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
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- 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