debt.....	76
Conversions from Payables to Debt.....	77
Conversions from Debt to Equity.....	77
Debt Forgiveness	77
Permanent Debt	77
Offshore Cash	78
Analysis Conclusions	78
Review Questions	79
Review Answers	80
Chapter 9 – Interpretation of Equity	81
Learning Objectives	81
Introduction	81
The Interpretation of Equity	81
The Book Value Concept.....	82
Tangible Book Value.....	83
Book Value per Share.....	83
Changes in Retained Earnings.....	84
Negative Retained Earnings	84
Appropriated Retained Earnings	85
Treasury Stock Usage	85
Number of Shares Authorized and Outstanding	86
Analysis Conclusions	86
Review Questions	87
Review Answers	88
Chapter 10 – Interpretation of Sales	89
Learning Objectives	89
Introduction	89
The Interpretation of Sales	89
The Trend of Sales	90
The Quality of Sales	90
The Reliability of Sales	91
The Timing of Revenue Recognition	91
Revenue at Gross or Net	91
Orders versus Sales	93
The Presence of Sales Discounts	93
The Trend of Sales Returns	94
Analysis Conclusions	94
Review Questions	95
Review Answers	96
Chapter 11 – Interpretation of the Cost of Sales and Gross Margin.....	97
Learning Objectives	97
Introduction	97
The Interpretation of the Cost of Sales and Gross Margin.....	97
Gross Margin Analysis	98

Table of Contents

Contribution Margin Analysis	99
The Inventory Build Concept.....	100
Direct Materials Changes.....	100
Obsolete Inventory Changes.....	101
Scrap Changes.....	101
Direct Labor Changes.....	101
Factory Overhead Changes	102
Freight In Changes	102
Analysis Conclusions	102
Review Questions	104
Review Answers	105
Chapter 12 – Interpretation of Operating Expenses.....	107
Learning Objectives	107
Introduction	107
The Interpretation of Operating Expenses	107
Horizontal Analysis	109
Strategy Impact on Operating Expenses	110
Research and Development Costs.....	110
Payroll Tax Wage Cap Issues.....	110
Commission Fluctuations.....	111
Noncash Operating Expenses.....	111
Rent Subleases	111
Supplies Expense and the Capitalization Limit	111
The Fixed Nature of Compensation in Operating Expenses	111
The Public Company Impact on Operating Expenses.....	112
The Big Bath.....	112
Analysis Conclusions	112
Review Questions	114
Review Answers	115
Chapter 13 – Interpretation of Other Income, Taxes, and Profits.....	117
Learning Objectives	117
Introduction	117
The Interpretation of Other Income, Taxes, and Profits	117
Implications of Interest and Dividend Income	118
Implications of Gains/Losses on Asset Sales	118
Effects of Interest Expense	118
Implications of Taxable Income.....	119
Effective Tax Rate	119
Net Profit Margin.....	119
Net Profit Ratio	119
Deflated Profit Growth	120
Core Earnings Ratio	121
Earnings per Share.....	122
Manipulation of Earnings per Share	123
Analysis Conclusions	124
Review Questions	125
Review Answers	126
Chapter 14 – Interpretation of Cash Flows.....	127
Learning Objectives	127
Introduction	127
The Interpretation of the Statement of Cash Flows	127
The Statement of Cash Flows	127
Overview of the Statement of Cash Flows.....	127
The Direct Method	128

Table of Contents

The Indirect Method.....	129
Examination of Cash Flows from Operating Activities.....	130
Examination of Cash Flows from Investing Activities	131
Examination of Cash Flows from Financing Activities.....	131
Cash Flow Return on Sales	132
Analysis Conclusions	133
Review Questions	134
Review Answers	135
Chapter 15 – Other Analysis Topics	137
Learning Objectives	137
Introduction	137
Financial Statement Audits, Reviews, and Compilations.....	137
Audit Opinions	137
Working Capital Analysis.....	138
Quick Ratio.....	139
Working Capital Productivity	140
Breakeven and the Margin of Safety.....	141
Breakeven Point.....	141
Dividend Performance.....	143
Dividend Payout Ratio	143
Dividend Yield Ratio	144
Analysis Conclusions	145
Review Questions	146
Review Answers	147
Chapter 16 – Additional Public Company Information.....	149
Learning Objectives	149
Introduction	149
The Form 10-K.....	149
Item 1. Business.....	151
Item 1A. Risk Factors	153
Item 1B. Unresolved Staff Comments	155
Item 1C. Cybersecurity	155
Item 2. Properties	155
Item 3. Legal Proceedings	156
Item 4. Mine Safety Disclosures.....	157
Item 5. Market for Company Stock.....	158
Item 6. Selected Financial Data	159
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation ..	160
Item 7A. Quantitative and Qualitative Disclosures about Market Risk	162
Item 8. Financial Statements and Supplementary Data	165
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	165
Item 9A. Controls and Procedures	165
Item 10. Directors, Executive Officers and Corporate Governance	167
Item 11. Executive Compensation.....	168
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.....	174
Item 13. Certain Relationships and Related Transactions, and Director Independence	175
Item 14. Principal Accountant Fees and Services.....	176
Analysis Conclusions	177
Review Questions	179
Review Answers	180
Glossary.....	181
Index	185