STUDY SESSION

7

Financial Reporting and Analysis

Income Statements, Balance Sheets, and Cash Flow Statements

The first three readings in this study session focus on the three major financial statements: the income statement, the balance sheet, and the cash flow statement. For each financial statement, the reading describes its purpose, construction, pertinent ratios, and common-size analysis. These readings provide a background for evaluating trends in a company's performance over several measurement periods and for comparing the performance of different companies over a given period. The final reading covers in greater depth financial analysis techniques based on the financial reports.

READING ASSIGNMENTS

Reading 24	Understanding Income Statements by Elaine Henry, PhD, CFA, and Thomas R. Robinson, PhD, CFA
Reading 25	Understanding Balance Sheets by Elaine Henry, PhD, CFA, and Thomas R. Robinson, PhD, CFA
Reading 26	Understanding Cash Flow Statements by Elaine Henry, PhD, CFA, Thomas R. Robinson, PhD, CFA, Jan Hendrik van Greuning, DCom, CFA, and Michael A. Broihahn, CPA, CIA, CFA
Reading 27	Financial Analysis Techniques by Elaine Henry, PhD, CFA, Thomas R. Robinson, PhD, CFA, and Jan Hendrik van Greuning, DCom, CFA

Note: New rulings and/or pronouncements issued after the publication of the readings in financial reporting and analysis may cause some of the information in these readings to become dated. Candidates are expected to be familiar with the overall analytical framework contained in the study session readings, as well as the implications of alternative accounting methods for financial analysis and valuation, as provided in the assigned readings. Candidates are not responsible for changes that occur after the material was written.

LEARNING OUTCOMES

READING 24. 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 accrual accounting, specific revenue recognition applications (including accounting for long-term contracts, installment sales, barter transactions, gross and net reporting of revenue), and implications of revenue recognition principles for financial analysis;

c calculate revenue given information that might influence the choice of revenue recognition method;

d describe key aspects of the converged accounting standards for revenue recognition issued by the International Accounting Standards Board and Financial Accounting Standards Board in May 2014;

e describe general principles of expense recognition, specific expense recognition applications, and implications of expense recognition choices for financial analysis;

f describe the financial reporting treatment and analysis of non-recurring items (including discontinued operations, unusual or infrequent items) and changes in accounting policies;

g distinguish between the operating and non-operating components of the income statement;

h 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;

i distinguish between dilutive and antidilutive securities and describe the implications of each for the earnings per share calculation;

j convert income statements to common-size income statements;

k evaluate a company's financial performance using common-size income statements and financial ratios based on the income statement;

l describe, calculate, and interpret comprehensive income;

m describe other comprehensive income and identify major types of items included in it.

READING 25. 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 distinguish between 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 convert balance sheets to common-size balance sheets and interpret common-size balance sheets;

h calculate and interpret liquidity and solvency ratios.

READING 26. 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 distinguish between 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 convert 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 27. FINANCIAL ANALYSIS TECHNIQUES

The candidate should be able to:

a describe tools and techniques used in financial analysis, including their uses and limitations;

b classify, 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.