INTERNATIONAL FINANCIAL STATEMENT ANALYSIS
CFA Institute is the premier association for investment professionals around the world, with over 124,000 members in 145 countries. Since 1963 the organization has developed and administered the renowned Chartered Financial Analyst® Program. With a rich history of leading the investment profession, CFA Institute has set the highest standards in ethics, education, and professional excellence within the global investment community and is the foremost authority on investment profession conduct and practice. Each book in the CFA Institute Investment Series is geared toward industry practitioners along with graduate-level finance students and covers the most important topics in the industry. The authors of these cutting-edge books are themselves industry professionals and academics and bring their wealth of knowledge and expertise to this series.
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5. Summary

Problems
The stated objective of the International Accounting Standards Board (IASB) is to produce accounting standards that are principle-based, internally consistent, and internationally converged. The resulting financial statements should provide a framework that gives capital market participants the tools to make rational and intelligent decisions. The role of the analyst as an interpreter of the numbers that appear in the financial statements is critical in this process.

Making valuation estimates and the accompanying decisions in an international context is, in principle, no different from a purely domestic one. In both cases, the financial reporting model is the primary source of the information required. Recommendations and decisions have to be made based on careful analysis. The learning outcomes and techniques described in this volume are designed to enable the analyst to do just that.

Collecting and analyzing data is the core analytical function, but communication is also critical. The best and most rigorous analysis has to be supplemented by an understanding of how investment decisions are made, or it will fail its purpose. It must be communicated to the intended recipient in a way that explains the logic behind the valuation estimate or recommendation and promotes understanding and action. Communication skills, in addition to analytical methods, are discussed in the readings.

The readings also point to the necessity of exercising judgment as part of the analytical process. This is particularly important in the context of International Financial Reporting Standards (IFRS). As noted, an important element of IFRS is that the standards are principle-based and not unduly prescriptive (as some perceive US Generally Accepted Accounting Principles to be). The objective is to allow a degree of flexibility that permits company management to present corporate results in the most meaningful way, while preserving the spirit intended—substance over form. However, this presents the analyst with an additional challenge in interpreting the published figures and comparing them with those of other entities.

CFA Institute and its members have long supported the development of a global set of accounting standards; the benefits, in terms of improved comparability for investors and lowered cost of capital for corporations, are evident. IFRS are now accepted or required, in whole or in part, in some 100 or more jurisdictions around the world. (So far, in the United States, only a few foreign registrants with the SEC are permitted to use the Standards.) Achieving comparability between companies reporting in Tokyo, Toronto, or Turin would seem to meet the cherished goal of a global financial reporting system. But a word of caution is warranted. Few countries want to give up sovereignty to an independent authority based in London, no matter how high the quality of the output may be. Standard setting is ultimately a political process, and powerful constituencies abound that have objectives that may differ from the provision of decision-useful information for investors. And in order to become law in many jurisdictions, some sort of endorsement mechanism has to be established. Endorsements can, in some cases, exclude provisions in standards, or offer exceptions or options not present in the original text. The result can be deviations from the published standards. While there may be one language,
various dialects can emerge, and the analyst must be vigilant to discern these differences, and their significance.

**Addendum: 30 September 2014**

Regrettably, Tony Cope, author of the preceding foreword, passed away in November 2013. As we prepare for the third edition and review his foreword to the second edition of the book, we cannot help but note how well his comments stand the test of time.

Tony was on the forefront of advocating for convergence in international accounting standards and for assuring consistency and transparency in how company performance is reported. Tony was a member of the US Financial Accounting Standards Board from 1993 to 2001. After playing a leading role in the Strategy Working Party that led to the creation of the International Accounting Standards Board (IASB) in 2001, Tony served as a member of the IASB from 2001 through 2007.

Tony made substantial, long-lasting contributions to the quality of global financial reporting. More than that, he was a friendly, caring person and is deeply missed by his many friends and colleagues.

Sandra Peters, CFA
11 November 2014
PREFACE

International Financial Statement Analysis is a practically oriented introduction to financial statement analysis. Each chapter covers one major area of financial statement analysis and is written by highly credentialed experts. By taking a global perspective on accounting standards, with a focus on international financial reporting standards (IFRS), and by selecting a broad range of companies for illustration, the book well equips the reader for practice in today’s global marketplace.

The content was developed in partnership by a team of distinguished academics and practitioners, chosen for their acknowledged expertise in the field, and guided by CFA Institute. It is written specifically with the investment practitioner in mind and is replete with examples and practice problems that reinforce the learning outcomes and demonstrate real-world applicability.

The CFA Program Curriculum, from which the content of this book was drawn, is subjected to a rigorous review process to assure that it is:

- Faithful to the findings of our ongoing industry practice analysis
- Valuable to members, employers, and investors
- Globally relevant
- Generalist (as opposed to specialist) in nature
- Replete with sufficient examples and practice opportunities
- Pedagogically sound

The accompanying workbook is a useful reference that provides Learning Outcome Statements, which describe exactly what readers will learn and be able to demonstrate after mastering the accompanying material. Additionally, the workbook has summary overviews and practice problems for each chapter.

We hope you will find this and other books in the CFA Institute Investment Series helpful in your efforts to grow your investment knowledge, whether you are a relatively new entrant or an experienced veteran striving to keep up to date in the ever-changing market environment. CFA Institute, as a long-term committed participant in the investment profession and a not-for-profit global membership association, is pleased to provide you with this opportunity.

THE CFA PROGRAM

If the subject matter of this book interests you, and you are not already a CFA charterholder, we hope you will consider registering for the CFA Program and starting progress toward earning the Chartered Financial Analyst designation. The CFA designation is a globally recognized standard of excellence for measuring the competence and integrity of investment professionals.
To earn the CFA charter, candidates must successfully complete the CFA Program, a global graduate-level self-study program that combines a broad curriculum with professional conduct requirements as preparation for a career as an investment professional.

Anchored by a practice-based curriculum, the CFA Program Body of Knowledge reflects the knowledge, skills, and abilities identified by professionals as essential to the investment decision-making process. This body of knowledge maintains its relevance through a regular, extensive survey of practicing CFA charterholders across the globe. The curriculum covers 10 general topic areas, ranging from equity and fixed-income analysis to portfolio management to corporate finance—all with a heavy emphasis on the application of ethics in professional practice. Known for its rigor and breadth, the CFA Program curriculum highlights principles common to every market so that professionals who earn the CFA designation have a thoroughly global investment perspective and a profound understanding of the global marketplace.
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International Financial Statement Analysis is designed to address the ever-increasing need for investment professionals and students to think about financial statement analysis from a global perspective. The text is a practically oriented introduction to financial statement analysis that is distinguished by its combination of a true international orientation, a structured presentation style, and abundant illustrations and tools covering concepts as they are introduced in the text. The authors cover this discipline comprehensively and with an eye to ensuring the reader’s success at all levels in the complex world of financial statement analysis.

Investments: Principles of Portfolio and Equity Analysis provides an accessible yet rigorous introduction to portfolio and equity analysis. Portfolio planning and portfolio management are presented within a context of up-to-date, global coverage of security markets, trading, and market-related concepts and products. The essentials of equity analysis and valuation are explained in detail and profusely illustrated. The book includes coverage of practitioner-important but often neglected topics, such as industry analysis. Throughout, the focus is on the practical application of key concepts with examples drawn from both emerging and developed markets. Each chapter affords the reader many opportunities to self-check his or her understanding of topics.

One of the most prominent texts over the years in the investment management industry has been Maginn and Tuttle’s Managing Investment Portfolios: A Dynamic Process. The third edition updates key concepts from the 1990 second edition. Some of the more experienced members of our community own the prior two editions and will add the third edition to their libraries. Not only does this seminal work take the concepts from the other readings and put them in a portfolio context, but it also updates the concepts of alternative investments, performance presentation standards, portfolio execution, and, very importantly, individual investor portfolio management. Focusing attention away from institutional portfolios and toward the individual investor makes this edition an important and timely work.


Quantitative Investment Analysis focuses on some key tools that are needed by today’s professional investor. In addition to classic time value of money, discounted cash flow applications, and probability material, there are two aspects that can be of value over traditional thinking. The first involves the chapters dealing with correlation and regression that ultimately figure into the formation of hypotheses for purposes of testing. This gets to a critical skill that challenges many professionals: the ability to distinguish useful information from the overwhelming quantity of available data. Second, the final chapter of Quantitative Investment Analysis covers portfolio concepts and takes the reader beyond the traditional capital asset pricing model (CAPM) type of tools and into the more practical world of multifactor models and arbitrage pricing theory.

All books in the CFA Institute Investment Series are available through all major booksellers. All titles also are available on the Wiley Custom Select platform at http://customselect.wiley.com, where individual chapters for all the books may be mixed and matched to create custom textbooks for the classroom.
INTERNATIONAL FINANCIAL STATEMENT ANALYSIS
1. INTRODUCTION

Financial analysis is the process of examining a company’s performance in the context of its industry and economic environment in order to arrive at a decision or recommendation. Often, the decisions and recommendations addressed by financial analysts pertain to providing capital to companies—specifically, whether to invest in the company’s debt or equity securities and at what price. An investor in debt securities is concerned about the company’s ability to pay interest and to repay the principal lent. An investor in equity securities is an owner with a residual interest in the company and is concerned about the company’s ability to pay dividends.
and the likelihood that its share price will increase. Overall, a central focus of financial analysis is evaluating the company’s ability to earn a return on its capital that is at least equal to the cost of that capital, to profitably grow its operations, and to generate enough cash to meet obligations and pursue opportunities. Fundamental financial analysis starts with the information found in a company’s financial reports. These financial reports include audited financial statements, additional disclosures required by regulatory authorities, and any accompanying (unaudited) commentary by management. Basic financial statement analysis—as presented in this chapter—provides a foundation that enables the analyst to better understand information gathered from research beyond the financial reports.

This chapter is organized as follows: Section 2 discusses the scope of financial statement analysis. Section 3 describes the sources of information used in financial statement analysis, including the primary financial statements (balance sheet, statement of comprehensive income, statement of changes in equity, and cash flow statement). Section 4 provides a framework for guiding the financial statement analysis process. A summary of the key points and practice problems in the CFA Institute multiple-choice format conclude the chapter.

2. SCOPE OF FINANCIAL STATEMENT ANALYSIS

The role of financial reporting by companies is to provide information about a company’s performance, financial position, and changes in financial position that is useful to a wide range of users in making economic decisions. The role of financial statement analysis is to use financial reports prepared by companies, combined with other information, to evaluate the past, current, and potential performance and financial position of a company for the purpose of making investment, credit, and other economic decisions. (Managers within a company perform financial analysis to make operating, investing, and financing decisions but do not necessarily rely on analysis of related financial statements. They have access to additional financial information that can be reported in whatever format is most useful to their decision.)

In evaluating financial reports, analysts typically have a specific economic decision in mind. Examples of these decisions include the following:

- Evaluating an equity investment for inclusion in a portfolio.
- Evaluating a merger or acquisition candidate.
- Evaluating a subsidiary or operating division of a parent company.
- Deciding whether to make a venture capital or other private equity investment.
- Determining the creditworthiness of a company in order to decide whether to extend a loan to the company and if so, what terms to offer.

1 The role of financial reporting is specified in International Accounting Standard (IAS) 1 Presentation of Financial Statements, paragraph 9, and paragraph 12 of the Framework for the Preparation and Presentation of Financial Statements. An updated framework is currently a joint project between the International Accounting Standards Board (IASB), which issues International Financial Reporting Standards (IFRS), and the Financial Accounting Standards Board (FASB). The FASB issues US generally accepted accounting principles (US GAAP) contained in the FASB Accounting Standards Codification™ (FASB ASC). The set of accounting standards that a company uses to prepare its financial reports depends on its jurisdiction. The IASB and FASB will be discussed further in a later chapter.