STUDY SESSION

8

Financial Statement Analysis (4)

This study session introduces the concept of financial reporting quality. The session examines the financial reporting quality differences that may exist between companies and the means for identifying them. Warning signs of poor or low quality reporting are covered. The application of financial analysis techniques to evaluate a company's past and projected performance, assess credit risk, and screen for potential equity investments follows. Common adjustments to reported financials to facilitate cross-company comparisons conclude the session.

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.

READING ASSIGNMENTS

Reading 25 Financial Reporting Quality
by Jack T. Ciesielski, CPA, CFA, Elaine Henry, PhD, CFA, and Thomas I. Selling, PhD, CPA

Reading 26 Applications of Financial Statement Analysis
by Thomas R. Robinson, PhD, CFA, J. Hennie van Greuning, DCom, CFA, Elaine Henry, PhD, CFA, and Michael A. Broihahn, CPA, CIA, CFA

LEARNING OUTCOMES

READING 25. FINANCIAL REPORTING QUALITY

The candidate should be able to:

- **a** compare and contrast financial reporting quality with the quality of reported results (including quality of earnings, cash flow, and balance sheet items);
- **b** describe a spectrum for assessing financial reporting quality;
- **c** explain the difference between conservative and aggressive accounting;

- **d** describe motivations that might cause management to issue financial reports that are not high quality;
- **e** describe conditions that are conducive to issuing low-quality, or even fraudulent, financial reports;
- **f** describe mechanisms that discipline financial reporting quality and the potential limitations of those mechanisms;
- **g** describe presentation choices, including non-GAAP measures, that could be used to influence an analyst's opinion;
- **h** describe accounting methods (choices and estimates) that could be used to manage earnings, cash flow, and balance sheet items;
- **i** describe accounting warning signs and methods for detecting manipulation of information in financial reports.

READING 26. APPLICATIONS OF FINANCIAL STATEMENT ANALYSIS

The candidate should be able to:

- **a** evaluate a company's past financial performance and explain how a company's strategy is reflected in past financial performance;
- **b** demonstrate how to forecast a company's future net income and cash flow;
- **c** describe the role of financial statement analysis in assessing the credit quality of a potential debt investment;
- **d** describe the use of financial statement analysis in screening for potential equity investments;
- **e** explain appropriate analyst adjustments to a company's financial statements to facilitate comparison with another company.