# Accredited Business Advisor (ABA) Part I

## Preparatory Course





NSA 75 Years
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# Chapter 21

## FINANCIAL STATEMENT ANALYSIS



### LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Understand the difference between financial reporting and general purpose financial statements
- Describe comparative financial statements and their use
- Evaluate various financial statement ratios and examine how to interpret ratio results
- Understand the limitations associated with using financial statement ratios

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## FINANCIAL REPORTING VERSUS GENERAL PURPOSE FINANCIAL STATEMENTS

The terms *financial report* and *financial statement* are sometimes used interchangeably, but they have very separate and distinct meanings.

- *Financial report* is an umbrella term used for several types of reports provided to management about the financial health of a company. Financial reports gather important financial information for distribution to the public (typically, this information includes financial statements such as balance sheet, income statement, statement of cash flow, etc.). These statements are all included under the umbrella term *financial reports*. Financial reports also include specific reporting that may analyze the financial health of an organization through ratio evaluation or trend analysis. All financial statements are financial reports, but not all financial reports are financial statements.

- Financial statements fall under the financial report umbrella. Financial statements provide specific information about the financial position of an organization (including assets, liabilities, shareholder equity, cash flow, and results of operations). They are typically in a table format that has references to footnotes that explain specific details.

## COMPARATIVE FINANCIAL STATEMENTS

Comparative financial statements are a complete set of financial statements issued by an organization that reveal information for more than one reporting period (e.g., two years, three years, etc.). Management may refer to a *financial package*. A financial package may include statements such as the balance sheet, income statement, and cash flow statement, which all may provide information for multiple periods. Comparative financial statements are useful in many ways including, the following:

- Investors and management can analyze the financial performance of an organization over multiple periods. This allows the professional to easily examine and look at trends that may be occurring in the business.

- Comparative information can also relate to specific comparison of various information such as expenses to revenues or assets to liabilities. Also, ratios can be calculated for several periods from the various statements and used for trend analysis. This information is also used in assessing the health of the organization.

- Comparative financial information may also be used by management during their strategic planning processes to assist in evaluating past and projecting future performance.

A comparative financial statement will typically include several periods of activity shown in columns. This allows for easy analysis and comparison. Following is a simplified example of a comparative balance sheet.

**ABC Inc.**

**Comparative Balance Sheet**

| | As of 12/31/20X3 | As of 12/31/20X2 | As of 12/31/20X1 |
|---|---|---|---|
| Current Assets | | | |
| Cash | XXX | XXX | XXX |
| Accounts Receivable | XXX | XXX | XXX |
| Inventory | XXX | XXX | XXX |
| **Total Current Assets** | XXX | XXX | XXX |
| Fixed Assets | XXX | XXX | XXX |
| **Total Assets** | XXX | XXX | XXX |
| Current Liabilities | | | |
| Accounts Payable | XXX | XXX | XXX |
| Accrued Expenses | XXX | XXX | XXX |
| Short-Term Debt | XXX | XXX | XXX |
| **Total Current Liabilities** | XXX | XXX | XXX |
| Long-Term Debt | XXX | XXX | XXX |
| **Total Liabilities** | XXX | XXX | XXX |
| **Shareholder's Equity** | XXX | XXX | XXX |
| **Total Liabilities and Shareholder's Equity** | XXX | XXX | XXX |

Comparative financial statements are important to the process of financial analysis. Financial analysis may include evaluating businesses' specific assets, liabilities, revenues, expenses, or other financial statement information. It can also include evaluating projects, budgets, and other finance-related transactions to determine their performance and suitability to the organization's objectives. One type of financial analysis is to evaluate whether an organization is stable, solvent, liquid, or profitable enough to warrant future investment. These types of analysis may include:

- Internal financial analysis, which helps managers come to business decisions through evaluation of historical trends
- External financial analysis, which helps shareholders and stakeholders evaluate potential for investing

When speaking of financial analysis, professionals often use various financial ratios to compare and analyze information incorporating the various financial statements. Ratios are important elements to assist in understanding the organization's activities, but it is also important to understand that ratios do not necessarily tell the whole story. Often, an individual ratio is of more use when evaluated in-line with other ratios or trend information. In any event, for ratios to be useful and meaningful, they must be:

- Calculated using reliable, accurate financial information
- Calculated consistently from period to period

- Used in comparison to internal benchmarks
- Used in comparison to other companies in your industry
- Viewed both at a single point in time and as an indication of broad trends and issues over time
- Carefully interpreted in the proper context, considering there are many other important factors and indicators involved in assessing performance

## UNDERSTANDING RATIOS BY EVALUATING THE CONCEPTS OF MATH EQUATIONS

Often, professionals get so caught up in "calculating" ratios and memorizing formulas that they lose sight of the meaning behind the numbers. One of the biggest challenges with ratios is determining whether an increase or a decrease in the ratio is a good thing or a bad thing. The answer relates to fundamental math principles and what happens when the numerator or denominator (or both) change. Let's review some basic math concepts.

First, the term *numerator* relates to the top number in a fraction, and *denominator* relates to the bottom number in a fraction. From a pure math perspective, when you divide the numerator by the denominator, you come up with a fraction. The higher the denominator is than the numerator, the smaller the fraction will be. The smaller the denominator is than the numerator, the larger the fraction. You can use the same analysis for the numerator and just invert the results. (The smaller the numerator is than the denominator, the smaller the fraction. The larger the numerator is than the denominator, the larger the fraction). Let's look at some examples:

| **Numerator Change** | | |
|---|---|---|
| Fraction | Percent | Comment |
| 2/3 | .66 | Here you can see the denominator of 3 stays constant, but the numerator decreased from 2 to 1. As a result, the fraction became a smaller percent. |
| 1/3 | .33 | |
| 3/8 | .375 | Here the denominator of 8 is constant, but the numerator increased from 3 to 5. As a result, the fraction became larger. |
| 5/8 | .625 | |
| **Denominator Change** | | |
| Fraction | Percent | Comment |
| 1/4 | .25 | In this instance, the numerator of *1* stays constant, but the denominator was changed from 4 to 2. This resulted in an increase in the fraction. |
| 1/2 | .50 | |
| 1/2 | .50 | This example is the inverse of the above. The numerator is left at *1*, but the denominator changed from 2 to 4. This resulted in a decrease in the fraction. |
| 1/4 | .25 | |

So what if the numerator and denominator both change? If this is the case, the professional would analyze which number had the largest change. If the denominator changed more (percentage wise) than the numerator, then the analysis described above of the denominator being larger than the numerator is relevant. If the numerator changed more (percentage wise) than the denominator, then the analysis described above of the numerator being larger than the denominator is relevant.

How does this help us in financial ratio analysis? The basic math concepts must be considered and applied to how balances on the financial statements increase and decrease. To understand the impact, go back to basic financial statement and accounting concepts of what constitutes a debit (increase) and what constitutes a credit (decrease). As an example, let's review accounts that impact the balance sheet:

# REVIEW QUESTIONS

**1.** Per GAAP, what are the three primary financial statements required to be prepared by organizations?

**a.** Income statement, statement of cash flow, statement of equity

**b.** Balance sheet, statement of equity, income statement

**c.** Balance sheet, income statement, statement of cash flow

**d.** Income statement, management discussion and analysis, balance sheet

**2.** What is the proper definition of *intangible assets*?

**a.** Goods available for sale as well as raw materials used to produce those goods

**b.** Money owed by customers to the entity for goods or services delivered on credit but not yet paid for by the customer

**c.** Assets purchased for long-term use by an organization that are not likely to be converted quickly into cash

**d.** An asset that is not physical in nature

**3.** Which of the following categories of liabilities would be considered a short-term liability?

**a.** Bonds payable

**b.** Accounts payable

**c.** Deferred tax liabilities

**d.** Capital leases

**4.** Which category of stock entitles the holder to a fixed dividend?

**a.** Common stock

**b.** Preferred stock

**c.** Treasury stock

**d.** Retained earnings

# ANSWERS TO REVIEW QUESTIONS

**1. a. *Incorrect.*** A partnership cannot be made up of only one person. The UPA provides governance and key regulations for business partnerships in several U.S. states.

**b. *Correct.*** Based on the Uniform Partnership Act, a partnership is "…an association of two or more persons to carry on as co-owners a business for profit." More than likely, this definition aligns with your general understanding of what a partnership represents.

**c. *Incorrect.*** While a partnership can be made up of three or more persons, this is not the minimum number of persons that must be involved with a partnership. Instead, the minimum number is lower.

**d. *Incorrect.*** Partnerships can take one of several forms. The easiest types of partnerships to form, and therefore the most popular ones, are the general partnership and the limited partnership. While a partnership can be made up of four or more persons, this is not the minimum number of persons that must be involved with a partnership.

**2. a. *Incorrect.*** The UPA was most recently released in 1997, but this is not the year in which it was last amended. It was amended at a later date.

**b. *Correct.*** The first UPA was released in 1914. The UPA has been revised, amended, and updated over the years.

**c. *Incorrect.*** This is not when the UPA was last amended. The UPA governs general partnerships, and also governs limited partnerships except where the limited partnership statute is inconsistent.

**d. *Incorrect.*** This is not when the UPA was last amended. As noted in the prefatory note in the UPA, the UPA has been adopted in every state in the United States other than Louisiana and has been the subject of remarkably few amendments in those states over the past 80 years.

**3. a. *Incorrect.*** Limited partners are not personally responsible for the debts of the partnership. This is one of the distinct advantages with a limited partnership arrangement. The limited partners have, however, invested the majority of the partnership's equity and capital, and usually have the first claim to the partnership's profits and losses, although the amount is normally limited.

**b. *Incorrect.*** This is not one of the types of partners within a partnership. Instead, partnerships often have either general partners or limited partners.

**c. *Incorrect.*** This is not one of the types of partners within a partnership. Partnerships can take one of several forms. The easiest types of partnerships to form and therefore the most popular ones are the general partnership and the limited partnership.

**d. *Correct.*** The general partner must take primary responsibility for the day-to-day management of the business. The general partner is also responsible for the majority of the risk of failure in the event that the partnership fails. Limited partners' risk of loss is limited to the amount they have invested in the partnership.