Analysis of Financial Statements

CLE Course Objectives:  This presentation provides an overview of the three standard financial statements: the balance sheet, the income statement, and statement of cash flow. Attendees will learn the main reasons financial statement analysis is performed in a business valuation and the basic process that is involved in the analysis.

CLE Course Length:  2-4 hours
Note: The length and content of the presentation can be altered to fit your firm’s individual needs and time constraints.

CLE Course Outline

Analysis of Financial Statements

I. What are the main reasons for financial statement analysis?
   a. An estimation of the amount of future economic benefits through the normalization and projection of future cash flows
   b. An assessment of the probability or risk that the projected future economic benefits will be realized

II. The standard financial statements
   a. Balance sheet
      i. Statement of financial position at a given point in time
      ii. Typical components of the balance sheet
         1. Current assets
         2. Non-current assets
         3. Current liabilities
         4. Non-current liabilities
         5. Shareholder’s equity
      iii. Total assets = total liabilities + shareholder’s equity
      iv. Provide an example of a balance sheet
   
   b. Income statement
      i. Presents a financial summary of a company’s operating results for a certain period of time
      ii. Also referred to as a profit and loss statement or P&L
      iii. Typical components of the income statement
         1. Line items
            a. Revenues
            b. Cost of goods sold
c. Operating expenses  
d. Tax expense  

2. Profitability measures  
   a. Gross profit  
   b. Operating profit  
   c. Pretax profit  

iv. Provide an example of the income statement  
c. Statement of cash flows  
   i. Describes the cash flows in and out of a business over an accounting period  
   ii. Focuses on the types of activities that create and use cash  
   iii. Typical components of a statement of cash flows  
      1. Operating activities  
      2. Investing activities  
      3. Financing activities  

iv. Provide an example of the statement of cash flows  

III. Discovery advice  
a. Quality and depth of accounting records  
   i. Audited statements  
   ii. Reviewed statements  
   iii. Compiled statements  
   iv. Federal tax returns  
   v. Internal statements  
      1. Full-year statements  
      2. Interim statements  

b. Relevant time period of accounting records  
   i. The most commonly used period is the five years prior to the valuation date  
   ii. The most recent economic cycle prior to the valuation date  

c. Accounting software  
d. Spreadsheet accounting  

IV. The process of financial statement analysis  
a. Spreading historical financial statements  
   i. The yearly financial statements are laid side by side in columnar format  
   ii. Compares the business to itself and identifies trends or unusual items requiring further investigation or analysis  

b. Normalizing historical financial statements  
   i. Financial statement adjustments are made for a variety of reasons  
      1. To develop historical earnings in order to predict future earnings  
      2. To present historical financial information on a normalized basis  
      3. To adjust for accounting practices that are different from industry or GAAP standards
4. To allow for comparison of the company itself or to other companies
5. To compare the debt and capital structure of the company to its competition
6. To compare compensation with industry benchmarks

ii. Normalization generally involves adjusting a number of broad categories
   1. Unusual items
   2. Non-recurring and extraordinary items
   3. Non-operating items
   4. Changes in accounting principle
   5. Non-conformance with GAAP standards
   6. Degree of ownership interest
      a. Controlling or non-controlling

c. Common-sizing normalized financial statements
   i. Expresses each line item on the financial statements as a percentage of some base number
      1. For the balance sheet, each line item is expressed as a percentage of total assets
      2. For the income statement, each line item is expressed as a percentage of sales
   ii. Helps to identify operational trends and allow for comparison between the company and the industry

d. Performing ratio analysis on the normalized financial statements
   i. Helps to identify and quantify a company’s strengths and weaknesses
   ii. Commonly-used financial ratios
      1. Growth ratios
      2. Profitability ratios
      3. Liquidity ratios
      4. Activity ratios
      5. Leverage ratios
      6. Return on investment ratios

e. Comparing the normalized financial statements to the industry
   i. Highlights differences between the company’s historical performance and industry averages
   ii. Identifies operating strengths and weaknesses of the company compared to its peers
   iii. Assesses management effectiveness
   iv. Shows where the company is outperforming or underperforming the industry

V. Company risk analysis
   a. An assessment of the probability or risk that the projected future economic benefits will be realized
      i. Strengths
Analysis of Financial Statements – CLE Course Outline

ii. Weaknesses  
iii. Opportunities  
iv. Threats  
v. Macro-environmental risks

To further inquire about or to schedule a Morones Analytics’ CLE presentation for your firm, please contact Paul Heidt, the Director of Valuation Research, at 503-906-1583 or at paul@moronesanalytics.com.