Study Guide

Section A: Financial Statement Analysis
While financial statements summarize the past performance of an organization, they also can provide users with valuable insights into future performance. Financial statement analysis is performed by stockholders and creditors and is also an important tool for management accountants and financial analysts to use to better understand their company's competitive position.

Financial statements can be analyzed to identify trends in key financial data, compare financial performance across companies, and calculate financial ratios that can be used to assess a company's current performance as well as its prospects for the future. In addition, the management accountant should be familiar with the analytical techniques used by external investors to evaluate their company.

This section focuses on important ratios and other analytical tools used to evaluate an organization's financial health, including coverage of special issues, such as foreign currency fluctuations, off-balance sheet financing, fair value accounting, and U.S. generally accepted accounting principles (GAAP) versus International Financial Reporting Standards (IFRSs).

LOS
Learning Outcome Statements Overview: Financial Statement Analysis

1. Section A.1. Basic Financial Statement Analysis

The candidate should be able to:

a. **For the balance sheet and income statement, prepare and analyze common-size financial statements; that is, calculate percentage of assets and sales, respectively; also called vertical analysis.**
   A. Common-size statements recast all items in a particular financial statement as a percentage of a selected (usually the largest and most important) item on the statement.
   B. A base amount (generally total assets on the balance sheet and net sales on the income statement) is valued at 100%, and the elements within the statement are expressed as a percentage of the base amount.

b. **For the balance sheet and income statement, prepare a comparative financial statement horizontal analysis; that is, calculate trend year over year for every item on the financial statement compared to a base year.**
   A. Horizontal common-size statements compare key financial statement (income statement or balance sheet) values and relationships for the same company over a period of years.

c. **Calculate the growth rate of individual line items on the balance sheet and income statement.**
   A. Growth rates for individual items are calculated by looking at the difference between the Year 2 amount and the Year 1 amount divided by the Year 1 (base) amount and converted to a percentage.

2. Section A.2. Financial Ratios

The candidate should be able to:

Liquidity

a. **Calculate and interpret the current ratio, the quick (acid test) ratio, the cash ratio, the cash flow ratio, and the net working capital ratio.**
   A. Current ratio—Measures the degree to which current assets cover current liabilities.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

   B. Quick (acid-test) ratio—Examines liquidity from a more immediate aspect than does the current ratio by eliminating inventory from current assets.

$$\text{Quick(Acid-Test) Ratio} = \frac{\text{Cash} + \text{Marketable Securities} + \text{Accounts Receivable}}{\text{Current Liabilities}}$$

   C. Cash ratio—Compares only cash and marketable securities to current liabilities, eliminating receivables and inventory from the asset portion.

$$\text{Cash Ratio} = \frac{\text{Cash} + \text{Marketable Securities}}{\text{Current Liabilities}}$$

   D. Cash flow ratio—Measures a firm's ability to meet its debt obligations with cash generated in the normal course of business.

$$\text{Cash Flow Ratio} = \frac{\text{Operating Cash Flow}}{\text{Current Liabilities}}$$

b. **Explain how changes in one or more of the elements of current assets, current liabilities, or unit sales can change the liquidity ratios and calculate that impact.**
   A. All else equal, an increase in current assets will cause an increase in liquidity ratios (as long as the current asset that is increased is part of the ratio numerator). This reflects that the company has more liquid assets to cover current obligations. All else equal, an increase in current liabilities will cause a decrease in liquidity ratios. An increase or decrease in unit sales will cause a corresponding increase or decrease in liquidity ratios because current assets (either cash or accounts receivable) will increase.

c. **Demonstrate an understanding of the liquidity of current liabilities.**
   A. Liquidity is a relative measure of the proximity of the asset or liabilities to cash—that is, how soon the asset or liability will be converted to cash. On the balance sheet, liabilities are ordered in order of liquidity. The soonest to be paid off is listed first.