

# STUDY SESSION

# 6

## Financial Statement Analysis (2)

**T**his study session addresses the three major financial statements—the income statement, the balance sheet, and the cash flow statement—by examining each in turn. The purpose, elements of, construction, pertinent ratios, and common-size analysis are presented for each major financial statement. The session concludes with a discussion of financial analysis techniques including the use of ratios to evaluate corporate financial health.

### READING ASSIGNMENTS

<b>Reading 17</b>	Understanding Income Statements by Elaine Henry, PhD, CFA, and Thomas R. Robinson, PhD, CFA
<b>Reading 18</b>	Understanding Balance Sheets by Elaine Henry, PhD, CFA, and Thomas R. Robinson, PhD, CFA
<b>Reading 19</b>	Understanding Cash Flow Statements by Elaine Henry, PhD, CFA, Thomas R. Robinson, PhD, CFA, J. Hennie van Greuning, DCom, CFA, and Michael A. Broihahn, CPA, CIA, CFA
<b>Reading 20</b>	Financial Analysis Techniques by Elaine Henry, PhD, CFA, Thomas R. Robinson, PhD, CFA, and J. Hennie van Greuning, DCom, CFA

**Note:** Changes in accounting standards as well as new rulings and/or pronouncements issued after the publication of the readings on financial reporting and analysis may cause some of the information in these readings to become dated. Candidates are *not* responsible for anything that occurs after the readings were published. In addition, candidates are expected to be familiar with the analytical frameworks contained in the readings, as well as the implications of alternative accounting methods for financial analysis and valuation discussed in the readings. Candidates are also responsible for the content of accounting standards, but not for the actual reference numbers. Finally, candidates should be aware that certain ratios may be defined and calculated differently. When alternative ratio definitions exist and no specific definition is given, candidates should use the ratio definitions emphasized in the readings.

**LEARNING OUTCOMES****READING 17. UNDERSTANDING INCOME STATEMENTS**

The candidate should be able to:

- a** describe the components of the income statement and alternative presentation formats of that statement;
- b** describe general principles of revenue recognition and accounting standards for revenue recognition;
- c** calculate revenue given information that might influence the choice of revenue recognition method;
- d** describe general principles of expense recognition, specific expense recognition applications, and implications of expense recognition choices for financial analysis;
- e** describe the financial reporting treatment and analysis of non-recurring items (including discontinued operations, unusual or infrequent items) and changes in accounting policies;
- f** contrast operating and non-operating components of the income statement;
- g** describe how earnings per share is calculated and calculate and interpret a company's earnings per share (both basic and diluted earnings per share) for both simple and complex capital structures;
- h** contrast dilutive and antidilutive securities and describe the implications of each for the earnings per share calculation;
- i** formulate income statements into common-size income statements;
- j** evaluate a company's financial performance using common-size income statements and financial ratios based on the income statement;
- k** describe, calculate, and interpret comprehensive income;
- l** describe other comprehensive income and identify major types of items included in it.

**READING 18. UNDERSTANDING BALANCE SHEETS**

The candidate should be able to:

- a** describe the elements of the balance sheet: assets, liabilities, and equity;
- b** describe uses and limitations of the balance sheet in financial analysis;
- c** describe alternative formats of balance sheet presentation;
- d** contrast current and non-current assets and current and non-current liabilities;
- e** describe different types of assets and liabilities and the measurement bases of each;
- f** describe the components of shareholders' equity;
- g** demonstrate the conversion of balance sheets to common-size balance sheets and interpret common-size balance sheets;
- h** calculate and interpret liquidity and solvency ratios.

## READING 19. UNDERSTANDING CASH FLOW STATEMENTS

The candidate should be able to:

- a** compare cash flows from operating, investing, and financing activities and classify cash flow items as relating to one of those three categories given a description of the items;
- b** describe how non-cash investing and financing activities are reported;
- c** contrast cash flow statements prepared under International Financial Reporting Standards (IFRS) and US generally accepted accounting principles (US GAAP);
- d** compare and contrast the direct and indirect methods of presenting cash from operating activities and describe arguments in favor of each method;
- e** describe how the cash flow statement is linked to the income statement and the balance sheet;
- f** describe the steps in the preparation of direct and indirect cash flow statements, including how cash flows can be computed using income statement and balance sheet data;
- g** demonstrate the conversion of cash flows from the indirect to direct method;
- h** analyze and interpret both reported and common-size cash flow statements;
- i** calculate and interpret free cash flow to the firm, free cash flow to equity, and performance and coverage cash flow ratios.

## READING 20. FINANCIAL ANALYSIS TECHNIQUES

The candidate should be able to:

- a** describe tools and techniques used in financial analysis, including their uses and limitations;
- b** identify, calculate, and interpret activity, liquidity, solvency, profitability, and valuation ratios;
- c** describe relationships among ratios and evaluate a company using ratio analysis;
- d** demonstrate the application of DuPont analysis of return on equity and calculate and interpret effects of changes in its components;
- e** calculate and interpret ratios used in equity analysis and credit analysis;
- f** explain the requirements for segment reporting and calculate and interpret segment ratios;
- g** describe how ratio analysis and other techniques can be used to model and forecast earnings.