Mapping to Curriculum

- Reading 23: Financial Reporting Mechanics
- Reading 24: Financial Reporting Standards
- Reading 25: Understanding Income Statements
Financial Reporting and Analysis
(Study session 7 – Reading 22)
Coverage for Reading 22 - FSA: An Introduction

1. Role of Financial reporting and Financial Statement Analysis (FSA)
2. System of Double Entry
3. Steps in FSA framework
4. Audit of financial statements
5. Internal Controls in an organisation
6. Basic Accounting Principles
Sequence of actions in business and its reporting

1. Business Transaction
2. Recording for future reference (Journals, Ledgers, Memo)
3. Proper presentation (Balance sheet, P/L, Cash Flow St)
4. Use of information by stakeholder

Accounting

Financial Reporting

Financial Statement Analysis
Roles of Financial reporting and Financial Statement Analysis

- **Financial reporting**: It is the way companies show their performance to outside world.

- International Accounting Standards Board (IASB) has described the role of financial reporting in its Framework for the Preparation & Presentation of Financial Statements as:

  “The objective of financial statements is to **provide information about the financial position, performance** and **changes in financial position** of an entity that is useful to a wide range of users in making economic decisions”.

- **Financial Statement Analysis (FSA)**: The role of FSA is to use the company’s financial statements & other relevant information to make economic decisions
  
  a) **FSA is used to**
  
  1. Evaluate company’s past performance and current financial position
  
  2. Project company’s ability to earn profits and future cash flows

  b) **So that economic decisions like the following can be taken:**

  1. Whether to invest in the company's securities
  
  2. Whether to extend bank credit to the company
Flow of information in an accounting system

1. **Journal entries**
   (record every transaction chronologically)

2. **General ledger**
   (sorts the entries in the general journal by accounts)

3. **Trial balance**
   (initial trial balance & adjusted trial balance)

4. **Financial statement**
   (Grouping into various financial line items)
Double entry accounting

Each transaction is recorded at least at two (double) accounts and in a way that balances both the sides of the balance sheet.

For example:

**A. An increase in an asset account** must be balanced by either:

- Increase in a liability or owners' equity account.
- Decrease in another asset account.

**B. An expenses incurred** (causing reduced earning leading to low retained earning to low equity hence lower liability) must be balanced by either:

- Reduction in cash (if expenses is incurred in cash).
- Increase in liability (if expenses is incurred on credit).

<table>
<thead>
<tr>
<th>Account 1</th>
<th>Account 2</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset ↑</td>
<td>Asset ↓</td>
<td>Purchase inventory with cash</td>
</tr>
<tr>
<td>Asset ↑</td>
<td>Liability ↑</td>
<td>Purchase inventory on credit</td>
</tr>
<tr>
<td>Asset ↓</td>
<td>Equity ↓</td>
<td>Company pays out Salary</td>
</tr>
</tbody>
</table>
Examples on Double entry accounting

1. Purchase furniture for $1,000 cash
   - Furniture (an asset) increases by $1,000.
   - Cash (an asset) decreases by $1,000.
   - Both assets and liabilities are balanced.
   - Both assets and liabilities are balanced.

2. Purchase furniture for $1,000 through raising $1,000 notes
   - Furniture (an asset) increases by $1,000.
   - Notes (liability) increases by $1,000.
   - Both assets and liabilities are balanced.

3. Pay $1000 for salary in cash
   - Salary (expenses) reduces net income, leading to low equity and lower liabilities by $1000.
   - Cash reduces by $1000.
   - Both assets and liabilities are balanced.
Two types of authorities in each country

1. **Standard-setting bodies**: professional organizations of accountants & auditors that establish financial reporting standards.

2. **Regulatory authorities**: government agencies that have the legal authority to enforce compliance with the reporting standards.

- Most national regulators are members of International Organization of Securities Commissions (IOSCO).
- IOSCO has three objectives:
  1. Protect Investors.
  2. Ensure fairness, efficiency & transparency.
  3. Reduce systemic risk.
- IOSCO goal is to bring uniformity in financial regulation across countries.
- IOSCO does not have legally enforceable power.
Structure of FSA

1. Determine the Objective and Context
2. Gather Data
3. Process the Data
4. Analyze and interpret the data
5. Report the Conclusions or Recommendations
6. Update the Analysis
### Stating the context or objective of Analysis

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lender</td>
<td>Credit worthiness</td>
</tr>
<tr>
<td>Investor</td>
<td>Returns from the investment</td>
</tr>
<tr>
<td>Supplier</td>
<td>Liquidity Position</td>
</tr>
<tr>
<td>Customer</td>
<td>Sustainability of operations</td>
</tr>
<tr>
<td>Capital Markets</td>
<td>Corporate Governance</td>
</tr>
<tr>
<td>Government</td>
<td>Revenue generation ability</td>
</tr>
<tr>
<td>Employees</td>
<td>Impact on wages/salaries</td>
</tr>
</tbody>
</table>

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Sources of information for an analyst

1. Financial statements
2. Supplementary information
3. Footnotes
4. Management Disclosure and Analysis
5. SEC filings
6. Proxy Statements
7. Other Sources
1. Financial Statements

- Are the different formats which have been prescribed by the law (accountancy) to be used for the purpose of financial reporting.
- Each format communicates a separate aspect of the business

- Different Financial Statements are:
  - Income Statements
  - Balance Sheet
  - Cash Flow
  - Statement of change in owner’s equity
2. Supplementary schedules

- These schedules detail out different consolidated figures given in financial statements.
- These are more or less voluntary disclosures by the company.

**Supplementary schedules** contains *additional* information like:

1. Operating income or sales by region or business segment
2. Reserves for an oil and gas company
3. Information about hedging activities and financial instruments

- Supplementary schedules are **not required to be audited**
3. Financial Statement Notes

Also known as FOOTNOTES:

- Provides information about accounting methods, assumptions & estimates used in preparing financial statements
- Provide additional information on business segment, related party transactions, acquisitions / disposals, contingencies, significant customers
- Allows users to improve their assessment of amount, timing & uncertainty of estimates reported in financial statements
- All footnotes are required to be audited

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>100</td>
<td>600</td>
</tr>
<tr>
<td>Revenue through related party</td>
<td>500</td>
<td>0</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>600</td>
<td>600</td>
</tr>
</tbody>
</table>

Since Company A has many related party transactions, company B’s revenues are more reliable
4. Management's Discussion and Analysis (MD&A)

- Management's Discussion and Analysis (MD&A) provides assessment of the financial performance of a firm from management’s perspective.

1. In the US, public companies are required to disclose following information in MD&A:
   - a) Result from operations with trends in sales and expense
   - b) General business overview based on known trends
   - c) Capital resources and liquidity along with trends in cash flows
   - d) Discussion on significant events & uncertainties

2. Additional information, not compulsorily required to be disclosed, under MD&A:
   - a) Effects of known trends on business
   - b) Accounting policies requiring significant judgment
   - c) Issues related to capital structure and liquidity
   - d) Information on unusual or infrequent items and extraordinary items etc.

- Qualitative business performance
- Significant effects of currently known trends, events
- Risks facing the organizations
- Outlook
5. Different SEC Filings

Form S-1
- Registration statement filed prior to the sale of new securities to the public.

Form 10-K
- Disclosure about business and its management, audited financial statements, legal matters etc.
- 40-F: corresponding form for Canadian companies listed on US exchanges
- 20-F: corresponding form for foreign issuers listed on US exchanges

Form 10-Q
- Quarterly Report: Financial statements may not be audited (but will be reviewed by auditors)

6-K
- Non-U.S. companies file for semiannual financial report
5. Different SEC Filings (Contd.)

Form 8-K
- Filed to disclose material event like:
  - Acquisitions and disposals
  - Changes in management or corporate governance
  - Accountants, financial statements, or other related matters
  - Press Releases

Form DEF-14A:
- **Proxy statement** for its shareholders (prior to the annual meeting or other shareholder vote).

Form 144:
- When a company issues securities to certain Qualified Institutional Buyers (QIB) without registering the securities with the SEC.

Form 3, 4, 5
- Details on **beneficial ownership** of securities by company's officers and directors.
- Can learn about **purchases and sales** of company securities by corporate insiders.
6. Proxy Statements

- It is a form to be used for voting in the absence of shareholder from the AGM.
- Issued to shareholders along with the notice of AGM highlighting the decisions that need shareholder’s approval like:
  a) Appointment of a director
  b) Appointment of an auditor
  c) Any M&A to be done

- Good source of information about the election of (and qualifications of) board members, compensation, management qualifications, and the issuance of stock options and sales of company securities by corporate insiders.
7. Other Sources of Information

a) Corporate Reports

b) Press Releases

c) Trade Journals

d) Statistical Reporting Services and Govt. Agencies
Audit of Financial Statements

**Auditor:** an accounting expert appointed by shareholders to independently review the FS prepared by the management.

- Every country’s regulatory body prescribes the minimum qualification that is required for an auditors.
- Attestation function – signing and certification that the FS are free from material errors.

**Objective of Audit**

- To get an independent opinion on fairness and reliability of financial statements.
- To check whether generally accepted accounting policies (GAAP) were followed.
- To examine efficiency of accounting & internal control system.
- To determine financial statements contain no material errors.

Audit reports to the shareholders and NOT to the management.

- Audit report is addressed to the shareholders and NOT to the management.

Auditor is not a BLOODHOUND. He is just a WATCH DOG.

- He has responsibility to reasonably assure the stakeholders about the fairness of FS.
- Different accounting fraud has led to a debate on the role and responsibility of the auditor.
Audit Reports – Types of Scenarios

On the basis of his analysis, an auditor can issue one of the following 4 reports:

1. **Unqualified opinion**
   - FS are free from **material omissions** and errors.
   - FS reflect the **true and fair picture** of the business.

2. **Qualified Opinion**
   - Except for few material issues, FS reflect the **true and fair picture** of the business.
   - Above material issues do not change the overall message communicated by the FS.
   - Auditors must **explain these exceptions** in the audit report.

3. **Adverse Opinion**
   - Statements DO NOT represent the true and fair picture.
   - There are material omissions / errors.

4. **Disclaimer of Opinion**
   - Due to some circumstances, an audit is unable to express any opinion on the FS, he issues a disclaimer.
   - Disclaimer DOES NOT mean that FS are incorrectly prepared by the management.
   - Disclaimer is Inability of expression.
4 elements of a standard report

1. FS preparation is responsibility of management

2. Accounting standards has been followed and there is reasonable assurance that FS are free from material errors

3. Accounting estimates and principles used in FS preparation are reasonable

4. Auditor’s Comment on the internal controls in the organisation
Auditor’s Report – Explanatory paragraph

- Auditor’s report contain explanatory paragraph when material loss is probable but the amount can’t be reasonable ascertained

- Uncertainties are caused due to issues related to:
  1. Going concern assumptions
  2. Any litigation
  3. Realization of assets values

- For example, in the case of British Petroleum oil spill, the auditor would include an explanatory paragraph on the material loss
Internal controls

- **Internal controls** are checks and balances implemented by the management which ensures that company uses a proper process to prepare and present accurate financial statements
  - Auditor is part of review mechanism – It is MGT’s primary responsibility to ensure that fraud does not happen.

- US GAAP requires auditor to comment on internal controls implemented by company:

- Management is required to provide a report on internal control system under the Sarbanes–Oxley Act that:
  - **Management is responsible** for maintaining the internal control systems.
  - Description on how management evaluates the internal control systems.
  - Assessment of the effectiveness of most recent year of the internal control systems.
  - Statement from management that firm’s auditors have assessed management internal controls.

**Internal Auditors**

- Appointed by management as part of the internal control system
- Regular employees or contractors
- Not necessary to be **qualified** accounting experts
Question Set 1

1. ABC company faces serious claims under a lawsuit filed against it. An interim judgment if goes against ABC can cause a probable material loss but this cannot be quantified at the time of preparing financial statements. Which of the following best describes desired action by auditor of ABC?
   A. Auditor should issue an explanatory note in audit report
   B. Auditor should issue qualify report
   C. Auditor should issue an adverse opinion

2. In U.S., which of the following information needs to be compulsorily disclosed under management discussions and analysis?
   A. Information on unusual or infrequent items and extraordinary items etc.
   B. Capital resources and liquidity along with trends in cash flows
   C. Discussion over accounting policies requiring significant judgment

3. A footnote in financial statement is least likely to contain information on:
   A. Accounting policies
   B. Estimations used
   C. Details on actual Capacities
4. Under Sarbanes Oxley Act
   A. Management is required to provide a report on internal controls
   B. Auditor is required to provide a report on internal controls
   C. Management is required to report that financial statements are their responsibility

5. Which of the following is least likely to be an objective for conducting an audit
   A. To get an independent opinion on fairness and reliability of financial statements
   B. To judge and examine efficiency of internal control system
   C. To uncover any financial frauds

6. If an auditor issues an "adverse opinion", she is referring to the fact that:
   A. The firm's financial statements do not fairly represent the company's financial performance and position.
   B. There is considerable uncertainty in the firm's asset-liability valuation, thus causing a concern about its operational health.
   C. The firm has inadequate controls in place and needs an on-going, frequent audit
1. **A.** When auditor faces a situation where material loss is probable but the amount can’t be reasonable ascertained, he should issue a detailed explanatory note in audit report on such uncertainties and impact.

2. **B.** In US, public companies are required to disclose 4 types of information in MD&A out of which one is - Capital resources and liquidity along with trends in cash flows.

3. **C.** Financial Statement notes (footnotes) includes accounting policies, estimates and assumption used in preparing Financial statements but not the Details on actual Capacities.

4. **A.** Management is required to provide a report on internal controls under the Sarbanes Oxley Act including that management is responsible for maintaining the internal control systems.

5. **C.** Out of four, two objectives of an audit are to get an independent opinion on fairness and reliability of financial statements & to judge and examine efficiency of internal control system.

6. **A.** The firm's financial statements do not fairly represent the company's financial performance and position.
   An adverse opinion is rendered in cases where financial statements are not prepared in accordance with accepted accounting principles, and this has a material effect on the fair presentation of the statements.
Basic Accounting Principles

- **Basic Accounting Assumptions**
  1. **Going Concern**: Business is expected to continue forever
  2. **Accrual**: Records transaction when these are done rather than when cash flow associated take place

- **Other Principles**
  1. **Materiality**: accounts to be prepared keeping materiality in mind
  2. **Conservatism**: Recognize all expenses and losses immediately but don’t account for profits and gains unless they actually accrue.
  3. **Substance over form**: Giving weight to the true nature of an item instead of its legal form
Fundamental Characteristics

1. Relevance
2. Faithful Representation

Four characteristics that enhances fundamental characteristics

1. Comparability
2. Verifiability
3. Timeliness
4. Understandability
Core principle for FS preparation

- International Accounting Standards No.1 - Principles

1. **Fair presentation**: no *malafide* intention while preparing the accounts
2. **Going concern**: The existence the legal company will continue forever
3. **Accrual basis**: Accounting when the actual transaction take place rather than when corresponding Cash flow occur.
4. **Consistency**: Stick to one policy after making a choice from various options available
5. **Materiality**: cost of collecting the information should always be less than the benefit of using that information
1. Which of the following statements regarding footnotes to the financial statements is FALSE?

   A. Footnotes provide information about policies, assumptions, estimates used by management.
   
   B. Footnotes may disclose what types of accounting methods are being used.
   
   C. Some supplementary schedules are audited whereas footnotes are not audited.
Question Set 2 (Contd.)

3. Which of the following statements represents information at a specific point in time?
   A. The income statement.
   B. The statement of cash flows.
   C. The balance sheet.

4. Which of the following items is least likely a financing activity?
   A. Dividends paid to shareholders.
   B. Purchase of treasury stock.
   C. Gain on sale of stock of a subsidiary.
Financial Reporting Mechanics
(Study session 7 – Reading 23)
How Business activities are classified for Financial reporting Purposes

- Business Activities may be classified into **three groups** for financial reporting purposes. Understanding the nature of an activity helps the analyst to ascertain where the company is doing good and where it is lacking.

1. **Operating Activities**: Activities that are part of a day-to-day business functionality of an entity. Eg. Sales of goods and services to customers, costs of providing the goods and services, taking deposits and making loans by bank.

2. **Investing Activities**: Activities associated with the acquisitions and disposals of a long term assets. Eg. Purchase and sale of a office building, plant and machinery, Purchase or sale of other entities equities or debt securities.

3. **Financing Activities**: Activities related to obtaining and repaying capital. Eg. Issuing Common shares, bonds etc. Issuance or repayments of debt, Payments of distribution (dividend).
Why FRA is important for an analyst

1. Credit Evaluation of borrower by the lender and assigning a rating.

2. Evaluating a subsidiary division of the parent company.

3. Managing Investment – identifying companies that are mis-priced.
   - Certain criterion are fixed for stock selection out of a big group.
   - **Back testing**: using historical data to check the efficiency of criterion selected.

4. Facilitate analyst’s adjustment for making justified comparisons between companies.
Basic Definitions

1. Accounts
   - Records which contain history of transactions undertaken for business.
   - Chart of accounts is the list of all the accounts used for accounting in the company.

2. Accounting
   “Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the results thereof.”

3. Accountancy
   - Principles / techniques / rules which are used in accounting are collectively called as Accountancy.
   - These rules are necessary to be followed to promote standardization.
   - Formed by technical organizations but enforced by regulatory body.

<table>
<thead>
<tr>
<th></th>
<th>The US</th>
<th>UK</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technical</td>
<td>FASB</td>
<td>IASB</td>
<td>ICAI</td>
</tr>
<tr>
<td>Regulatory</td>
<td>SEC</td>
<td>FSA</td>
<td>SEBI</td>
</tr>
</tbody>
</table>
Basic Definitions (Contd.)

4. **Financial Reporting**
   - The process of placing different ledger balances from Trial balance into different formats.

5. **Financial Statements**
   - Are the different formats which have been prescribed by the law (accountancy) to be used for the purpose of financial reporting.
   - Each format communicates a separate aspect of the business.
   - Different Financial Statements are:
     1. Income Statements
     2. Balance Sheet
     3. Cash Flow
     4. Statement of change in owner’s equity

6. **Financial Statement Analysis (or Reporting Analysis)**
   - Is the process of making use of the information derived from the financial statement.
   - Done by any stakeholders (shareholder, employee, govt, banker, suppliers, customers, society, etc.).
   - To make some economic decision.
Basic Definitions (Contd.)

All entities can be divided into 5 basic categories

- Assets
- Liability
- Income
- Expense
- Owner’s Equity
Balance Sheet (includes Assets, Liabilities and Equity)

**Assets**
1. Property, Plant & Equipment
2. Intangible Assets
3. Investments
4. Prepaid expenses
5. Inventory (Stocks)
6. Accounts Receivables
7. Marketable Securities
8. Cash & Bank

**Liabilities and Equity**
1. Owner equity
2. Reserves
3. Long term loan
4. Short term loan
5. Accounts payable
6. Advanced received
7. Unearned revenue
8. Accrued expenses

*Risk Capital*

*Long Term finances*

*Short Term finances*

*Long Term* Non-operational

*Short Term*

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## Income Statement (includes Incomes and Expenses)

<table>
<thead>
<tr>
<th>Profit and Loss Account</th>
<th>Particulars</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td></td>
</tr>
<tr>
<td>(Less)</td>
<td>COGS (All direct expenses)</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td></td>
</tr>
<tr>
<td>(Less)</td>
<td>Selling &amp; Distribution Exp</td>
</tr>
<tr>
<td>(Less)</td>
<td>Administrative Exp</td>
</tr>
<tr>
<td>(Less)</td>
<td>General Exp</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td></td>
</tr>
<tr>
<td>(Less)</td>
<td>Depreciation</td>
</tr>
<tr>
<td><strong>EBIT</strong></td>
<td></td>
</tr>
<tr>
<td>(Less)</td>
<td>Interest</td>
</tr>
<tr>
<td><strong>EBT</strong></td>
<td></td>
</tr>
<tr>
<td>(Less)</td>
<td>Income Tax Expense</td>
</tr>
<tr>
<td><strong>PAT</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Profit and Loss Appropriation Account</th>
<th>Particulars</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PAT</strong></td>
<td></td>
</tr>
<tr>
<td>(Less)</td>
<td>Preference Dividend</td>
</tr>
<tr>
<td></td>
<td><strong>Earning Attributable to Common stockholders</strong></td>
</tr>
<tr>
<td>(Less)</td>
<td>Common Dividends</td>
</tr>
<tr>
<td></td>
<td><strong>Retained Earnings</strong></td>
</tr>
</tbody>
</table>

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Link Between financial Management and Accountancy

Broad rules for effective Financial Management (Actual may be different for different industries):

1. Short term liabilities should be used to finance the Short term assets & Long term liabilities be used to finance the long term assets

2. At any point in time, amount of risk capital should not fall below one half of the borrowed capital

3. Repayment of Liability can be from:
   a) Cash generated by operations (Primary sources)
   b) By liquidating an asset (Secondary sources)

4. Intangible assets are the most abused form of application of funds

To execute these principles, we need to know the value of financial parameters which are derived from Accounts
Any Value outflow can take three forms

Value outflow

Value does not mean only cash. It can also be effort, time, energy. For the purpose of accounting, we will have to convert all qualitative parameters into monetary terms.

- **Asset**
  - Future benefit

- **Expenditure**
  - Current benefit

- **Loss**
  - No Benefit
Classification of Activities

- All the activities of ANY business can be divided into three categories
- These three categories are:
  1. MUTUALLY EXCLUSIVE and
  2. EXHAUSITIVE

1. **Operating activity**: transactions that involve the firm’s primary activities.
   - This includes the main route by which any company intends to make profits
   - It includes the day to day business functions of a company

2. **Investing activity**: activities associated with the acquisition and disposal of long term assets.

3. **Financing activity**: activities related to obtaining or repaying capital to be used in the business.

The same transaction can be classified differently by both the entities
Practice - Classification of Activities

Identify the classification of the activity from point of view of both the entities involved:

1. SBI gave a loan to Maruti for $100 Mn
2. Maruti used that amount to buy a land from Ansals for constructing a factory $80 Mn
3. An investor opened a time deposit account with SBI for $1Mn
4. An investor got share in SBI’s IPO for $1Mn
5. Ansals sold a commercial space to an investor for his office
6. Ansals purchased a piece of land from Farmers near Bhiwadi
7. Maruti sold scrap generated during the production process
8. Bharti made investments into mutual funds to park surplus funds
9. Ranbaxy made investments into mutual funds to earn some extra return
10. Reliance paid the fees to the GOI for allocation of an oil exploration site in US
The Magical Equation

- This equation will always balance for
  1. All the transactions done by the business
  2. At ALL points in TIME during the life of the company

- This equation is a substitute of rules of Debit and Credit which are not necessary for an analyst
Practice – Basic Accounting Equation

Identify the classification of the activity from point of view of both the entities involved:

1. SBI gave a loan to Maruti for $100 Mn
2. Maruti used that amount to buy a land from Ansals for constructing a factory $80 Mn
3. An investor opened a time deposit account with SBI for $1Mn
4. An investor got share in SBI’s IPO for $1Mn
5. Ansals sold a commercial space of $1M to an investor for $1.6 M
6. Ansals purchased a piece of land from Farmers (cost $ 0.5M) near Bhiwadi for $2M
7. Maruti sold scrap generated during the production process for $ 15M
8. Bharti made investments into mutual funds to park surplus funds for $10M
9. Ranbaxy made investments into mutual funds to earn some extra return for $10M
10. Reliance paid $1.1M as fees to the GOI for allocation of an oil exploration site in US.
Financial Reporting Standards
(Study session 7 – Reading 24)
Reporting standards

- If reporting standards didn’t exist then financial statements can take any form because of possible assumptions & estimates

- Reporting standards
  1. Makes financial statements much more comparable
  2. **Fixes a range on** management estimates which otherwise could have substantially varied
  3. Makes Financial statements **useful to a wide range of users** including security analysts
  4. For e.g.: Depreciation methods, inventory valuation methods, representation of assets at book value etc are made standardized by reporting standards
Barriers to develop a universal accounting standard

- Accounting standards differ across countries:
  - Depending upon the economic structure of a nation and prevalent conditions in a particular country.
  - Treatment of a particular item or issue is different in different countries.
  - This is a major barrier for setting up universal accounting standards.

- Other reasons are:
  - Political pressures from business groups who will be affected by changes in reporting standards.
  - Pressure from others who will be affected by changes in reporting standards.
IFRS – Financial Statement’s Objectives

- Ideas on which IASB bases its standards are expressed in the IFRS “Framework for Preparation & Presentation of Financial Statements”.

- According to IFRS, objective of financial statements are:
  - To provide information on financial position, performance and changes in the financial position of an entity.
  - Provide information that is useful to a wide variety of users for taking economic decisions.
IFRS – An overview

![Diagram of Reporting Elements]

- **Objective**: To provide financial information that is useful in making decisions about providing resources to the entity.
  - Relevance
  - Faithful representation
  - Comparability, verifiability, timeliness, understandability
- **Performance**
  - Income
  - Expenses
  - Capital maintenance adjustments
  - Past cash flows
- **Financial Position**
  - Assets
  - Liabilities
  - Equity
- **Constraint**
  - Cost (cost/benefit considerations)
- **Underlying Assumption**
  - Accrual basis
  - Going concern

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IFRS – Financial Statement Characteristics

- Fundamental Characteristics
  1. Relevance
  2. Faithful Representation

- Four characteristics that enhances fundamental characteristics
  1. Comparability
  2. Verifiability
  3. Timeliness
  4. Understandability
IFRS Description – Financial Statement’s Elements

IFRS describes the financial statement elements as:

1. **Assets**: Resources which are expected to accrue economic benefits in future periods

2. **Liabilities**: Obligations which are expected to accrue economic costs in future periods

3. **Equity**: Residual interest equal to Assets – Liabilities

4. **Income**: Includes revenue and gains; result of past transaction which accrued economic benefits either by way of increasing assets or decreasing liabilities

5. **Expenses**: Includes expenses and losses; result of past transaction which accrued economic costs either by way of decreasing assets or increasing liabilities
Constraints:

1. FSs can directly present only quantitative information but not the non-quantifiable information like brand loyalty, capacity for innovation, etc.

2. Strike a balance between reliability (free of errors) v/s timeliness

3. Strike a balance between cost of preparing FSs v/s benefits to users through FSs

Assumptions

1. **Accrual basis:** financial statements should reflect transactions at the time they actually occur, not necessarily when cash is paid

2. **Going concern:** entity is expected to continue its operations in foreseeable future
 Required Financial Statements
- Statement of financial position (Balance sheet)
- Statement of comprehensive income (Single statement or Income statement + Statement of comprehensive income)
- Statement of changes in equity
- Statement of cash flows
- Notes, summarizing accounting policies and disclosing other items
- In certain cases, Statement of financial position from earliest comparative period

General Features
- Fair presentation
- Going concern
- Accrual basis
- Materiality and aggregation
- No offsetting
- Frequency of reporting
- Comparative information
- Consistency of presentation

Structure and Content
- Classified balance sheet
- Minimum specified information on face
- Minimum specified note disclosures
- Comparative information
General requirements for financial statements

International Accounting Standard (IAS) No. 1 states that:

- **Financial statements** required are:
  1. Balance sheet
  2. Statement of comprehensive income
  3. Cash flow statement
  4. Statement of changes in owner’s equity
  5. Explanatory notes, including a summary of accounting policies

- **Fundamental principles** while preparing financial statements are:
  1. Fair presentation
  2. Going concern basis
  3. Accrual basis of accounting
  4. Consistency
  5. Materiality (no omissions and misstatements)
General requirements for financial statements (Cont...)

Fundamental principles while presenting financial statements are

- **No offsetting** of assets against liabilities unless specific standard permits it
- **Aggregation** of similar items
- Should present a **classified balance sheet** showing current & non-current assets & liabilities
- **Minimum information** on the face supported by detailed information in footnotes
- **Comparative information** with information on prior periods
Comparison of FASB and IASB framework

Differences in Principles:
- **FASB** framework, unlike the IASB framework, is **not at top GAAP hierarchy**
- IASB framework places more **emphasis on the going concern** assumption
- IASB requires management to **consider the framework** if no explicit standard exists on an issue, but the FASB does not
- **FASB** pushes for **relevance** and **reliability** as primary characteristics
- **IASB** lists **comparability** and **understandability** as primary characteristics

Differences in Financial Elements:
- Assets is **source** of economic benefits under IASB and is economic benefit itself under FASB
- IASB considers income and expenses for performance whereas **FASB considers** slight differently through revenue, expenses, gains, losses & **comprehensive income**
- FASB uses words **probable** for assets/ liabilities unlike IASB
- FASB does not allow values of most assets to be adjusted upwards
- Select companies need to report reconciliation between different standards (IASB / FASB) like company listed in US but incorporated outside US needs to report such statement
Coherent Financial Reporting framework

- The system of recording the business transactions which is consistent internally and fits together logically.

**Characteristics**
- Transparent
- Comprehensive
- Consistent

- Different bases for measuring value of assets and liabilities (historical cost, current cost, realizable value, present value)
- Both IASB & FASB recognize the need for fair value for certain elements

### Barriers

<table>
<thead>
<tr>
<th>Valuation</th>
<th>Standard Setting</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade off between relevance &amp; reliability</td>
<td>Principle based</td>
<td>Asset/Liability</td>
</tr>
<tr>
<td>Different bases for measuring value of assets and liabilities (historical cost, current cost, realizable value, present value)</td>
<td>Rule based</td>
<td>Revenue/expenses</td>
</tr>
<tr>
<td>Both IASB &amp; FASB recognize the need for fair value for certain elements</td>
<td>Objectives based</td>
<td>Asset/liability approach (gives preference to the proper valuation of balance sheet)</td>
</tr>
<tr>
<td>IFRS is based on principles (requires considerable use of judgment)</td>
<td></td>
<td>revenue/expense approach (focuses on the income statement)</td>
</tr>
<tr>
<td>GAAP is moving from rules-based (using specific tests) to objectives (a combo of principles and rules).</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Post your Queries at our Forum**
Importance of monitoring developments

- An analyst needs to monitor the developments in financial reporting standards.

- This will equip an analyst better to understand the impact on company’s performance and financial position in present and future.

- An analyst should go through accounting policies as presented in footnotes and management discussion and analysis statement to evaluate the impact on financial statements and make projections.

- An analyst should be cautious on uncertainty caused by not following new standard by management even when required while reporting financial results.
Questions

1. Which of the following is least likely to be a stated goal of International Accounting Standard Board (IASB)?
   
   A. Develop global accounting standards to bring transparency, comparability, and high quality
   
   B. Promote use of accounting standards with highest quality and transparency
   
   C. Achieve convergence between various national accounting standards and global accounting standards

2. Which of the following is most likely to be primary assumptions followed while preparing FS under IFRS
   
   A. Accrual basis
   
   B. Going concern
   
   C. Materiality
Questions (Cont…)

3. Which of the following statement is correct
   
   A. IFRS is principal based whereas U.S. GAAP is rules based standard setting approach
   
   B. IFRS is rule based, whereas U.S. GAAP is principal based standard setting approach
   
   C. There is no difference in standard setting approach between IFRS and US GAAP
1. **B.** IASB promotes use of global accounting standards and brings convergence between national and global accounting standards.

2. **C.** FSs should provide faithful representation of all transactions and events, should not be biased, should be complete, favor to substance over and prudent and conservative in making estimates to become reliable.

3. **A.** IFRS is principal based (relies on broad framework) whereas U.S. GAAP is rules based (Specific rule for each transaction) standard setting approach.
IASB has following 4 goals:

- Develop **global accounting standards** to bring transparency, comparability, and high quality in financial statements
- **Promote use** of such global accounting standards
- **Achieve convergence** between various national accounting standards and global accounting standards.
- Take **care** of needs of **emerging markets** and **small firms** while implementing global accounting standards
Understanding Income Statements
(Study session 8 – Reading 25 (Part 1)
Coverage for the topic

1. Basic Terms

2. Different Formats of preparation of Income St.

3. Accrual Principle
   a) Revenue (Income) Recognition
   b) Expense Recognition

4. Exceptions to Accrual Principles
   a) Long Terms Contracts
   b) Installment Sales

5. Gross and Net Reporting of Revenue

6. Comprehensive Income

7. Non-Sustainable Items

8. Forecasting Income Statement
**Income Statements - Meaning**

Financial Statement which provide information about the **financial performance** of the company is called as Income Statement or Profit & Loss statement or Statement of earnings or Statement of Operations.

**Revenue**
1. Sales of goods
2. Commission received
3. Gain on sale of investment
4. Other incomes
5. Income from Services

**Expenses**
1. Purchase of goods
2. Manufacturing
3. Administrative
4. Selling & Distribution
5. Depreciation
6. Finance exp
7. Loss on sale of investment

It is always calculated for a specified PERIOD
Basic Terms

1. **Revenue**: is all the sources of income put together whereas Sales is the primary source of Income
   - Revenue is same as Income OR Turnover
   - Revenue or turnover is a wider term than Sales
   - **Net** revenue = **Gross** revenue – returns – allowances – duties and taxes

2. **Expenses**: is the cost incurred to earn the revenue.
   - Expensed may be classified by nature or by their function
     - **By Function**
       1. Manufacturing
       2. Sales
       3. Distribution
       4. Administrative
     - **By Nature**
       1. Depreciation
       2. Material Consumption
       3. Salary
       4. Rent
       5. Taxes

3. **Profit OR Net Income** = excess of revenues over expenses.
   - Represents an economic benefit to the firm by way of inflows or increase in assets or decrease in liabilities except contribution by equity participants.
   - Other gains and losses are included in Net income. These may or may not result from ordinary business activity
## Presentation Formats

### Horizontal
- Where Income and Expenses come beside each other

### Vertical
- Where Income and Expenses come in the same column one after the other

### Multi-Step

<table>
<thead>
<tr>
<th>Operating Profits</th>
<th>Multi-Step</th>
<th>Single Step</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (Less) COGS</td>
<td></td>
<td>Sales (Less) COGS</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>(Less) Selling Exp</td>
<td>(Less) Selling Exp</td>
</tr>
<tr>
<td>(Less) Selling Exp</td>
<td>(Less) Administrative Exp</td>
<td>(Less) Administrative Exp</td>
</tr>
<tr>
<td>(Less) Administrative Exp</td>
<td>(Less) General Exp</td>
<td>(Less) General Exp</td>
</tr>
<tr>
<td>(Less) General Exp</td>
<td>(Less) Depreciation</td>
<td>(Less) Depreciation</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td>(Less) Interest</td>
<td>(Less) Interest</td>
</tr>
<tr>
<td>(Less) Depreciation</td>
<td>(Less) Income Tax</td>
<td>(Less) Income Tax</td>
</tr>
<tr>
<td><strong>EBIT</strong></td>
<td></td>
<td><strong>PAT</strong></td>
</tr>
<tr>
<td>(Less) Interest</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>EBT</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Less) Income Tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>PAT</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **EBITDA** is the same as **EBIT**
- **EBIT** is the same as **EBT**
- **EBT** is the same as **PAT**

### Same amount

**Horizontal**: Where Income and Expenses come beside each other  
**Vertical**: Where Income and Expenses come in the same column one after the other
# Use of Accrual Method for Income Statement

<table>
<thead>
<tr>
<th></th>
<th>CASH</th>
<th>ACCRUAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>Received</td>
<td>Earned</td>
</tr>
<tr>
<td>Expenses</td>
<td>Paid</td>
<td>Incurred</td>
</tr>
</tbody>
</table>

- When you pay for the goods but have not consumed them – Expense Paid
- When you Consume the goods– Expense Incurred

- Accrual is one of the two basic Accounting Assumption (the other being Going Concern)
- Accrual Advocates giving emphasis on the **actual happening** of the transaction rather than **cash flows** associated
- Accrual is implemented separately for Revenue and for Expenses
Revenue Recognition rules – US GAAP

- These are the rules for Revenue recognition rules and not Expense Recognition
- These rules are guiding principles on when to take any income to the Income Statement

2 Methods

Allowed

Accrual
- Actual transaction has happened
- Service is complete
- When payment certain

Cash
- Only when actual cash is received
- Irrespective of actual transaction

Not Allowed

- In addition to above Accrual Rules, following two conditions are also imperative:
  1. Agreement between buyer and seller necessary
  2. Price should be determined or determinable
Revenue Recognition rules - IFRS

Conditions necessary for recognition of revenue

1. Risk and Reward should be transferred
2. There is no continuing control or management over goods sold
3. Revenue can be reliably measured
4. There is a probable flow of economic benefits
5. The cost can be reliably measured

The essence of the conditions is same as in US GAAP
Converged Accounting Standard issued by IASB & FASB in May 2014

Since we know that Revenue Recognition varies globally, which makes comparisons of revenue challenging. Therefore IASB & FASB issued a converged accounting standard in May 2014 which introduces some changes to the principles of revenue recognition thereby enhancing comparability.

The converged standard aims to provide a principles-based approach to revenue recognition that can be applied to many revenue generating activities. Basically there are five steps in recognizing revenue:

1. Identify the contract(s) with a customer
2. Identify the performance obligation in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligation in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation
Expense Recognition rules

- These rules are guiding principles on **when to take any Expense to the Income Statement**

**Direct expense**
- Expenses which can be related to the final output are called **Direct Expenses**
- We follow Matching principle: Take expenses in Income St of that year which includes the corresponding Revenue (output sold)
- E.g. Direct Material, Direct Labor, direct Expenses like primary packing, Warranty, Bad debt

**Period cost**
- Expenses which can NOT be related to the final output are called **INDIRECT Expenses**
- Take expenses in Income St of that year for which these expense belong to - Rent for 2011 should be taken to the Income statement of 2011 irrespective of the output
- E.g., CEO’s Salary, Advertisement, Listing Charges, Interest Cost, etc.

The expenses will be taken to the Income Statement as per above mentioned rules notwithstanding the payment for these expenses.
These four terms arise as a result of Accrual Accounting

1. **Accrued expense = service taken + no payment**
   - Rent due not paid by 31st Dec, Provision for doubtful AR / Warranty

2. **Prepaid expense = Service not taken + payment made**
   - Rent which has been paid in advance for 2 years

3. **Accrued revenue = Services rendered + payment due**
   - Sales made but payment not received

4. **Unearned revenue = Service not rendered + payment received**
   - Advance received from the customer before the delivery date
Exceptions to the Accrual Principles

- Accrual Advocates giving emphasis on the actual happening of the transaction rather than cash flows associated.
- On accrual basis, revenue is to be booked only when the performance of contract is complete.
- However, there are two categories of exceptions to this principle i.e. revenue is not booked at the time of completion of performance.

- **Long term contracts**
  - Proportionate Method
  - Complete Contract Method

- **Installment Sales with Uncertainty**
  - Installment Method
  - Cost Recovery Method

Revenue booked in advance
Revenue booked with a lag
Exception 1 - Long Term Contracts

- Contracts which extend beyond one accounting period and cost is incurred every year whereas revenue / fees is earned only at the end of the last year

1. Percentage of completion method: When total costs & revenue can be estimated
   - Total profit earned is split over the entire contract period
   - Steps involved are:
     1. Degree of completion = cost incurred in X year / total estimated cost of the project
     2. Proportionate revenue = degree of completion X total estimated revenue
     3. Profit in X year = proportionate revenue – cost incurred in X year

2. Completed contract method - When total cost & revenue can not be estimated
   - No cost or revenue is recognized in any year except the last
   - In last year, recognize all cost, all revenue and hence all profit

Note: If total revenue – total cost is expected loss, the entire loss needs to be booked in the year of calculation itself. This is followed in case of completed contract method also.
Exception 2 – Installment Sales

- When sales is made and payment is to be received in parts over extended period and there is uncertainty over collection

  1. **Installment method:** to be used when collectability of cash is *reasonably* uncertain
     - Total profit spread over years in ratio of actual cash received
     - Steps involved are:
       1. Profit margin = (total revenue – total cost) / total revenue
       2. Profit recognized in X year = Profit margin X Cash received in X year
     - Mainly used for real estate

  2. **Cost recovery method:** to be used when collectability of revenue is *highly* uncertain
     - Payments received are first set off against cost
     - Once costs have been met, payment received = profit

Note: If there would have been no uncertainty over collection, entire profit is booked at the time of Sale itself
Barter / Exchange transaction

- Transactions where goods are exchanged for other goods and money is NOT the medium of exchange.

- **Special case of Barter: Round trip transaction** – when good being exchanged are almost similar (Pen drives for DVD, shares for debt instruments).

- **Under US GAAP** - Revenue booked as per fair value only if the firm has some historical experience for such transaction on cash basis and can use that experience to ascertain the fair value.

- **Under IFRS**: a firm can book revenue only when it can ascertain the Fair value of similar non barter transactions with *unrelated parties*. 
Gross v/s Net Reporting of Revenue

1. Gross Reporting
   • Sales and certain elements of COGS are reported separately
   • Sales are higher under this approach

2. Net Reporting
   • Sales and certain elements of COGS are reported on Net basis (Gross sales – COGS)
   • Sales are lower under this approach

- There is a tendency on part of the broker to use Gross Reporting in order to increase its size of the Income Statement

- Criterion when can a firm use Gross Revenue Reporting under US GAAP
  1. Be the primary obligor under the contract
  2. Bear the inventory risk and credit risk
  3. Be able to choose its supplier
  4. Have reasonable freedom to establish the price

If ALL FOUR conditions are met, the broker is deemed to have become a QUASI - OWNER
Comprehensive Statement

Comprehensive income (CI) is a measure that include all changes to equity other than owner’s contribution and distribution to them

- Statement of CI include both, Net Income & OCI. Presentation options include (IFRS+US GAAP):
  1. Income St is reported as a separate statement after which Statement of CI begins OR
  2. There is ONE Statements which contains both Income Statement and OCI
  3. (US GAAP only): OCI can be reported separately in Equity

- Comprehensive Income does not include transactions with owners
  - Issuing stocks
  - Re-acquiring stocks
  - Paying dividend

Other Comprehensive Income (OCI)

1. Other comprehensive incomes are the transactions do not enter income statement but affect equity directly

2. Some common examples of Other Comprehensive Income are:
   - Foreign currency translation adjustments
   - Minimum pension liability adjustments
   - Unrealized gains and losses on cash flow hedging derivatives
   - Unrealized gains and losses on Available-for-sale investments
Non-Sustainable Items

- While analysing the financial statement from the purpose of FORECASTING them, it is imperative to remove the effect of **One-time Incomes and Expenses**

- The objective of analyst is to create a **sustainable base** using which the forecasting can be done

- There are three major category of non-sustainable items:
  1. Extraordinary items
  2. Discontinued Operations
  3. Unusual OR infrequent items

1. Extraordinary Items

- Material Items (Income or expense) which have both the characteristics:
  i. Unusual AND
  ii. Infrequent AND

- It is mandatory for the company to show these separately (net of tax) from continuing operations
Non-Sustainable Items (Contd.)

2. Discontinued Operations
   - Part of business which management has decided to part with (sale to other / shut down)
   - The modes of separation can be different – hiving it off, closure, de-merger, etc.
   - Discontinuation of any product or just one of the variant is not OPERATIONS

Important Concepts

1. Measurement date: Day when the company has a developed a plan for discontinuation (mere discussion or informal meeting does not suffice)

2. Phase out period: time difference b/w actual phasing out and measurement date

- It is mandatory for the company to show these separately (net of tax) from continuing operations
- What is significant is the year starting which and year ending which this separate disclosure is required
3. Unusual OR infrequent items
   - Items which do not qualify both the parameters of being Extraordinary
   - In other words, items which are either Unusual OR Infrequent
   - Under US GAAP: It is NOT mandatory for the company to show these separately (net of tax) from continuing operations
     - Reported above the line before pre-tax before net income from continuing operations
     - Analyst will have to find these from different sources of information
   - Under IFRS: items that are material and relevant for understanding the operations of the firm need to be disclosed separately from the main heading of expenses

   - E.g includes:
     1. Gain (loss) from disposal of a business segment or assets
     2. Gain (loss) from sale of investment in subsidiary
     3. Impairments, write-offs, write-downs, restructuring
     4. Integration expense for recently acquired business

   Analyst should decide whether to include these for forecasting the firm’s earnings
### Method of Disclosure of Non-sustainable Items

| + | Revenue from the sale of goods and services |
| -- | Operating expenses |
| = | Operating income from continuing operations |
| + | Other non-operating income and expenses |
| = | Recurring income before interest and taxes from continuing operations |
| -- | Financing costs |
| = | Recurring income from continuing operations (pretax) |
| +/- | Unusual or infrequent items |
| = | Pretax earnings from continuing operations |
| -- | Income tax expense |
| = | **Net income from continuing operations** |
| +/- | Income from discontinued operations, extraordinary items, and **cumulative effect of accounting changes (all net of tax)** |
| = | Reported **NET INCOME** |

Income statement of previous year (which is presented for comparison with current year) is also restated.
Basic Terms (Contd.)

1. **Accounting Principles**: Accounting policies used for making accounts
   a) Depreciation – SLM or WDV
   b) Inventory – LIFO or FIFO

2. **Prior Period Items**: Mistakes done in past which were discovered in the current year
   - *Bonafide* in nature
   - Slipped everyone’s attention including the auditor

3. **Accounting Estimates**: Estimate / assumptions used for estimating any parameter whose exact value is not available at the time of accounting
   a) Salvage Value or Life of the long lived asset
   b) Warranty Expenses as a % of Sales
   c) Provision of doubtful debt as a % of Sales
Basic Terms (Contd.)

- Adjustment to be made in case of any change

- Retstate earlier years’ financial statements (reported ones) and

- Make an adjustment in the opening balance for the years which are not reported
Steps involved in Forecasting the Income Statement

1. Non sustainable items are excluded from the reported PAT

2. Income statement is common-sized

3. Fixed cost are segregated from Variable cost

4. Sales for the future period is estimated using various assumption on
   - Volume growth
   - Price realization per unit
   - Market share

5. Once we get the Sales of future years, fixed cost remains same

6. Variable cost is estimated = Sales of future year X Common size ratio percentage

The discipline of Financial Modelling has become extremely advanced and analyst is able to create a financial model that can very closely replicate the expected performance.
Matching Principle concepts

1. Warranty expense
   - If a firm provides a warranty to the customer, the matching principle:
     • Requires the firm to estimate warranty expense (accounting estimate)
     • Recognize these expenses in the period of sale to match these expenses with revenues rather than a later period when these are actually incurred

2. Provision for Bad Debt
   - If firm is selling goods or services on credit, they may not be able to collect the whole money as some of the customers default
   - Hence the matching principle requires:
     • Firms to estimate bad debt expense and
     • Recognize these expenses in the period of the sale rather than a later period when these are actually incurred
Questions

1. Cash collection is a critical event for income recognition under the:

<table>
<thead>
<tr>
<th>Cost-Recovery Method</th>
<th>Installment Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. No</td>
<td>Yes</td>
</tr>
<tr>
<td>B. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>C. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

2. Changing an accounting estimate

A. Is reported prospectively
B. Requires restatement of all prior period statements presented in the current financial statements
C. Is reported by adjusting the beginning balance of retained earnings for the cumulative effect of the change
Solution:

- Answer: 1. B.
  
  Cash collection is a critical event for income recognition under both Cost Recovery and Installment method.

- Answer: 2. A.
  
  A change in an accounting estimate is reported prospectively. No restatement of prior period statements is necessary.
Questions

3. For a non financial firm, are depreciation expense and interest expense included or excluded from operating expenses in the income statement?

<table>
<thead>
<tr>
<th>Depreciation Expense</th>
<th>Interest Expense</th>
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<tbody>
<tr>
<td>A. Included</td>
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</tr>
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<td>C. Excluded</td>
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</tr>
<tr>
<td>C. Excluded</td>
<td>Included</td>
</tr>
</tbody>
</table>

5. Which of the following is least likely a condition necessary for revenue recognition?

A. Cash has been collected
B. The goods have been delivered
C. The price has been determined
Solution:

- Answer: 3. B.
  For non-financial firm - depreciation expense is an operating expense, whereas interest expense is a financing expense.

- Answer: 4. A.
  For financial firm – both depreciation expense and interest expense are operating expenses.

- Answer: 5. A.
  Conditions for Revenue Recognition
  Actual transaction has happened
  Service is complete
  When payment is certain

In addition to above Accrual Rules, following two conditions are also imperative:

1. Agreement between buyer and seller necessary
2. Price should be determined or determinable
6. AAA has a contract to build a building for $100,000 with an estimated time to completion of three years. A reliable cost estimate for the project is $60,000. In the first year of the project, AAA incurred costs totaling $24,000. How much profit should AAA report at the end of the first year under the percentage of completion method and completed contract method?

<table>
<thead>
<tr>
<th>Percentage of completion</th>
<th>Completed Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. $16000</td>
<td>$0</td>
</tr>
<tr>
<td>B. $16000</td>
<td>$40000</td>
</tr>
<tr>
<td>C. $40000</td>
<td>$0</td>
</tr>
</tbody>
</table>

7. Which principle requires that cost of goods sold be recognized in the same period in which the sale of the related inventory is recorded?

A. Going concern
B. Certainty
C. Matching
Solution:

- **Answer: 6. A.**
  
The correct answer is Percentage of completion: $16,000, Completed Contract: $0.

  $24,000/$60,000 = 40% of the project completed. 40% of $100,000 = $40,000 revenue. $40,000 revenue - $24,000 cost = $16,000 profit for the period. No profit would be reported in the first year using the completed contract method.

- **Answer: 7.C.**
  
  Matching principle requires that cost of goods sold be recognized in the same period in which the sale of the related inventory is recorded to match these expenses with revenues.
Questions

8. Which of the following transaction affects owners equity but does not affect net income?
   A. Foreign currency translation gain
   B. Repaying the face amount on a bond issued at par
   C. Dividends received from available for sale securities

9. Which of the following is least likely to be included when calculating comprehensive income?
   A. Unrealized loss from cash flow hedging derivatives
   B. Unrealized gain from available for sale securities
   C. Dividends paid to common shareholders

10. Under IFRS, revenue from a barter transaction
    A. Must be based on the fair value of revenue from similar non-barter transactions with unrelated parties
    B. Must be based on the fair value of revenue from similar non-barter transactions with related parties
    C. Can be recognized at fair value only if the firm has historically received cash payments for such goods and services and can use this historical experience to determine fair value
Solution:

- Answer: 8. A.
  Other comprehensive incomes are the transactions do not enter income statement but affect equity directly

  **Some common examples of Other Comprehensive Income are:**
  1. Foreign currency translation adjustments
  2. Minimum pension liability adjustments
  3. Unrealized gains and losses on cash flow hedging derivatives
  4. Unrealized gains and losses on Available-for-sale investments

- Answer: 9. C.
  Comprehensive Income does not include transactions with owners
  1. Issuing stocks
  2. Re-acquiring stocks
  3. Paying dividend

- Answer: 10. A.
  Under IFRS, revenue from a barter transaction must be based on the fair value of revenue from similar non-arter transactions with unrelated parties
Questions

11. Mountain Infrastructure Ltd has a contract spanning over the next 3 years. The total revenue earned by the contract is $20 Million. The total estimated costs are $10 Million. What is the revenue to be recognized in year 2 using the percentage of completion method? What is the revenue recognized in year 2 by the completed contract method? The costs projection for the contract are as of the table below.

<table>
<thead>
<tr>
<th>Project Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
</tr>
<tr>
<td>Year 2</td>
</tr>
<tr>
<td>Year 3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Percentage of completion</th>
<th>Completed Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. $12 Million</td>
<td>$0</td>
</tr>
<tr>
<td>B. $4 Million</td>
<td>$40000</td>
</tr>
<tr>
<td>C. $4 Million</td>
<td>$0</td>
</tr>
</tbody>
</table>

Post your Queries at our Forum
**Solution:**

- **Answer:** 11.

**%age of completion Method**

<table>
<thead>
<tr>
<th></th>
<th>Project Costs</th>
<th>Percent of Total Project</th>
<th>Revenue Earned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$6 Million</td>
<td>60%</td>
<td>$12 Million</td>
</tr>
<tr>
<td>Year 2</td>
<td>$2 Million</td>
<td>20%</td>
<td>$4 Million</td>
</tr>
<tr>
<td>Year 3</td>
<td>$2 Million</td>
<td>20%</td>
<td>$4 Million</td>
</tr>
<tr>
<td>Total</td>
<td>$10 Million</td>
<td>100%</td>
<td>$20 Million</td>
</tr>
</tbody>
</table>

In case of the completed contract method, since the will project complete in year 3, no revenue is recognized in year 2.
12. Soft Corporation gives Chemical X worth $50,000 to Westside Rivers in exchange of a service. How is revenue recognized in this case under IASB and FASB?

   I. Fair value of similar non barter transactions with unrelated parties
   II. Fair value only if the company has received cash payments for such services historically.

A. IASB follows Statement I and FASB follows statement II.
B. IASB follows Statement II and FASB follows statement I.
C. Both IASB and FASB follows statement II.
13. ABC Inc. purchases land at $400 million. It sells it to company XYZ for $600. The payment is to be collected over a period of three years. Below is the payment schedule to ABC Inc.

<table>
<thead>
<tr>
<th>Year</th>
<th>Payment to ABC (in $ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>200</td>
</tr>
<tr>
<td>Year 2</td>
<td>200</td>
</tr>
<tr>
<td>Year 3</td>
<td>200</td>
</tr>
<tr>
<td>Total</td>
<td>600</td>
</tr>
</tbody>
</table>

Which of the following is the profit recognized in year 2 by both installment sales method and by cost recovery method:

<table>
<thead>
<tr>
<th></th>
<th>Installment Sales</th>
<th>Cost Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>66</td>
<td>66</td>
</tr>
<tr>
<td>B</td>
<td>0</td>
<td>66</td>
</tr>
<tr>
<td>C</td>
<td>66</td>
<td>0</td>
</tr>
</tbody>
</table>
Solution:

- Answer: 12.A.
  IASB follows Statement I and FASB follows statement II.

- Answer: 13.C.

**By Installment Sales Method:**
Profit = Cash collected during the period x Total expected profit / Total Sales
\[= 200 \times 200 / 600\]
\[= 66\]

**By Cost Recovery Method:**
Profit is recognized when cash collected exceeds costs incurred.
In this case, a profit is not observed till year 3, since all costs are recovered in year 2
14. Ponca brothers follows percentage of completion method while Jinal brothers follows completed contract method. Both receive a contract on 1st January, 2012, to be completed on 31st December, 2020. Which of the following is most likely to be true?

Assume everything else is same for both the companies throughout the contract period.

A. During the years 2012 to 2019 ROE and ROA will be higher for Ponca brothers.
B. Ponca brothers’ share price may fall due to higher income volatility
C. Cash flows for years 2012 to 2019 is higher in case of Ponca brothers because in percentage of completion method revenue is recognized every year. On the other hand cash flows for year 2020 is higher for Jinal brothers because revenue is recognized in 2020

15. Which of the following is not a criterion that must be met in order to use gross revenue reporting under US GAAP?

A. Be able to choose its supplier
B. Have reasonable attitude to establish the price
C. Be the secondary obligor under the contract
Solution:

- Answer: 14. A.
  During the years 2012 to 2019 ROE and ROA will be higher for Ponca brothers. The reason is that, in percentage of completion method revenue is recognized every year. On the other hand revenue is recognized in 2020 under completed contract method. So, except for final year net income is higher for Ponca brothers. Thus, ROE and ROA are also higher.

- Answer: 15. C
  Be the primary obligor under the contract
Five Minute Recap

Key Financial Statements:
- Income statement: Financial performance over a particular period of time.
- Balance Sheet: Financial position at a particular point of time.

Expanded accounting equation:
Assets = liabilities + contributed capital + opening retained earnings + revenues – expenses – dividends

FS qualitative characteristics:
- Comparable
- Understandable
- Relevant
- Reliable

Auditor’s Reports Opinion:
- Unqualified opinion: Free from material omissions and errors
- Qualified Opinion: make any exception to the accounting principles
- Adverse Opinion: Financial Statements are not presented fairly or are materially non conforming with accounting standards

Revenue Recognition Methods:
Installment method: Profit is recognized as cash is collected.
- Profit = Cash collected during the period x Total expected profit / Total Sales

Cost Recovery Method: Book profits after recovering costs
- Profit is recognized when cash collected exceeds costs (costs + interest) incurred

Revenue- Recognition methods:
- Percentage of completion method:
- Completed Contract Method

Accruals and other adjustments:
- Accrued Revenue
- Unearned revenue
- Prepaid expenses
- Accrued expenses

Fundamental principles while preparing financial statements are:
- Fair presentation
- Going concern basis
- Accrual basis of accounting
- Consistency
- Materiality

Relationships among financial statements:
Income Statement and Balance Sheet:
Retained Earnings_{t+1} = Retained Earnings_t + Net Income
Cash flow and Balance Sheet
Cash_{t+1} = Cash_t + Net Cash Flow

<table>
<thead>
<tr>
<th>Method</th>
<th>Used for</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>Tangible Fixed Assets</td>
</tr>
<tr>
<td>Amortization</td>
<td>Intangible Fixed Assets with finite lives</td>
</tr>
<tr>
<td>Impairment</td>
<td>Intangible Fixed Assets with infinite lives</td>
</tr>
</tbody>
</table>