**CAREER CLUSTER**
Finance

**CAREER PATHWAY**
Corporate (Banking) Finance

**INSTRUCTIONAL AREA**
Financial Analysis

# FINANCIAL STATEMENT ANALYSIS EVENT

# PARTICIPANT INSTRUCTIONS

- The event will be presented to you through your reading of the General Performance Indicators, Specific Performance Indicators and Case Study Situation. You will have up to 60 minutes to review this information and prepare your presentation. You may make notes to use during your presentation.
- You will have up to 15 minutes to make your presentation to the judge (you may have more than one judge).
- Turn in all of your notes and event materials when you have completed the event.

## GENERAL PERFORMANCE INDICATORS

- Communications skills – the ability to exchange information and ideas with others through writing, speaking, reading or listening
- Analytical skills – the ability to derive facts from data, findings from facts, conclusions from findings and recommendations from conclusions
- Production skills – the ability to take a concept from an idea and make it real
- Priorities/time management – the ability to determine priorities and manage time commitments
- Economic competencies

## SPECIFIC PERFORMANCE INDICATORS

- Describe the relationship between economic conditions and financial markets.
- Demonstrate financial analysis applications.
- Spot problems in/issues with financial statements.
- Describe types of financial statement analysis (e.g., ratio analysis, trend analysis, etc.).
- Discuss limitations of using financial statements to assess business performance.

## CASE STUDY SITUATION

FAIRFAX INC., is a medium sized retail distribution company. The recent global pandemic has not been kind to the company's financial statements, and some of your creditors are concerned about solvency and going-concern potential.

As the accountant for FAIRFAX, you have been asked to develop some key ratios from the company's comparative financial statements. This information is to be used to convince creditors that FAIRFAX is solvent and will survive this unprecedented economic time.

The data requested and the calculations developed from the financial statements are as follows:

| | **2020** | **2019** |
|---|---|---|
| Current Ratio | 3.1:1 | 2.1:1 |
| Acid Test ratio | 0.8:1 | 1.4:1 |
| Asset Turnover | 2.8 times | 2.2 times |
| Net Income | Up 32% | Down 8% |
| EPS | $3.30 | $2.50 |
| Book value per share | Up 8% | Up 11% |
| ROE | 23% | 27% |

## YOUR CHALLENGE

Before meeting with the creditors, the finance team at FAIRFAX would like you to comment on how each of these items supports the company's solvency and going-concern potential. The company wants to use your comments to support its presentation of data to the creditors.

You are to prepare the comments as requested, giving the implications and the limitations of each item separately. Then prepare a general conclusion that might be drawn from the individual items.

You will meet with a member or members of the finance team to present the information. You will begin the meeting with a general overview of how the current economic market has affected the company financials and why? You must also offer a brief overview into the types of financial analysis you used and why.

## SOLUTION

There are three bases of comparison: intracompany (used here); intercompany, which compares an item of financial relationship to data from another similar company; and industry, which compares company data to industry averages.

The current ratio increase is a favourable indication as to short-term solvency, but alone tells little about the going-concern prospects of the client. From this ratio change alone, it is impossible to know the amount and direction of the changes in individual accounts, total current assets, and total current liabilities. Also unknown are the reasons for the changes.

The acid test ratio is an unfavourable indication as to short-term solvency, especially when the current ratio increase is also considered. This decline is also unfavorable to the going-concern prospects of the company, because it reflects a declining cash position and raises questions as to reasons for the increases in other current assets, such as inventories.

The change in asset turnover cannot alone tell anything about either solvency or going-concern prospects. There is no way to know the amount and direction of the changes in the two items (i.e., net sales and total assets). An increase in sales would be favourable for going-concern prospects, while a decrease in assets could reflect a number of scenarios and would need to be investigated further.

The increase in net income is a favourable indicator for both solvency and going-concern prospects, although much depends on the quality of receivables generated from sales and how quickly they can be converted into cash. A significant factor here may be that despite a decline in sales management has been able to reduce costs to produce this increase. Indirectly, the improved income picture may have a favourable impact on solvency and going-concern potential by enabling the client to borrow currently to meet cash requirements.

The 32% increase in earnings per share, which is identical to the percentage increase in net income, is an indication that there has probably been no change in the number of common shares. This, in turn, indicates that financing was not obtained through the issue of common shares. It is not possible to reach conclusions about solvency and going-concern prospects without additional information about the nature and extent of financing.

The percentage increases in book values per share demonstrate nothing so far as solvency and going-concern potential are concerned. It is probable that the smaller percentage increase in the current year only reflects the larger base value created in the preceding year. It is not possible to tell from these figures what the dividend policy of the company is, or whether there is an increase in net assets which is capable of generating future earnings, thus making it possible to raise capital for current needs by the issue of additional common shares.

The decrease in the return on common shareholders' equity from 27% to 23% either means that the numerator, net income, decreased, or that the denominator, shareholders' equity, increased. Since we know that net income actually increased 32%, then the reason for the decline in the return on common shareholders' equity must be attributable to an increase in the common shareholders' equity. We can speculate that additional common shares were not issued (since earnings per share increased proportionately with net income), therefore the common shareholders' equity must have increased by other means—perhaps by a donation. Nothing in the decline in the return on common shareholders' equity indicates any decline in solvency or going-concern potential.

The collective implications of the above data are that the company is about as solvent and as viable as a going concern at the end of the current year as it was at the beginning, although there may be a need for short-term operating cash.

Although a quick evaluation of a company can be made using only a few ratios and comparing these with past ratios and industry statistics, the creditors should realize the limitations of such analysis even from the best prepared statements carrying an auditor's unqualified opinion.

A limitation on comparisons with industry statistics or other companies within the industry exists because material differences can be created through the use of alternative (but acceptable) accounting methods. Further, when evaluating changes in ratios or percentages, the evaluation should be directed to the nature of the item being evaluated because very small differences in ratios or percentages can represent significant changes in dollar amounts or trends.

Ratios should be considered in conjunction with (not instead of) careful examination of the financial statements themselves, and the accompanying notes.

The creditors should evaluate conclusions drawn from ratio analysis in the light of the current status of, and expected changes in, such things as general economic conditions, the company's competitive position, the public's demand (for the product itself, increased quality of the product, control of noise and pollution, etc.), and the company's specific plans.

## EVALUATION INSTRUCTIONS

The participants are to be evaluated on their ability to perform the specific performance indicators stated on the cover sheet of this event and restated on the Judge's Evaluation Form. Although you may see other performance indicators demonstrated by the participants, those listed in the Performance Indicators section are the critical ones you are measuring for this particular event.

### Evaluation Form Interpretation

The evaluation levels listed below and the evaluation rating procedures should be discussed thoroughly with your event director and the other judges to ensure complete and common understanding for judging consistency.

| Level of Evaluation | Interpretation Level |
|---|---|
| Exceeds Expectations | Participant demonstrated the performance indicator in an extremely professional manner; greatly exceeds business standards; would rank in the top 10% of business personnel performing this performance indicator. |
| Meets Expectations | Participant demonstrated the performance indicator in an acceptable and effective manner; meets at least minimal business standards; there would be no need for additional formalized training at this time; would rank in the 70-89$^{th}$ percentile of business personnel performing this performance indicator. |
| Below Expectations | Participant demonstrated the performance indicator with limited effectiveness; performance generally fell below minimal business standards; additional training would be required to improve knowledge, attitude and/or skills; would rank in the 50-69$^{th}$ percentile of business personnel performing this performance indicator. |
| Little/No Value | Participant demonstrated the performance indicator with little or no effectiveness; a great deal of formal training would be needed immediately; perhaps this person should seek other employment; would rank in the 0-49$^{th}$ percentile of business personnel performing this performance indicator. |

# FINANCIAL STATEMENT ANALYSIS 2021

**JUDGE'S EVALUATION FORM**
Association Event 1

**INSTRUCTIONAL AREA**
Financial Analysis

Participant: ____________________________

Participant: ____________________________

ID Number: ____________________________

| Did the participants: | | Little/No Value | Below Expectations | Meets Expectations | Exceeds Expectations | Judged Score |
|---|---|---|---|---|---|---|
| **PERFORMANCE INDICATORS** | | | | | | |
| **1.** | Describe the relationship between economic conditions and financial markets? | 0-1-2-3 | 4-5-6-7-8 | 9-10-11-12 | 13-14-15 | |
| **2.** | Demonstrate financial analysis applications? | 0-1-2-3 | 4-5-6-7-8 | 9-10-11-12 | 13-14-15 | |
| **3.** | Spot problems in/issues with financial statements? | 0-1-2-3 | 4-5-6-7-8 | 9-10-11-12 | 13-14-15 | |
| **4.** | Describe types of financial statement analysis? | 0-1-2-3 | 4-5-6-7-8 | 9-10-11-12 | 13-14-15 | |
| **5.** | Discuss limitations of using financial statements to assess business performance? | 0-1-2-3 | 4-5-6-7-8 | 9-10-11-12 | 13-14-15 | |
| **PRESENTATION** | | | | | | |
| **6.** | Demonstrate clarity of expression? | 0-1 | 2-3 | 4 | 5 | |
| **7.** | Organize ideas? | 0-1 | 2-3 | 4 | 5 | |
| **8.** | Show evidence of mature judgment? | 0-1 | 2-3 | 4 | 5 | |
| **9.** | Overall performance: appropriate appearance, poise, confidence, presentation, technique and response to judge's questions | 0-1-2 | 3-4-5 | 6-7-8 | 9-10 | |
| | | | | | **TOTAL SCORE** | |