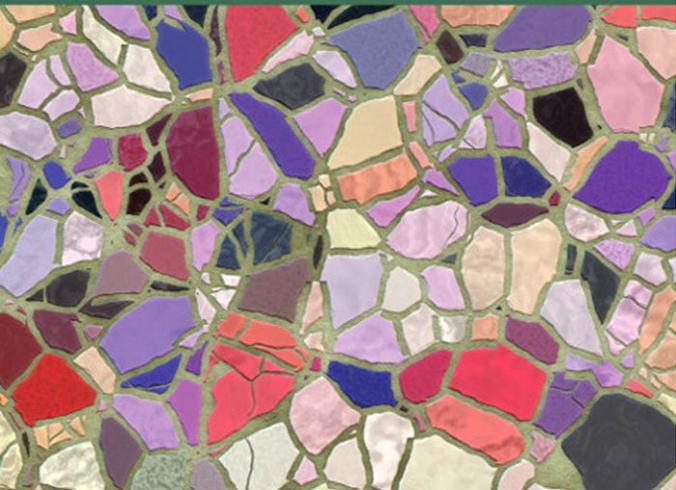




UNDERSTANDING
Financial Statements

TENTH EDITION

LYN M. FRASER | AILEEN ORMISTON





UNDERSTANDING FINANCIAL STATEMENTS

TENTH EDITION

Lyn M. Fraser

Aileen Ormiston

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**For Eleanor
—Lyn M. Fraser**

**For my father, Mike, Josh, and Jacqui
—Aileen Ormiston**

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Preface to the Tenth Edition

In this new edition of *Understanding Financial Statements*, Aileen and I continue with our objective of taking readers behind the numbers, dazzling presentations, and slick brand marketing of corporate annual reports to assess the reality of a firm's financial condition and performance. Based on the dramatic events that have unfolded in financial markets and the accounting environment as well as extensive feedback from our readers—faculty, students, practitioners, and many others who use the book to develop a better understanding of financial statement analysis—we have introduced some significant new elements in this tenth edition.

- Chapter 1 has been updated to include examples relating to ongoing financial turmoil, the evidence of corporate fraud, the rash of major corporate failures, and the staggering collapse of financial markets. The first chapter also introduces a new company, Sage Inc., which is used throughout the book to illustrate how to read and interpret financial statements.
- Material has been added and reorganized to emphasize the importance of *financial reporting quality* and to provide relevant examples from current corporate reporting.
- In every edition, we have focused on *cash flow from operations* as a measure of financial performance, but Chapter 4 in this tenth edition offers new material to underline its importance as an analytical tool and to enhance the discussion of the usefulness of the *statement of cash flows*, especially in light of the magnitude and quantity of recent business failures.
- Four new cases based on real-world companies have been added at the end of each chapter, along with new study questions and problems and an updated template for financial statement analysis.
- The text addresses current issues in financial reporting, including financial reporting reforms, the process for developing accounting standards, and the potential for requiring the adoption of international accounting standards.
- To lighten the load, we have introduced in this tenth edition a variety of “illustrations” that we hope will appeal to our readers. Let us know!

As always, our intent is to present the material in this book in a manner that is accessible, readable, and relevant in order to help readers make practical sense of complex financial information.

Lyn M. Fraser



Organization of the Tenth Edition

Chapter 1 provides an overview of financial statements and presents approaches to overcoming some of the challenges, obstacles, and blind alleys that may confront the user of financial statements: (1) the volume of information, with examples of specific problems encountered in such areas as the auditor's report and the management discussion and analysis section as well as material that is sometimes provided by management but is not useful for the analyst; (2) the complexity of the accounting rules that underlie the preparation and presentation of financial statements; (3) the variations in quality of financial reporting, including management discretion in some important areas that affect analysis; and (4) the importance of financial information that is omitted or difficult to find in conventional financial statement presentations.

Chapters 2, 3, 4, and 5 describe and analyze financial statements for a mythical but potentially real company, Sage Inc., which sells recreational products through retail outlets in the southwestern United States. The specifics of this particular firm should be helpful in illustrating how financial statement analysis can provide insight into a firm's strengths and weaknesses. But the principles and concepts covered throughout the book apply to any set of published financial statements (other than for specialized industries, such as financial institutions and public utilities).

Because one company cannot provide every account and problem the user will encounter in financial statements, additional company examples are introduced throughout the text where needed to illustrate important accounting and analytical issues.

Chapters 2 through 4 discuss in detail a basic set of financial statements: the balance sheet in Chapter 2, the income (earnings) statement and statement of stockholders' equity in Chapter 3, and the statement of cash flows in Chapter 4. The emphasis in each of these chapters is on what the financial statements convey about the condition and performance of a business firm as well as how the numbers have been derived. Appendix 3A discusses and illustrates issues that relate to the quality of earnings—and thus the usefulness—of financial reporting. The chapter contains a step-by-step checklist of key items to help the analyst assess the quality of reporting, and real-company examples of each step are provided.

With this material as background, Chapter 5 covers the interpretation and analysis of the financial statements discussed in Chapters 2 through 4. This process involves the

calculation and interpretation of financial ratios, an examination of trends over time, a comparison of the firm's condition and performance with its competitors, and an assessment of the future potential of the company based on its historical record. Chapter 5 also reviews additional sources of information that can enhance the analytical process. Appendix 5A shows how to evaluate the segmental accounting data reported by diversified companies that operate in several unrelated lines of business.

Self-tests at the ends of Chapters 1 through 5 provide an opportunity for the reader to assess comprehension (or its absence) of major topics; solutions to the self-tests are given in Appendix B. For more extensive student assignments, study questions and problems are placed at the end of the chapters. Cases drawn from actual company annual reports are used to highlight in a case-problem format many of the key issues discussed in the chapters.

Appendix A covers the computation and definition of the key financial ratios that are used in Chapter 5 to evaluate financial statements.

Appendix B contains solutions to self-tests for Chapters 1 through 5.

Appendix C presents a glossary of the key terms used throughout the book.

The ultimate goal of this book is to improve the reader's ability to translate financial statement numbers into a meaningful map for business decisions. It is hoped that the material covered in the chapters and the appendixes will enable each reader to approach financial statements with enhanced confidence and understanding of a firm's historical, current, and prospective financial condition and performance.



Uses for the Tenth Edition

Understanding Financial Statements is designed to serve a wide range of readers and purposes, which include:

1. Text or supplementary text for financial statement analysis courses.
2. Supplementary text for accounting, finance, and business management classes, which cover financial statement analysis.
3. Study material for short courses on financial statements in continuing education and executive development programs.
4. Self-study guide or course material for bank credit analysis training programs.
5. Reference book for investors and others who make decisions based on the analysis of financial statements.



Features of the Tenth Edition

In revising the text, we have paid close attention to the responses received from faculty who teach from the book, from students who take courses using the book as a primary or supplementary text, and from other readers of the book. Our primary objective remains to convey to readers the conceptual background and analytical tools necessary to understand and interpret business financial statements. Readers and reviewers of earlier editions have commented that the strengths of this book are its readability, concise coverage, and accessibility. We have attempted to retain these elements in the tenth edition.

The tenth edition incorporates new requirements and changes in accounting reporting and standards, as well as the following items:

- New examples are provided in all chapters to illustrate accounting concepts and the current accounting environment.
- Chapter 1 has been updated to include examples of accounting fraud that have occurred in recent years.
- Chapter 1 introduces Sage Inc., the company used throughout the book to illustrate how to read and interpret financial statements.
- Appendix 1A is new to this edition and includes excerpts from the Form 10-K of Sage Inc., including the financial statements and notes for the company, the auditor's report, and the management's discussion and analysis.
- The content found on the balance sheet has been updated in Chapter 2 to better reflect the current format of balance sheets.
- The section on the quality of financial reporting on the balance sheet (in Chapter 5 of the ninth edition) has been moved to Chapter 2.
- The interpretation of the income statement, using Sage Inc., in Chapter 3 now illustrates how the management's discussion and analysis can be used when completing an analysis of a company.
- Appendix 3A (formerly Chapter 5) has been updated with new examples and includes a discussion of the quality of earnings.
- A new introduction has been written for Chapter 4 to explain the importance of the cash flow statement and enhance the discussion of the preparation of the statement of cash flows.

- The section on the quality of financial reporting on the statement of cash flows (in Chapter 5 of the ninth edition) has been moved to Chapter 4.
- Chapter 5 was Chapter 6 in prior editions and has been updated to be consistent with the reorganization of the entire text.
- Study questions and problems have been updated in each of the five chapters.
- The writing skills problems, research problems, and Internet problems have been retained in this edition.
- The Intel cases offer the student the opportunity to analyze a real company throughout the text, and in this edition the highlighted company is Intel, a high-technology firm. Information for the Intel cases is available on the Pearson Web site: www.pearsonhighered.com/fraser.
- The comprehensive analysis case has been retained in the textbook to illustrate how to complete a financial statement analysis using the template available on the Pearson Web site: www.pearsonhighered.com/fraser. The company used is Avnet, and each chapter contains a case to help students apply the content of the chapter as well as learn to use the financial statement analysis template.
- Four new cases (including the Intel and Avnet cases) have been added at the end of all chapters based on real-world companies.
- Appendix 5A illustrates how to analyze segmental data using Sage Inc., the firm used throughout the textbook.
- The footnotes provided throughout the text contain resources that may be used by instructors to form the basis of a reading list for students.
- The tenth edition includes other features of earlier editions that readers have found useful: self-tests at the end of each chapter, with solutions provided; end-of-chapter study questions and problems; and a glossary of key terms used in the text.
- The Solutions and Instructor's Manual and Test Item File, available at www.pearsonhighered.com/fraser, contain solutions to study questions, problems, and cases; a sample course project with assignment outline and a test bank for Chapters 1 through 5 are also provided. Both objective and short-answer test questions are included.
- The Web site for the text has been updated and includes templates to use for financial calculations, PowerPoint slides that can be downloaded for use in class, and an online version of the self-tests.

We hope that readers will continue to find material in *Understanding Financial Statements* accessible, relevant, and useful.



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We would like to acknowledge with considerable appreciation those who have contributed to the publication of this book.

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We would also like to thank the editorial, production, and marketing departments of Pearson for their assistance at each stage of the writing and production process. Taking a book through production once the writing is completed always presents challenges to the authors and to Pearson. This particular 10th edition had an urgency to get the book into print early in 2012 to provide timely updating of material that relates to turmoil in the financial markets and economy as well as to accounting fraud and financial reporting quality. Heather Johnson has been superb in meeting this schedule, and the authors are appreciative of her exceptionally efficient handling of the process in a patient and cordial manner.

The list would be incomplete without mentioning the pets in our households who helped keep us in good humor throughout the revision of this edition: Toot, AddieMae, Escalante, Mooli, Teddy, Toby, Torin, and Tisha.

Lyn M. Fraser

Aileen Ormiston



About the Authors

Lyn M. Fraser has taught undergraduate and graduate classes in financial statement analysis at Texas A&M University and has conducted numerous seminars on the subject for executive development and continuing education courses. A Certified Public Accountant, she is the co-author with Aileen Ormiston of *Understanding the Corporate Annual Report: Nuts, Bolts, and a Few Loose Screws* (Prentice Hall, 2003) and has published articles in the *Journal of Accountancy*, the *Journal of Commercial Bank Lending*, the *Magazine of Bank Administration*, and the *Journal of Business Strategies*. She has been recognized for Distinguished Achievement in Teaching by the Former Students Association at Texas A&M University and is a member of Phi Beta Kappa.

Aileen Ormiston teaches accounting in the Business Department of Mesa Community College in Mesa, Arizona, and has taught in the MBA and honors programs at Arizona State University. She received her bachelor's degree in accounting from Michigan State University and a master's degree in finance from Texas A&M University. Prior to embarking on her teaching career, Aileen worked in cost accounting and also as an auditor in public accounting. Mesa Community College was one of 13 universities and colleges that received a grant from the Accounting Education Change Commission, and Aileen was actively involved in developing the new accounting curriculum. As a result of her pioneering work in changing accounting education, she was the recipient of the "Innovator of the Year" award from the League for Innovation in the Community College. For her service to honors students, Aileen has been named a Phi Theta Kappa mentor.

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Financial Statements

An Overview

maze (māz), n. 1. An intricate, usually confusing network of passages, some blind and some leading to a goal. 2. Anything made up of many confused or conflicting elements. 3. A mental state of confusion or perplexity.

Map or Maze

A *map* helps its user reach a desired destination through clarity of representation. A *maze*, on the other hand, attempts to confuse its user by purposefully introducing conflicting elements and complexities that prevent reaching the desired goal. Business financial statements have the potential for being both map and maze.

As a map, financial statements form the basis for understanding the financial position of a business firm and for assessing its historical and prospective financial performance. Financial statements have the capability of presenting clear representations of a firm's financial health, leading to informed business decisions.

Unfortunately, there are mazelike interferences in financial statement data that hinder understanding the valuable information they contain. The sheer quantity of information contained in financial statements can be overwhelming and intimidating. Independent auditors attest to the fairness of financial statement presentation, but many lawsuits have been filed and won against accounting firms for issuing "clean" auditors' reports on companies that subsequently failed. The complexity of accounting policies underlying the preparation of financial statements can lead to confusion and variations in the quality of information presented. In addition, these rules are constantly evolving and changing. Management discretion in a number of areas influences financial statement content and presentation in ways that affect and even impede evaluation. Some key information needed to evaluate a company is not available in the financial statements, some is difficult to find, and much is impossible to measure.



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One of the main objectives of this book is to ensure that financial statements serve as a map, not a maze—that they lead to a determination of the financial health of a business enterprise that is as clear as possible for purposes of making sound business decisions about the firm.

Ongoing financial turmoil, major corporate failures, and the staggering collapse of financial markets underscore the need for financial analysts, financial advisors, creditors, investors, and individuals managing personal assets to have a basic understanding of financial statements. While this book focuses on firms operating primarily in nonfinancial industries, many of the underlying principles discussed in the book apply as well to the kinds of financial services and investment management firms—the Wall Street banks—that triggered the economic collapse of 2008, the most serious economic crisis in modern history.

One example of an essential “map-like” principle conveyed in this book over all its editions is the importance of **cash flow from operations** as a key performance measure. This concept is fully discussed and illustrated in Chapter 4. Many firms have gone bankrupt while presenting rosy net income figures because of their inability to generate cash from operations. Lehman Brothers is a classic case.

In the three years prior to its bankruptcy in 2008, the largest in U.S. history, Lehman Brothers reported steadily increasing and robust net income figures of \$3.3 billion in 2005, \$4.0 billion in 2006, and \$4.2 billion in 2007. Cash flow from operations, however, which should have provided at least a hint of the financial disaster to come, was negative in those three years: \$12.2 billion in 2005, \$36.4 billion in 2006 and a whopping \$45.6 billion in 2007. As asset values tumbled, a company that already had staggering levels of debt had to borrow more and more to cover its failure to generate cash. The bankruptcies of the early 2000s such as Enron and WorldCom had similar map-like red flags. (See, for example, “I Told My Daughter Not to Invest in Enron” in *Understanding the Corporate Annual Report—Nuts, Bolts, and a Few Loose Screws*, Lyn M. Fraser and Aileen Ormiston, Prentice Hall, 2003).

The material in this book will convey information about how to read and evaluate business financial statements, and the authors will attempt to present the information in a straightforward manner, with relevant examples, that will be readily accessible to any reader, regardless of background or perspective. The book is intended for use by those who want to learn more about the content and interpretation of financial statements for such purposes as making sound investment and credit decisions about a company, evaluating a firm for current or prospective employment, surviving and advancing professionally in the current economic climate, and perhaps even passing an

important examination or course. Throughout the book, the authors attempt to simplify and explain complex accounting and financial issues in a way that allows readers not only to understand the information presented in annual reports but to identify areas of potential strength and weakness—based on the reader’s interpretation rather than on the “spin” provided by company management.



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The reader can expect more than a dull exposition of financial data and accounting rules. Throughout these pages we will attempt—using timely examples, illustrations, and explanations—to get behind the numbers, accounting policies, and tax laws to assess how well companies are actually performing. The chapters and appendixes in the book show how to approach financial statements to obtain practical, useful information from their content. Although the examples in the book are based on corporate financial statements, the discussion also applies to the financial statements of small business firms that use generally accepted accounting principles.

The emphasis throughout the book is on analysis. In the first four chapters of the book, we will look at the contents of an annual report and break the financial statements into parts for individual study to better understand the whole of their content as a map to intelligent decision making. To fully analyze a firm, it is important to assess the value of the information supplied by management. This material will be covered in Appendix 3A, on the quality of earnings. The final chapter of the book combines all parts learned in prior chapters with analytical tools and techniques to illustrate a comprehensive financial statement analysis.

Usefulness

Financial statements and their accompanying notes contain a wealth of useful information regarding the financial position of a company, the success of its operations, the policies and strategies of management, and insight into its future performance. The objective of the financial statement user is to find and interpret this information to answer questions about the company, such as the following:

- Would an investment generate attractive returns?
- What is the degree of risk inherent in the investment?

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- <http://serazard.com/lib/The-Secret-Life-of-Marilyn-Monroe.pdf>
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