Financial Statement Analysis

LEARNING OUTCOMES

Introduction to Financial Statement Analysis

The candidate should be able to:

- □ describe the roles of financial reporting and financial statement analysis
- □ describe the roles of the statement of financial position, statement of comprehensive income, statement of changes in equity, and statement of cash flows in evaluating a company's performance and financial position
- □ describe the importance of financial statement notes and supplementary information—including disclosures of accounting policies, methods, and estimates—and management's commentary
- □ describe the objective of audits of financial statements, the types of audit reports, and the importance of effective internal controls
- □ identify and describe information sources that analysts use in financial statement analysis besides annual financial statements and supplementary information
- □ describe the steps in the financial statement analysis framework

Financial Reporting Standards

The candidate should be able to:

- □ describe the objective of financial reporting and the importance of financial reporting standards in security analysis and valuation
- □ describe the roles of financial reporting standard-setting bodies and regulatory authorities in establishing and enforcing reporting standards
- □ describe the International Accounting Standards Board's conceptual framework, including qualitative characteristics of financial reports, constraints on financial reports, and required reporting elements

- □ describe general requirements for financial statements under International Financial Reporting Standards (IFRS)
- □ describe implications for financial analysis of alternative financial reporting systems and the importance of monitoring developments in financial reporting standards

Understanding Income Statements

The candidate should be able to:

- □ describe the components of the income statement and alternative presentation formats of that statement
- □ describe general principles of revenue recognition and accounting standards for revenue recognition
- □ calculate revenue given information that might influence the choice of revenue recognition method
- □ describe general principles of expense recognition, specific expense recognition applications, and implications of expense recognition choices for financial analysis
- □ describe the financial reporting treatment and analysis of non-recurring items (including discontinued operations, unusual or infrequent items) and changes in accounting policies
- □ contrast operating and non-operating components of the income statement
- □ 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
- □ contrast dilutive and antidilutive securities and describe the implications of each for the earnings per share calculation
- □ formulate income statements into common-size income statements
- □ evaluate a company's financial performance using common-size income statements and financial ratios based on the income statement
- □ describe, calculate, and interpret comprehensive income
- □ describe other comprehensive income and identify major types of items included in it

Understanding Balance Sheets

The candidate should be able to:

- □ describe the elements of the balance sheet: assets, liabilities, and equity
- □ describe uses and limitations of the balance sheet in financial analysis
- □ describe alternative formats of balance sheet presentation
- □ contrast current and non-current assets and current and non-current liabilities
- □ describe different types of assets and liabilities and the measurement bases of each
- □ describe the components of shareholders' equity
- □ demonstrate the conversion of balance sheets to common-size balance sheets and interpret common-size balance sheets
- □ calculate and interpret liquidity and solvency ratios

Understanding Cash Flow Statements

The candidate should be able to:

- □ 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
- □ describe how non-cash investing and financing activities are reported

- ☐ contrast cash flow statements prepared under International Financial Reporting Standards (IFRS) and US generally accepted accounting principles (US GAAP)
- ☐ compare and contrast the direct and indirect methods of presenting cash from operating activities and describe arguments in favor of each method
- ☐ describe how the cash flow statement is linked to the income statement and the balance sheet
- ☐ 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
- ☐ demonstrate the conversion of cash flows from the indirect to direct method
- ☐ analyze and interpret both reported and common-size cash flow statements
- ☐ calculate and interpret free cash flow to the firm, free cash flow to equity, and performance and coverage cash flow ratios

Financial Analysis Techniques

The candidate should be able to:

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

Inventories

The candidate should be able to:

- ☐ contrast costs included in inventories and costs recognised as expenses in the period in which they are incurred
- ☐ describe different inventory valuation methods (cost formulas)
- ☐ calculate and compare cost of sales, gross profit, and ending inventory using different inventory valuation methods and using perpetual and periodic inventory systems
- ☐ calculate and explain how inflation and deflation of inventory costs affect the financial statements and ratios of companies that use different inventory valuation methods
- ☐ explain LIFO reserve and LIFO liquidation and their effects on financial statements and ratios
- ☐ demonstrate the conversion of a company's reported financial statements from LIFO to FIFO for purposes of comparison
- ☐ describe the measurement of inventory at the lower of cost and net realisable value
- ☐ describe implications of valuing inventory at net realisable value for financial statements and ratios
- ☐ describe the financial statement presentation of and disclosures relating to inventories
- ☐ explain issues that analysts should consider when examining a company's inventory disclosures and other sources of information

- ◻ calculate and compare ratios of companies, including companies that use different inventory methods
- ◻ analyze and compare the financial statements of companies, including companies that use different inventory methods

Long-Lived Assets

The candidate should be able to:

- ◻ compare the financial reporting of the following types of intangible assets: purchased, internally developed, acquired in a business combination
- ◻ explain and evaluate how capitalising versus expensing costs in the period in which they are incurred affects financial statements and ratios
- ◻ describe the different depreciation methods for property, plant, and equipment and calculate depreciation expense
- ◻ describe how the choice of depreciation method and assumptions concerning useful life and residual value affect depreciation expense, financial statements, and ratios
- ◻ explain and evaluate how impairment, revaluation, and derecognition of property, plant, and equipment and intangible assets affect financial statements and ratios
- ◻ describe the different amortisation methods for intangible assets with finite lives and calculate amortisation expense
- ◻ describe how the choice of amortisation method and assumptions concerning useful life and residual value affect amortisation expense, financial statements, and ratios
- ◻ describe the revaluation model
- ◻ explain the impairment of property, plant, and equipment and intangible assets
- ◻ explain the derecognition of property, plant, and equipment and intangible assets
- ◻ describe the financial statement presentation of and disclosures relating to property, plant, and equipment and intangible assets
- ◻ analyze and interpret financial statement disclosures regarding property, plant, and equipment and intangible assets
- ◻ compare the financial reporting of investment property with that of property, plant, and equipment
- ◻ identify and contrast costs that are capitalised and costs that are expensed in the period in which they are incurred

Income Taxes

The candidate should be able to:

- ◻ describe the differences between accounting profit and taxable income and define key terms, including deferred tax assets, deferred tax liabilities, valuation allowance, taxes payable, and income tax expense
- ◻ explain how deferred tax liabilities and assets are created and the factors that determine how a company's deferred tax liabilities and assets should be treated for the purposes of financial analysis
- ◻ calculate income tax expense, income taxes payable, deferred tax assets, and deferred tax liabilities, and calculate and interpret the adjustment to the financial statements related to a change in the income tax rate
- ◻ calculate the tax base of a company's assets and liabilities
- ◻ evaluate the effect of tax rate changes on a company's financial statements and ratios
- ◻ identify and contrast temporary versus permanent differences in pre-tax accounting income and taxable income

- □ explain recognition and measurement of current and deferred tax items
- □ describe the valuation allowance for deferred tax assets—when it is required and what effect it has on financial statements
- □ analyze disclosures relating to deferred tax items and the effective tax rate reconciliation and explain how information included in these disclosures affects a company's financial statements and financial ratios
- □ identify the key provisions of and differences between income tax accounting under International Financial Reporting Standards (IFRS) and US generally accepted accounting principles (GAAP)

Non-Current (Long-Term) Liabilities

The candidate should be able to:

- □ determine the initial recognition, initial measurement and subsequent measurement of bonds
- □ describe the effective interest method and calculate interest expense, amortisation of bond discounts/premiums, and interest payments
- □ explain the derecognition of debt
- □ describe the role of debt covenants in protecting creditors
- □ describe the financial statement presentation of and disclosures relating to debt
- □ explain motivations for leasing assets instead of purchasing them
- □ explain the financial reporting of leases from a lessee's perspective
- □ explain the financial reporting of leases from a lessor's perspective
- □ compare the presentation and disclosure of defined contribution and defined benefit pension plans
- □ calculate and interpret leverage and coverage ratios

Financial Reporting Quality

The candidate should be able to:

- □ compare and contrast financial reporting quality with the quality of reported results (including quality of earnings, cash flow, and balance sheet items)
- □ describe a spectrum for assessing financial reporting quality
- □ explain the difference between conservative and aggressive accounting
- □ describe motivations that might cause management to issue financial reports that are not high quality
- □ describe conditions that are conducive to issuing low-quality, or even fraudulent, financial reports
- □ describe mechanisms that discipline financial reporting quality and the potential limitations of those mechanisms
- □ describe presentation choices, including non-GAAP measures, that could be used to influence an analyst's opinion
- □ describe accounting methods (choices and estimates) that could be used to manage earnings, cash flow, and balance sheet items
- □ describe accounting warning signs and methods for detecting manipulation of information in financial reports

Applications of Financial Statement Analysis

The candidate should be able to:

- □ evaluate a company's past financial performance and explain how a company's strategy is reflected in past financial performance
- □ demonstrate how to forecast a company's future net income and cash flow
- □ describe the role of financial statement analysis in assessing the credit quality of a potential debt investment

- ☐ describe the use of financial statement analysis in screening for potential equity investments
- ☐ explain appropriate analyst adjustments to a company's financial statements to facilitate comparison with another company