LM01 · FINANCIAL STATEMENT ANALYSIS · CFA LEVEL I

Introduction to Financial Statement Analysis

The analyst's framework for evaluating a firm's performance and financial position

What This Reading Covers

Financial reporting is how companies show their financial performance to investors, creditors, and other interested parties by preparing and presenting financial statements. **Financial statement analysis** uses those statements — combined with other information — to make economic decisions and decide whether to invest in a firm.

Roles of Financial Statement Analysis

1. Use financial statements and other information to make **economic decisions**
2. Evaluate **past performance** and **current financial position**
3. Form opinions about the company's ability to **earn profits**, **generate cash flow**, and its **risk factors**

Learning Outcome Statements

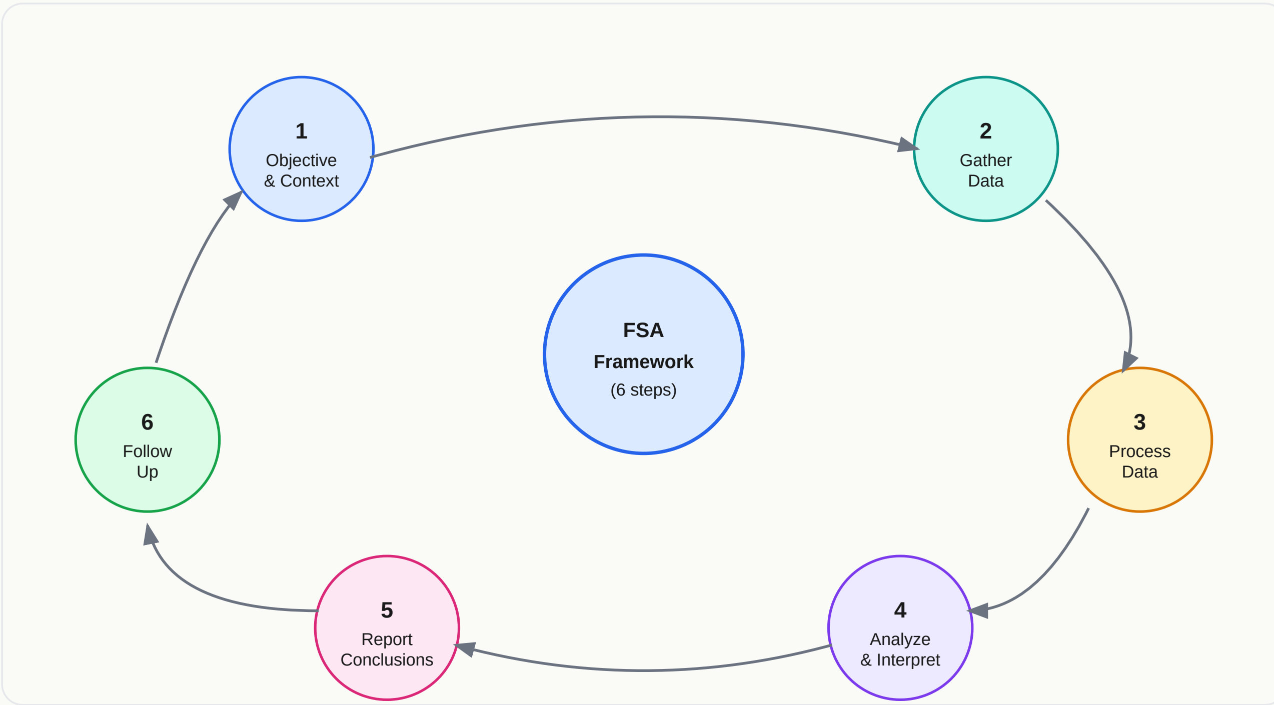
LOS a	Describe the financial statement analysis framework
LOS b	Describe the roles of the balance sheet, income statement, cash flow statement, and statement of changes in equity
LOS c	Describe the importance of financial statement notes and MD&A
LOS d	Describe the objective of audits and types of audit opinions
LOS e	Identify and describe other information sources used by analysts

Exam Tip: The 6-step framework, the four primary statements and what each measures, the four audit-opinion types (unqualified, qualified, adverse, disclaimer), and the list of SEC filings (10-K, 10-Q, 8-K, proxy) are the highest-frequency testables in LM01.

LOS A · FINANCIAL STATEMENT ANALYSIS FRAMEWORK

The Six-Step Analysis Framework

THE FSA FRAMEWORK — A CIRCULAR WORKFLOW



Detailed Actions at Each Step

STEP	ACTION	KEY DETAILS
1	Define the **purpose and context** of the analysis (objective and context)	Based on your function, client inputs, and organizational guidelines. Determine the time frame and resources available for the task.
2	**Collect / gather data**	From financial statements and other information sources.
3	**Process the data**	Make adjustments to financial statements; create graphs, ratios, common-size statements, etc.
4	**Analyze and interpret** the processed data	Apply judgment to the outputs of step 3.
5	Develop and **communicate conclusions / recommendations**	Report findings to the end user of the analysis.

6	**Follow up** / update the analysis	Conduct periodic reviews to check whether previous conclusions are still valid.

Remember: Step 6 is what makes this a framework rather than a linear checklist — the analyst must revisit earlier conclusions as new information becomes available.

LOS B · ROLES OF THE PRIMARY FINANCIAL STATEMENTS

The Four Primary Financial Statements

Financial reports include the **balance sheet, income statement, cash flow statement, and statement of changes in equity**. Periodic (interim) statements are unaudited; annual statements are audited, and all are prepared in accordance with applicable accounting standards.

WHAT EACH STATEMENT ANSWERS

BALANCE SHEET	INCOME STMT	CASH FLOW	CHANGES IN EQUITY
Financial Position	(Comp. Income)	Sources & Uses	
Point in time	Period of time	Period of time	Period of time
Assets = Liabilities + Owner's Equity	**Revenues − Expenses = Net Income**	**CFO (operations) CFI (investing) CFF (financing)**	**Paid-in capital Retained earnings OCI items**
What the firm owns, owes, and owners' residual claim	Performance over the period; also OCI (NI + OCI = TCI)	Change in cash from three activity categories	Beg. bal + Inc. − Dec. = End. for each account

Balance Sheet (Statement of Financial Position)

Reports the firm's **financial position at a specific point in time**.

ACCOUNTING EQUATION

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Assets resources controlled by the firm

Liabilities obligations to creditors

Equity residual claim of owners (A − L)

Assets What the company owns — resources the company controls

Liabilities What the company owes — obligations to lenders/creditors

Owner's Equity What the owners own — excess of assets over liabilities

IFRS specifies categories but not format; ordering by liquidity may differ. Typical presentation: current assets → long-lived assets (most to least liquid); current liabilities → non-current liabilities → equity.

Income Statement (Statement of Comprehensive Income)

Reports the firm's **financial performance over a period of time**.

$$\text{Net Income} = \text{Revenues} + \text{Other Income} - \text{Expenses}$$

Under IFRS, firms may present as a **single statement** of comprehensive income, or as **two statements**: an income statement plus a statement of comprehensive income (which begins with net income).

Other Comprehensive Income (OCI)

All items that impact owner's equity but are not the results of transactions with shareowners. Examples: **unrealized gains/losses** on certain securities, **foreign currency translations**, and **pension actuarial gains/losses**.

$$\text{NI} + \text{OCI} = \text{Total Comprehensive Income (TCI)}$$

Net income is expressed as both Basic and Diluted EPS. Consolidated statements are prepared when ownership is greater than 50%.

Cash Flow Statement

Reports the firm's **sources and uses of cash over a period of time**, in three categories:

CFO

Cash from day-to-day operating activities

CFI

Cash from acquisition and disposal of long-term assets (e.g., property and equipment)

CFF

Cash from activities related to obtaining or repaying capital used in the business

Statement of Changes in Owner's Equity

Reports the **changes in the owners' investment in the firm over time**. For each equity account:

$$\text{Beginning balance} + \text{Increases} - \text{Decreases} = \text{Ending balance}$$

Paid-in capital	Amount raised from owners
Retained earnings	Firm's profits that have been retained (not paid as dividends)

LOS C · FINANCIAL STATEMENT NOTES & MD&A

Financial Statement Notes and Management Commentary

Beyond the four statements, two types of narrative disclosure are essential to any analyst: the **footnotes** (notes to the financial statements) and **management's commentary / MD&A**.

Financial Statement Notes (Footnotes)

Footnotes provide **further details about the information summarized in the financial statements**. They allow users to improve their assessments of the **amount, timing, and uncertainty** of the estimates reported.

Footnotes do the following

1. Provide information about **accounting methods, assumptions, and estimates** used by management.
2. Are **audited**, whereas other disclosures, such as supplementary schedules, are **not audited**.
3. Provide additional information on business acquisitions/disposals, legal actions, employee benefit plans, contingencies and commitments, significant customers, related-party transactions, segment position and performance, and significant post-balance-sheet events.

Other Topics Frequently in Footnotes

Commitments and contingencies, legal proceedings, employee stock options and other benefits, related party transactions, and business and geographic segments.

Business / Operating Segments

A **business segment** or operating segment is a portion of a larger company that accounts for **more than 10% of the company's revenues, assets, or income**. Both U.S. GAAP and IFRS require companies to report segment data, but required disclosures are a subset of those for the company as a whole. **Geographic segments** are identified when they meet the size criterion and have a business environment different from other segments.

Workshop mind-map supplement: a segment should also earn at least **75% of its revenue externally**, and disclosure for each segment includes revenue (external and internal), segment result (operating profit), carrying amount of segment assets and liabilities, cost of PP&E and intangibles acquired, D&A and other non-cash expenses, income tax expense, and share of profit/loss from equity-accounted investments.

Management's Commentary / MD&A

MD&A (Management Discussion and Analysis) provides an assessment of the financial performance and condition of the company **from the perspective of its management**. For publicly held U.S. companies, MD&A is **required to discuss**:

1. **Trends, significant events, and uncertainties** that affect the firm
2. Effects of **inflation and changing prices**, if material
3. Impact of **off-balance-sheet and contractual obligations**
4. **Accounting policies that require significant judgment** by management
5. **Forward-looking expenditures and divestitures**

IFT source notes: additional MD&A topics include **liquidity and capital resources, off-balance-sheet obligations, and planned capital expenditures**.

Exam Tip: Footnotes are **audited**; supplementary schedules and most MD&A content are **not audited**. If a question contrasts what is and isn't covered by the auditor, footnotes are always in — press releases and corporate PR content are always out.

LOS D · AUDITS AND AUDIT OPINIONS

Audits of Financial Statements

An **audit** is an independent review of an entity's financial statements. Public accountants conduct audits and examine the financial reports and supporting records. The objective is to enable the auditor to **express an opinion on the fairness and reliability** of the financial reports.

Responsibilities & Scope

The independent certified public accounting firm is **employed by the board of directors** and is responsible for seeing that the financial statements conform to generally accepted accounting principles (GAAP). The auditor examines the company's accounting and **internal control systems**, confirms assets and liabilities, and generally tries to be confident there are **no material errors**.

Three Parts of the Standard Auditor's Opinion

1. Financial statements are prepared by **management** and are its responsibility; the auditor has performed an **independent review**.
2. **Generally accepted auditing standards were followed**, thus providing reasonable assurance that the statements contain no material errors.
3. The auditor is satisfied that the statements were prepared in accordance with accepted accounting principles and that the **accounting principles chosen and estimates made are reasonable**. The report must contain additional explanation when accounting methods have **not been used consistently between periods**.

The Four Audit Opinion Types

UNQUALIFIED (CLEAN)

Reasonable assurance that the financial statements are fairly presented, free from material omissions and errors. Also called "unmodified" or "clean" opinion. This is what companies want — and what analysts hope to see.

QUALIFIED

Some **misstatement or exception to accounting standards**. The auditor issues a qualified opinion and **explains these exceptions in the audit report**.

ADVERSE

Statements are **not presented fairly** or are **materially nonconforming** with accounting standards.

DISCLAIMER OF OPINION

Auditor is **unable to express an opinion** (e.g., scope limitation). Any opinion other than unqualified is sometimes referred to as a **modified opinion**.

Explanatory Paragraphs & Key Audit Matters

The auditor's opinion will also contain an **explanatory paragraph** when a material loss is probable but the amount cannot be reasonably estimated. Such uncertainties may relate to:

1. The **going concern assumption** (the firm will continue to operate for the foreseeable future)
2. The **valuation or realization of assets**
3. **Litigation**

Key / Critical Audit Matters

An audit report must also include a section called **key audit matters** (international reports) or **critical audit matters** (United States), which highlights accounting choices that are of **greatest significance to users** of financial statements.

Sarbanes-Oxley — Internal Controls (U.S. only)

Under U.S. GAAP, the auditor must **state an opinion on a publicly traded company's internal controls** — the processes by which the company ensures that it presents accurate financial statements. Internal controls are the responsibility of the firm's **management**. Under the Sarbanes-Oxley Act, management is required to provide a **report on the company's internal control system**.

Exam Tip: Memorize the order of strictness: **Unqualified (clean)** → **Qualified** → **Adverse** → **Disclaimer**. A disclaimer is not "worse than adverse" in a strict ranking — it means the auditor could not form an opinion at all. An unqualified opinion does *not* guarantee no fraud; it only offers *reasonable assurance*.

QUIZ 1 · CHECKPOINT

Test Your Understanding: Framework, Statements, Audit

Q1. Which of the following is *not* one of the six steps of the financial statement analysis framework?

Q2. Which statement reports the firm's *financial position at a specific point in time*?

Q3. An auditor issues an opinion stating that the financial statements are "not presented fairly." This is *best* described as a:

Q4. Which of the following is *most likely* audited?

Q5. Under IFRS, "Other Comprehensive Income" (OCI) would *most likely* include:

LOS E · OTHER INFORMATION SOURCES

Other Sources of Information for Analysts

In addition to the four primary financial statements, notes, and MD&A, analysts can obtain information from many other sources. The 2025 workshop groups them into four buckets:

ISSUER SOURCES

Earnings calls, presentations and investor day events, press releases, company website and company visits, communications (speaking) with management.

PUBLIC THIRD-PARTY SOURCES

Industry white papers, journals, government economic statistics, media sources, social media.

PROPRIETARY THIRD-PARTY SOURCES

Analyst reports, reports from data platforms, reports from agencies or consultancies.

PROPRIETARY PRIMARY RESEARCH

Analysts can generate their own information through surveys, conversations, and product evaluations — commissioned studies, hands-on experience, and technical specialists.

Specific Source Detail

SOURCE	WHAT ANALYSTS GET
Proxy statements	Issued to shareholders when matters require a shareholder vote. Filed with the SEC and available from EDGAR. A good source of information about the **election of (and qualifications of) board members, compensation, management qualifications, and the issuance of stock options**.
Corporate reports & press releases	Written by management; often viewed as **public relations or sales materials**. Not all material is independently reviewed by outside auditors. Often found on the company's website.
Earnings guidance	Management may provide guidance to analysts before releasing the firm's financial statements.
Economic & industry information	Trade journals, statistical reporting services, and government agencies — used to assess economic conditions and compare the company to competitors.

Analyst-generated data	Surveys, conversations, product evaluations performed by the analyst directly.

Caution on Management-Produced Content

Corporate reports and press releases are often PR-oriented and are **not independently reviewed by outside auditors**. Treat them as inputs, not audited facts.

LOS E · REGULATORY FILINGS (SEC FORMS)

SEC-Required Filings

Any company issuing securities in the U.S. is subject to the rules and regulations of the **SEC** (Securities and Exchange Commission). Companies must submit **standardized filings electronically via EDGAR**.

Key SEC Forms Listed in the Sources

FORM	PURPOSE
Form S-1	Registration statement for a new securities offering.
Form 10-K	Annual financial statement filing (audited).
Form 10-Q	Quarterly financial statement filing.
Form 8-K	Filed to report **events** such as acquisitions and disposals of major assets, or changes in management or corporate governance.
Form DEF-14A	Definitive proxy statement (matters requiring a shareholder vote).
Form 144	Notice of proposed sale of restricted securities.
Forms 3, 4, and 5	Filings by directors, officers, and beneficial owners of more than 10% of equity (insider ownership/changes).
Proxy statements	Issued to shareholders when matters require a vote; available via EDGAR.

WHEN TO EXPECT EACH FILING

ANNUAL	QUARTERLY	EVENT-DRIVEN	SHAREHOLDER VOTE
10-K	**10-Q**	**8-K**	**DEF-14A**
audited financials	interim statements	M&A, mgmt changes	proxy statement

Exam Tip: The three filings most likely to appear on the exam: **10-K** (annual), **10-Q** (quarterly), **8-K** (event-driven — acquisitions/disposals, management changes). Proxy statements are filed via Form DEF-14A on EDGAR.

SUPPLEMENT · STANDARD-SETTING BODIES AND REGULATORS

Standard Setters vs. Regulatory Authorities

STANDARD-SETTING BODIES

Private-sector professional organizations of accountants and auditors that **set** financial reporting standards. Typically independent, not-for-profit.

Examples: FASB, IASB

REGULATORY AUTHORITIES

Government agencies with legal authority to **recognize, require, and enforce** compliance with financial reporting standards.

Examples: SEC (U.S.), FCA (U.K.)

The Two Primary Standard Setters

IASB

International Accounting Standards Board — sets the **International Financial Reporting Standards (IFRS)**. Some older standards are referred to as **International Accounting Standards (IAS)**.

Principal objective: develop/promote the use and adoption of a single set of standards that produce **transparent, comparable, and decision-useful** information — and promote convergence of standards.

FASB

Financial Accounting Standards Board — sets **U.S. Generally Accepted Accounting Principles (U.S. GAAP)**.

Significant differences between IFRS and U.S. GAAP still exist despite ongoing convergence efforts.

IOSCO — International Organization of Securities Commissions

Members make up **95% of the world's financial markets**. IOSCO is **not a regulatory body** and does not develop regulations, but its members work together to improve cross-border cooperation and make national regulations more uniform.

Three Core Objectives of Regulation

1. **Protect investors**
2. Ensure markets are **fair, efficient, and transparent**
3. **Reduce systemic risk**

IFRS vs. U.S. GAAP

A significant percentage of listed companies use either IFRS or U.S. GAAP. An analyst must be cautious when comparing financial measures between companies reporting under different frameworks — **specific adjustments** may be needed to achieve comparability. Analysts must monitor the rapidly evolving standards and assess their implications for security analysis and valuation.

QUIZ 2 · CHECKPOINT

Test Your Understanding: Notes, Sources, Filings

Q6. A U.S.-listed company has just announced the acquisition of a major competitor. Which SEC filing is *most likely* used to disclose this event?

Q7. An analyst looking for information on the qualifications and compensation of a company's board of directors is *best* served by reviewing:

Q8. Which body is a *regulatory authority* rather than a standard-setting body?

Q9. Which of the following is *most likely* a business or operating segment per the sources?

Q10. IOSCO is *best* described as:

INTEGRATION · PUTTING THE FRAMEWORK TO WORK

How an Analyst Uses Each Piece

The sources describe a layered information landscape. Here is how each input feeds an analyst's decision.

INPUT	WHAT IT ANSWERS	AUDITED?
Balance sheet	What does the firm own and owe at a point in time?	Yes (annual)
Income statement	What was performance over the period? (NI, OCI, EPS)	Yes (annual)
Cash flow statement	Where did cash come from / go? (CFO, CFI, CFF)	Yes (annual)
Statement of changes in equity	How did each equity account move over the period?	Yes (annual)
Footnotes	What accounting methods, estimates, and additional details lie behind the numbers?	**Yes**
MD&A	What does management think about trends, liquidity, off-balance-sheet items, and forward plans?	No (generally)
Audit report	Are the statements fairly presented? (4 opinion types)	N/A (is the audit)
Proxy statement	Board composition, compensation, stock options	No
Corporate press releases	Management-supplied updates	No
Earnings calls / Investor days	Management narrative and guidance	No
Industry white papers, analyst reports, gov't data	Context, benchmarks, competitive positioning	Varies

Footnotes & MD&A — Why Both Matter

The 2025 mind-map captures the role crisply: **Footnotes and MD&A help explain the financial statements** — providing extra information on the primary statements and disclosing significant choices or methods, estimates, and assumptions used.

Periodic vs. Annual Statements

Periodic (interim)

Unaudited. Typically quarterly (e.g., 10-Q).

Annual

Audited. Filed on Form 10-K for U.S. companies.

SUPPLEMENT · SEGMENT REPORTING

Business & Geographic Segment Disclosures

Both U.S. GAAP and IFRS require companies to report **segment data**. The required disclosure items are a **subset** of the required disclosures for the company as a whole.

Segment Definition Criteria

1. A portion of a larger company that accounts for **more than 10%** of the company's **revenues, assets, or income**
2. Earns **75% of its revenue externally** (workshop criterion)
3. For **geographic segments**: must meet the size criterion *and* have a business environment different from that of other segments or the remainder of the company's business

Disclosures Required for Each Segment

Core figures

- Revenue (external and internal)
- Segment result (operating profit)
- Income tax expense

Asset-related

- Carrying amount of segment assets and liabilities
- Cost of PP&E and intangibles acquired
- Depreciation and amortization expense
- Other non-cash expenses

Equity-accounted investments

Share of profit/loss from equity-accounted investments (associates / joint ventures).

Exam Tip: A common exam question pattern: given thresholds (e.g., "10% of revenue OR 10% of assets OR 10% of income"), can a sub-unit be classified as a reportable segment? Remember — "OR" not "AND." Meeting any one triggers segment reporting.

QUIZ 3 · CHECKPOINT

Test Your Understanding: Integration

Q11. In the six-step financial statement analysis framework, "making adjustments to financial statements, and creating graphs, ratios, and common-size statements" occurs during which step?

Q12. An auditor is unable to collect sufficient evidence to form an opinion on a firm's financial statements. Which opinion type *most likely* applies?

Q13. Under Sarbanes-Oxley, the auditor of a U.S. publicly traded company must also provide an opinion on the company's:

Q14. Which MD&A disclosure topic is *required* for U.S. publicly held companies?

Q15. Which statement about an unqualified audit opinion is *most accurate*?

MODULE COMPLETE

Your Scorecard

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LM01 Key Takeaways — Exam-Ready Cheat Sheet

The 6-Step Framework

1. **Define the purpose and context** — set scope, client needs, timeline, resources.
2. **Collect data** — financial statements + other sources.
3. **Process data** — adjustments, ratios, graphs, common-size statements.
4. **Analyze and interpret** the processed data.
5. **Communicate conclusions** or recommendations.
6. **Follow up** — periodic reviews to check whether prior conclusions still hold.

The Four Primary Statements

1. **Balance sheet** (statement of financial position) — point in time; Assets = Liabilities + Equity.
2. **Income statement** (statement of comprehensive income) — period of time; Rev − Exp = NI; NI + OCI = TCI.
3. **Cash flow statement** — period of time; CFO + CFI + CFF = change in cash.
4. **Statement of changes in equity** — period of time; Beg + Inc − Dec = End for each equity account.

Footnotes & MD&A

5. **Footnotes are audited**; supplementary schedules and press releases are not. Footnotes cover accounting methods/estimates, acquisitions, legal actions, segments, contingencies, related-party transactions, employee benefits.

6. **MD&A** (U.S. required) — trends, inflation effects, off-balance-sheet obligations, judgmental policies, forward-looking expenditures and divestitures.

Audit Opinions (4 Types)

7. **Unqualified (clean)** — reasonable assurance of fair presentation.
8. **Qualified** — specific exceptions explained.
9. **Adverse** — not presented fairly / materially nonconforming.
10. **Disclaimer** — auditor unable to express an opinion. "Modified" = anything other than unqualified.

Other Sources & SEC Filings

11. **Issuer sources** — earnings calls, investor days, press releases, company visits. **Third-party** — white papers, analyst reports, government data. **Proprietary primary** — surveys, product evaluations.
12. **Key SEC forms:** S-1 (registration), **10-K** (annual), **10-Q** (quarterly), **8-K** (events: M&A, mgmt changes), DEF-14A (proxy), Form 144, Forms 3/4/5.
13. **Segment:** >10% of revenue, assets, or income; 75% of revenue external; separate disclosure required.

Last-Minute Exam Checklist

Framework: Purpose → Data → Process → Analyze → Communicate → Follow-up

Four statements: BS (point) · IS (period) · CF (period) · Equity (period)

Audited: Primary statements + footnotes. **Not audited:** MD&A, press releases, supp. schedules

Audit opinions: Unqualified → Qualified → Adverse → Disclaimer

SEC forms: 10-K (yr) · 10-Q (qtr) · 8-K (event) · DEF-14A (proxy)

Standard setters (private): IASB → IFRS · FASB → U.S. GAAP. **Regulators (gov):** SEC, FCA. **IOSCO:** not a regulator — sets objectives