



51A Middle Street, Newburyport, MA 01950

Phone: 800-588-7039

contact@bhfe.com

www.bhfe.com

Course Information

Course Title: *Interpretation of Financial Statements* #363624

Number of continuing education credit hours recommended for this course

In accordance with the standards of the CFP Board, the IDFA, the IWI, and the National Registry of CPE Sponsors, CPE credits have been granted based on a 50-minute hour.

CFP®: 7.5 CFP Board of Standards Sponsor ID Number: 1008.

CDFA®: 11 Registered with the Institute for Divorce Financial Analysts.

CIMA®, CPWA®, RMA®: 11 Course # 24BCNHF009, IWI CE Sponsor ID# 222740.

CPA: 11 Accepted in all states.

National Registry of CPE Sponsors ID Number: 107615.

Sponsor numbers for states requiring sponsor registration

Florida Division of Certified Public Accountancy: 0004761 (Ethics #0011467)

Hawaii Board of Accountancy: 14003

New York State Board of Accountancy (for ethics): 002146

Ohio State Board of Accountancy: CPE.51 PSR

Pennsylvania Board of Accountancy: PX178025

Texas State Board of Accountancy: 009349

Course Description

Financial statements are designed to show the performance, financial condition, and cash flows of a business. The *Interpretation of Financial Statements* course reveals how to convert these statements into an open book that can be explored in depth, giving crucial insights to investors, lenders, and creditors. The course does so by describing the structure of the financial statements, noting a number of tools for extracting information from the statements, and providing a wealth of additional insights into the reasons for the presence of or changes in certain numbers within the statements. In short, this course contains the complete set of tools for breaking down and examining a set of financial statements.

Course Content

Publication/Revision date: 2/15/2024.

Author: Steven M. Bragg, CPA.

Final exam (online): Fifty-five questions (multiple-choice).

Program Delivery Method

Self-Study (NASBA QAS)

Subject Codes/Field of Study

NASBA (CPA): Finance; CFP Board: Financial Planning; IDFA: Investment Planning; IWI: Technical Investment Management.

Course Level, Prerequisites, and Advance Preparation Requirements

Level: NASBA (CPA): Overview; CFP Board: Advanced; IDFA: Intermediate; IWI :Overview

Prerequisites: None

Advance Preparation: None.

Learning Objectives:

- Recognize the accrual basis of accounting concept and how it functions, as well as the accounting equation concept.
- Specify the business situations indicated by different cash levels and cash designations.
- Cite the uses of the contribution margin and days sales outstanding measurements, as well as the situations in which they can be misleading.
- Specify the industry situations in which an investment in inventory is considered to be more or less critical, as well as the reasons for different inventory turnover levels.
- Cite the calculations used for the different depreciation methods, and the effects on profitability of the various depreciation rules.
- State the contents of the prepaid expenses line item, as well as the situations that can change this balance. Also note the circumstances under which goodwill is considered to be impaired.
- Identify the business conditions that can alter the balances in the current liabilities line items.
- Identify the circumstances causing a change in debt classification, as well as the situations in which the debt level can be considered minor.
- Specify the effects of debt-to-equity conversions on measurements, as well as the contents of the book value and tangible book value measurements.
- Recognize the situations causing reliable sales, as well as the types of investors attracted to rapid sales growth.
- Identify the contents of the cost of goods sold, and the methods used to improve the gross margin percentage.
- Define the contents of operating expenses, and the business situations that can cause these line items to change.
- Recognize the situations in which net operating losses may be generated, and the techniques used to improve the net profit margin and earnings per share.
- Specify the contents of the different classifications within the statement of cash flows.
- Identify the types of audit examinations, the uses to which the margin of safety can be put, and the contents of the dividend analysis formulas.
- Specify the required contents of the different sections of the Form 10-K.

Instructions for Taking This Course

- Log in to your secure account at www.bhfe.com. Go to "My Account."
- You must complete this course within one year of purchase (If the course is "Expired," contact us and we will add the latest edition of the course to your account (no charge).
- **To retain the course-PDF after completion (for future reference) and to enable enhanced navigation:** From "My Account," Download and save the course-PDF to your computer. This will enable the search function (Menu: Edit>Find) and bookmarks (icon on left side of document window).
- **Complete the course by** following the learning objectives listed for the course, studying the text, and, if included, studying the review questions at the end of each major section (or at the end of the course).
- **Once you have completed studying the course** and you are confident that the learning objectives have been met, answer the final exam questions (online).

Instructions for Taking the Online Exam

- Log in to your secure account at www.bhfe.com. Go to "My Account."
- A passing grade of at least **70%** is required on the exam for this course.
- You will have three attempts to pass the exam (call or email us after three unsuccessful attempts for instructions).
- The exam is not timed, and it does not need to be completed in one session.
- For a printed copy of the exam questions, open the exam and press "Print Exam."
- Once you pass the exam, the results (correct/incorrect answers) and certificate of completion appear in "My Account." A confirmation email is also sent.
- CFP Board and IRS credit hours, if applicable, are reported on Tuesdays and at the end of the month.

Have a question? Call us at 800-588-7039 or email us at contact@bhfe.com.

About the Author

Steven Bragg, CPA, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a Bachelor's degree in Economics from the University of Maine. He has been a two-time president of the Colorado Mountain Club, and is an avid alpine skier, mountain biker, and certified master diver. Mr. Bragg resides in Centennial, Colorado. He has written more than 250 books and courses, including *New Controller Guidebook*, *GAAP Guidebook*, and *Payroll Management*.

Copyright © 2024 by AccountingTools, Inc. All rights reserved.

Published by AccountingTools, Inc., Centennial, Colorado.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without the prior written permission of the Publisher. Requests to the Publisher for permission should be addressed to Steven M. Bragg, 6727 E. Fremont Place, Centennial, CO 80112.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

Table of Contents

Chapter 1 - Overview of the Financial Statements	1
The General Ledger	1
The Accrual Basis of Accounting	2
Costs versus Expenses	3
The Balance Sheet.....	4
The Income Statement	6
The Statement of Cash Flows	8
Interactions between the Financial Statements	10
Financial Statement Footnotes	11
Interpretation Tools.....	12
Ratio Analysis	13
Horizontal Analysis	14
Experience.....	15
Chapter 2 - Interpretation of Cash and Investments.....	18
The Interpretation of Cash and Investments	18
Natural Cash Balance	19
Relevance of a Low Cash Figure.....	20
Restricted Cash.....	20
Events Triggering Changes in Cash	21
Sources of Cash.....	21
The Impact of Sales Growth on Cash.....	22
Sufficiency of the Cash and Investment Balance	23
The Liquidity of Investments	23
The Return on Investment	24
Analysis Conclusions.....	24
Chapter 3 - Interpretation of Receivables	26
The Interpretation of Accounts Receivable.....	26
Inherent Profit Margin.....	27
Age of the Trade Receivables.....	28
Age of the Other Accounts Receivable	31
No Allowance for Doubtful Accounts.....	31
Reliability of the Allowance for Doubtful Accounts.....	31
No Allowance for Other Accounts Receivable.....	32
Amount of Bad Debts Recognized	32
Analysis Conclusions.....	32
Chapter 4 - Interpretation of Inventory	35
The Interpretation of Inventory	35
Relative Importance of Inventory.....	36
Age of the Inventory.....	38
Reality of the Ending Balance.....	40
Type of Costing System Used	41
Ownership of the Inventory	41
Reliability of the Reserve for Obsolete Inventory.....	41
Amount of Obsolete Inventory and Inventory Adjustments Recognized	42
What is a Hidden Reserve?.....	42
Analysis Conclusions.....	43
Chapter 5 - Interpretation of Fixed Assets.....	46
The Interpretation of Fixed Assets	46
Depreciation Method.....	49
Existence of Depreciation.....	52
Sufficiency of Depreciation.....	52

What is Being Capitalized	53
What is Being Derecognized	54
Proportion of Sales to Fixed Assets	54
Cash Flow Support of Fixed Assets	55
Proportion of Repairs to Fixed Assets	56
Analysis Conclusions	57
Chapter 6 - Interpretation of Other Assets	60
The Interpretation of Prepaid Expenses	60
Nature of the Account Contents	61
The Increasing Account Balance	62
The Impact of Sales Growth on Prepaid Expenses	62
The Interpretation of Goodwill	62
Goodwill Impairment	63
Goodwill Amortization	64
Analysis Conclusions	64
Chapter 7 - Interpretation of Current Liabilities	66
The Interpretation of Current Liabilities	66
Days Payables Outstanding	68
Changes in Payable Days	68
Sales Tax Payables Issues	69
Dividends Payable Issues	69
Wages Payable Issues	70
Income Taxes Payable Issues	70
Warranty Liability Issues	70
Unearned Revenues	70
Analysis Conclusions	71
Chapter 8 - Interpretation of Debt	73
The Interpretation of Debt	73
Financial Leverage	74
Debt-Equity Ratio	75
Interest Coverage Ratio	75
Relative Size of Debt	76
Seasonal Borrowings	76
Line of Credit Usage	76
Shifts from Long-term to Short-term Debt	77
Conversions from Payables to Debt	77
Conversions from Debt to Equity	77
Debt Forgiveness	78
Permanent Debt	78
Offshore Cash	78
Analysis Conclusions	79
Chapter 9 - Interpretation of Equity	81
The Interpretation of Equity	81
The Book Value Concept	82
Tangible Book Value	83
Book Value per Share	84
Changes in Retained Earnings	84
Negative Retained Earnings	85
Appropriated Retained Earnings	85
Treasury Stock Usage	86
Number of Shares Authorized and Outstanding	86
Analysis Conclusions	87
Chapter 10 - Interpretation of Sales	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.....	92
Orders versus Sales.....	93
The Presence of Sales Discounts	94
The Trend of Sales Returns	95
Analysis Conclusions.....	95
Chapter 11 - Interpretation of the Cost of Sales and Gross Margin	97
The Interpretation of the Cost of Sales and Gross Margin.....	97
Gross Margin Analysis	99
Contribution Margin Analysis	100
The Inventory Build Concept	101
Direct Materials Changes	102
Obsolete Inventory Changes.....	102
Scrap Changes	102
Direct Labor Changes.....	103
Factory Overhead Changes.....	103
Freight In Changes	103
Analysis Conclusions.....	104
Chapter 12 - Interpretation of Operating Expenses	106
The Interpretation of Operating Expenses	106
Horizontal Analysis	108
Strategy Impact on Operating Expenses.....	109
Research and Development Costs	109
Payroll Tax Wage Cap Issues.....	110
Commission Fluctuations	110
Non-Cash Operating Expenses.....	110
Rent Subleases.....	110
Supplies Expense and the Capitalization Limit	111
The Fixed Nature of Compensation in Operating Expenses.....	111
The Public Company Impact on Operating Expenses	111
The Big Bath	112
Analysis Conclusions.....	112
Chapter 13 - Interpretation of Other Income, Taxes, and Profits.....	114
The Interpretation of Other Income, Taxes, and Profits.....	114
Implications of Interest and Dividend Income	115
Implications of Gains/Losses on Asset Sales	115
Effects of Interest Expense.....	116
Implications of Taxable Income	116
Effective Tax Rate.....	116
Net Profit Ratio	117
Deflated Profit Growth.....	118
Core Earnings Ratio	119
Earnings per Share.....	120
Manipulation of Earnings per Share	121
Analysis Conclusions.....	122
Chapter 14 - Interpretation of Cash Flows.....	124
The Statement of Cash Flows	124
Overview of the Statement of Cash Flows	124
The Direct Method	125
The Indirect Method.....	127
Examination of Cash Flows from Operating Activities.....	128
Examination of Cash Flows from Investing Activities.....	129
Examination of Cash Flows from Financing Activities.....	130

Cash Flow Return on Sales.....	131
Analysis Conclusions.....	132
Chapter 15 - Other Analysis Topics.....	134
Financial Statement Audits, Reviews, and Compilations	134
Audit Opinions.....	135
Working Capital Analysis.....	135
Quick Ratio.....	136
Working Capital Productivity.....	137
Breakeven Point.....	138
Dividend Performance	141
Dividend Payout Ratio	141
Dividend Yield Ratio.....	142
Analysis Conclusions.....	143
Chapter 16 - Additional Public Company Information	145
The Form 10-K	145
Item 1. Business	148
Item 1A. Risk Factors.....	151
Item 1B. Unresolved Staff Comments.....	153
Item 1C. Cybersecurity.....	153
Item 2. Properties	153
Item 3. Legal Proceedings	154
Item 4. Mine Safety Disclosures.....	155
Item 5. Market for Company Stock	156
Item 6. Selected Financial Data.....	159
Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operation	159
Item 7A. Quantitative and Qualitative Disclosures about Market Risk.....	162
Item 8. Financial Statements and Supplementary Data	164
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.....	164
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	176
Item 13. Certain Relationships and Related Transactions, and Director Independence	177
Item 14. Principal Accountant Fees and Services.....	178
Analysis Conclusions.....	179
Answers to Chapter Questions	182
Glossary	194
Index	197

Preface

When someone asks for information about a business, they are likely to receive its financial statements. These statements quantify the results, financial position, and cash flows of a business. However, these documents only provide information at quite a high level, and so may obscure more than they reveal. *The Interpretation of Financial Statements* is designed to cut through this obscurity, describing a number of tools for dissecting financial statements, as well as a wealth of additional insights into the reasons for the presence of or changes in certain numbers.

The bulk of the book covers three topics, which are the interpretation of the balance sheet, income statement, and cash flows. Eight chapters address the various parts of the balance sheet, another four chapters cover the income statement, and a separate chapter examines the statement of cash flows. There is also a lengthy chapter pertaining to the contents and interpretation of additional public company information. In these chapters, we describe the accounts that make up the various line items in the financial statements, demonstrate the use of applicable analysis tools, and also discuss specific operational and financial issues that may be causing certain results to appear in the financial statements.

You can find the answers to many questions about the interpretation of financial statements in the following chapters, including:

- What are the circumstances under which a business can report a cash balance of exactly zero?
- What policy decisions can lead to an increase in the amount of accounts receivable?
- What might cause a spike in the cost of goods sold just prior to the end of the year?
- Are there any valid reasons for a decline in the proportion of depreciation to fixed assets?
- What is the implication of accounts payable being converted into debt?
- What are the circumstances under which a business might elect to buy back shares?
- What techniques can be used to evaluate the quality of sales?
- How can the capitalization limit impact the supplies expense?
- What are the possible reasons for an unusually large dividend?
- Which discussion topics in the Form 10-K can be used to evaluate the compensation of the management team?

The Interpretation of Financial Statements is designed for someone reviewing the financial statements of a business from the outside. This may be a lender, supplier, investor, or financial analyst. It can also be used by students to gain a deeper understanding of how to examine financial statements.

Centennial, Colorado
February 2024