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Question# 1:

- **IAS 2 Inventories**

- **Importance of IAS 2**

The objective of IAS 2 is to prescribe the accounting treatment for inventories. It provides guidance for determining the cost of inventories and for subsequently recognising an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

- **Overview**

Prescribes the accounting for inventories.

- **Initial measurement of inventory**

Inventories are stated at the lower of cost and net realisable value (NRV).

Costs include purchase cost, conversion cost (materials, labour and overheads), and other costs to bring inventory to its present location and condition, but not foreign exchange differences (see IAS 21).

For inventory that is not interchangeable, specific costs are attributed to the specific individual items of inventory. For interchangeable items, cost is determined on either a First in First Out (FIFO) or weighted average basis. Last In First Out (LIFO) is not permitted.

- **Cost of goods sold**

When inventory is sold, the carrying amount is recognised as an expense in the period in which the related revenue is recognised.

- **Impairment**

Write-downs to NRV are recognised as an expense in the period the loss occurs. Reversals arising from an increase in NRV are recognised as a reduction of the inventory expense in the period in which they occur.

- **Interpretations**

None

- **Changes effective this year**

None

- **Pending changes**

None

- **History**

Issued in the set of improved Standards effective for annual periods beginning on or after
1 January 2005.

- **IAS 7 Statement of Cash Flows**

- **Importance of IAS 7**

The objective of IAS 7 is to require the presentation of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows, which classifies cash flows during the period according to operating, investing, and financing activities.

- **Overview**

Requires a statement of cash flows to present information about changes in cash and cash equivalents, classified as operating, investing and financing activities.

- **Cash and cash equivalents**

Cash equivalents include investments that are short-term (less than three months from date of acquisition), readily convertible to a known amount of cash, and subject to an insignificant risk of changes in value.

- **Operating, investing and financing cash flows**

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. Operating cash flows are reported using either

The direct (recommended) or the indirect method. Cash flows from taxes on income are classified as operating unless they can be specifically identified with financing or investing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Aggregate cash flows from obtaining or losing control of subsidiaries are presented separately and classified as investing activities.

Investing and financing transactions that do not require the use of cash are excluded from the statement of cash flows, but need to be disclosed.

- **Reconciliation of financing balances**

Entities must reconcile the opening and closing amounts in the statement of financial position for items classified as financing activities.

- **Interpretations**

None

- **Changes effective this year**

None

- **Pending changes**

None

- **History**

Originally issued for periods beginning on or after 1 January 1994, it was adopted by the IASB and included in the original set of Standards effective for annual periods beginning on or after 1 January 2005. It was amended to require the disclosures of changes in liabilities arising from financing activities, effective for annual periods beginning on or after 1 January 2017.

- **IAS 9 Accounting for Research and Development Activities**

Superseded by IAS 38 effective 1 July 1999

- **IAS 38 Intangible Assets**

- **Importance of IAS 38**

The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another IFRS. The Standard requires an entity to recognise an intangible asset if, and only if, certain criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures regarding intangible assets.

- **Overview**

Prescribes the accounting treatment for recognising, measuring and disclosing intangible assets that are not dealt with in another IFRS Standard.

- **Definition**

An intangible asset is an identifiable non-monetary asset without physical substance. Examples include software, brands, music and film rights and development assets.

- **Recognition**

Intangible assets are recognised if it is probable that the future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably.

There are specific recognition criteria for internally-generated intangible assets.

All research costs are charged to expense when incurred. Development costs are capitalised only after technical and commercial feasibility of the resulting product or service have been established.

Internally-generated goodwill, brands, mastheads, publishing titles, customer lists, start-up costs, training costs, advertising costs and relocation costs are never recognised as assets.

If an intangible item does not meet the definition and the recognition criteria, the costs are recognised as an expense when incurred.

If an entity recognises a prepayment asset for advertising or promotional expenditure, it is only able to do so up to the point at which it has the right to access the goods purchased or up to the point of receipt of services. Mail order catalogues are specifically identified as a form of advertising and promotional activities, and are expensed when they are received.

- **Subsequent measurement**

Intangible assets are classified as having either a finite or indefinite life. Indefinite means that there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows, not infinite. Intangible assets may be accounted for using a cost model or, in limited cases, a revaluation model.

- **Cost model**

Assets are carried at cost less any accumulated amortisation and any accumulated impairment losses.

Normally, subsequent expenditure on an intangible asset after its purchase or completion is recognised as an expense.

The cost of an intangible asset with a finite useful life is amortised over that life, normally to a nil residual value. Impairment testing under IAS 36 is required whenever there is an indication that the carrying amount exceeds the recoverable amount of the intangible asset.

Intangible assets with indefinite useful lives are not amortised but are tested for impairment on an annual basis. If the recoverable amount is lower than the carrying amount, an impairment loss is recognised. The entity also considers whether the intangible continues to have an indefinite life.

- **Revaluation model**

If an intangible asset has a quoted market price in an active market, a revaluation model can be used. The asset is carried at fair value at revaluation date less any subsequent amortisation or impairment.

Revaluations must be carried out regularly. When the revaluation model is used, all items of a given class must be revalued. However, if there is no active market for a particular asset within that class that asset is measured using the cost model.

Revaluation increases are recognised in other comprehensive income and accumulated in equity. Revaluation decreases are charged first against the revaluation surplus in equity related to the specific asset, and any excess against

profit or loss. When the revalued asset is disposed of, the revaluation surplus remains in equity and is not reclassified to profit or loss.

- **Interpretations**

SIC-32 Intangible Assets – Web Site Costs clarifies which initial infrastructure development and graphic design costs incurred in web site development are capitalised.

- **Changes effective this year**

None

- **Pending changes**

None

- **History**

Originally issued to apply to intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004, and to all other intangible assets prospectively for periods beginning on or after 31 March 2004. It was adopted by the IASB and included in the original set of Standards effective for annual periods beginning on or after 1 January 2005.

- **IAS 18 Revenue**

superseded by IFRS 15 as of 1 January 2018

- **IFRS 15 Revenue from Contracts with Customers**

- **Importance of IFRS 15**

The objective of IFRS 15 is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer. Application of the standard is mandatory for annual reporting periods starting from 1 January 2018 onwards. Earlier application is permitted.

- **Overview**

Prescribes the accounting for revenue from sales of goods and rendering of services to a customer.

The Standard applies only to revenue that arises from a contract with a customer. Other revenue such as from dividends received would be recognised in accordance with other Standards.

- **Contract with a customer**

A contract with a customer is within the scope of this Standard when it has commercial substance, the parties have approved it, the rights of the parties regarding the goods or services to be transferred and the payment terms can be identified, the parties are committed to perform their obligations and enforce their rights and it is probable that the entity will collect the consideration to which it is entitled.

- **Core principle**

The Standard uses a control model.

An entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

- **Five steps**

The Standard sets out five steps an entity applies to meet the core principle.

Step 1: Identify the contract with a customer. It is the contract that creates enforceable rights and obligations between the entity and its customer.

Step 2: Identify the performance obligations in the contract. Each promise to transfer to a customer a good or service that is distinct is a performance obligation and is accounted for separately.

Step 3: Determine the transaction price. The transaction price is the amount of consideration to which the entity expects to be entitled in exchange for transferring promised goods or services to the customer. It could be a fixed or variable amount or in a form other than cash. If the consideration is variable, the entity must estimate the amount to which it expects to be entitled, but recognises it only to the extent that it is highly probable that a significant reversal will not occur when the uncertainty is resolved. The transaction price is adjusted for the effects of the time value of money if the contract includes a significant financing component.

Step 4: Allocate the transaction price to the performance obligations in the contract. The transaction price is allocated to each performance obligation on the basis of the relative stand-alone selling prices of each distinct good or service promised in the contract. If a stand-alone selling price is not observable, an entity estimates it.

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation. Revenue is recognised when (or as) the performance obligation is satisfied and the customer obtains control of that good or service. This can be at a point in time (typically for goods) or over time (typically for services). The revenue recognised is the amount allocated to the satisfied performance obligation.

- **Application guidance**

The Standard includes application guidance for specific transactions such as performance obligations satisfied over time, methods for measuring progress of performance obligations, sales with a right of return, warranties, principal versus agent considerations, customer options for additional goods or services, non-refundable upfront fees, bill and hold arrangements and customers unexercised rights, licensing, repurchase agreements, consignment arrangements and customer acceptance.

The Standard also includes guidance on variable consideration and time value of money and specific disclosure requirements.

- **Interpretations**

None

- **Changes effective this year**

None

- **Pending changes**

None

- **History**

Issued in 2014 for annual periods beginning on or after 1 January 2018, IFRS 15 replaced IAS 11 Construction Contracts and IAS 18 Revenue and related Interpretations, including IFRIC 13 Customer Loyalty Programmes, IFRIC 15 Agreements for the Construction of Real Estate, IFRIC 18 Transfers of Assets from Customers, and SIC 31 Revenue – Barter Transactions Involving Advertising Services.

Some clarifications were issued in April 2016, with the same effective date.

Question# 2:

- **The concept of IFRS**

IFRS stands for international financial reporting standards. It's a set of accounting rules and standards that determine how accounting events should be reported in your business's financial statements. Issued by the International Accounting Standards Board (IASB), IFRS aims to make financial statements consistent, comparable, and transparent across the world. The United States is one notable country that doesn't prescribe to IFRS, instead following a system called GAAP.

- **The importance of IFRS**

Today, cross-border transactions are commonplace, with vast numbers of businesses seeking investment opportunities across the globe. In the past, this sort of internationalism was hampered by different countries maintaining different accounting standards, adding cost, complexity, and risk to business deals. IFRS eliminates that problem by ensuring that different countries adopt the same, globally applicable set of accounting standards.

- **IFRS 10 Consolidated Financial Statements Dealing with different financial elements**

- **Control**

An investor controls an investee when it has power over the investee, exposure, or rights, to variable returns from its involvement with the investee and the ability to use its power over the investee to affect the amount of the returns.

An investor has power when it has existing rights that give it the current ability to direct the relevant activities of the investee—the activities that significantly affect the investee's returns.

Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings. It is possible to have control with less than half the voting rights (sometimes referred to as de-facto control).

In other cases, the assessment will be more complex and require more than one factor to be considered, for example when power results from one or more contractual arrangements.

The Standard includes guidance on distinguishing between rights that give the holder power and rights that are intended to protect the investor's interest

in the entity. Protective rights might include a right to vote on major transactions such as significant asset purchases or to approve borrowings above a specified level.

Distinguishing between rights that give power and rights that are protective requires an understanding of the relevant activities of the entity.

Sometimes an entity will delegate its power to an agent. The Standard emphasises the importance of identifying when a party that appears to have control over an entity is only exercising power as an agent of a principal.

- **Consolidated financial statements**

When a parent-subsidary relationship exists, consolidated financial statements are required.

These are financial statements of a group (parent and subsidiaries) presented as those of a single economic entity.

There are two exceptions to this requirement. If, on acquisition, a subsidiary meets the criteria to be classified as held for sale in accordance with IFRS 5, it is accounted for under that Standard. The other exception is for investment entities.

- **Investment entities**

An entity that obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; commits to its investor(s) that its business purpose

is to invest funds solely for returns from capital appreciation, investment income, or both; and measures and evaluates the performance of substantially all of its investments on a fair value basis is an investment entity.

An investment entity does not consolidate its subsidiaries. Instead it measures the investment at fair value through profit or loss in accordance with IFRS 9.

- **Consolidation procedures**

Intragroup balances, transactions, income and expenses are eliminated.

All entities in the group use the same accounting policies and, if practicable, the same reporting date.

Non-controlling interests (NCI) are reported in equity separately from the equity of the owners of the parent. Total comprehensive income is allocated between NCI and the owners of the parent even if this results in the NCI having a deficit balance.

- **Changes in the ownership interest**

A change in the ownership interest of a subsidiary, when control is retained, is accounted for as an equity transaction and no gain or loss is recognised.

Partial disposal of an investment in a subsidiary that results in loss of control triggers remeasurement of the residual holding to fair value at the date control is lost. Any difference between fair value and carrying amount is a gain or loss on the disposal, recognised in profit or loss.

- **IFRS 13 Fair Value Measurement Dealing with different financial elements**

- **Fair value**

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants, under current market conditions.

- **Fair value hierarchy**

When an entity estimates fair value, the estimate is classified on the basis of the nature of the inputs the entity has used.

Level 1 inputs are quoted prices in active markets for identical assets and liabilities that the entity can access at the measurement date.

Level 2 inputs are those other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and interest rates and yield curves observable at commonly quoted intervals.

Level 3 inputs are unobservable for the asset or liability. Examples include an entity using its own data to forecast the cash flows of a cash-generating unit (CGU) or estimating future volatility on the basis of historical volatility.

Entities are required to use valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. However, the objective of estimating the exit price at the measurement date remains the same regardless of the extent to which unobservable inputs are used.

- **Disclosure**

The disclosures depend on the nature of the fair value measurement (e.g. whether it is recognised in the financial statements or merely disclosed) and the level in which it is classified. The disclosure requirements are most extensive when level 3 inputs are used, including sensitivity analysis.

Question# 3

The importance of each of the 4 major financial statements while going for financial analysis

I. Income Statement

The purpose of the income statement is to provide a financial summary of the firm's operating results during a specified time period. It includes both the sales for the firm and the costs incurred in generating those sales. Other expenses, such as taxes, are also included on this statement.

II. Balance Sheet

The purpose of the balance sheet is to present a summary of the assets owned by the firm, the liabilities owed by the firm, and the net financial position of the owners as of a given point in time. The assets are often referred to as investments and the liabilities and owners' equity as financing.

III. Statement of Retained Earnings

This statement reconciles the net income earned during the year, and any cash dividends paid, with the change in retained earnings during the year.

IV. Statement of Cash Flows

This statement provides a summary of the cash inflows and the cash outflows experienced by the firm during the period of concern. The inflows and outflows are grouped into the cash flow areas of operations, investment, and financing.

Question# 4

• Liquidity Ratio

The liquidity of a firm is measured by its ability to satisfy its short-term obligations as they come due. Liquidity refers to the solvency of the firm's overall financial position—the ease with which it can pay its bills. Because a common precursor to financial distress and bankruptcy is low or declining liquidity, these ratios are viewed as good leading indicators of cash flow problems. The two basic measures of liquidity are the current ratio and the quick (acid-test) ratio.

Current Ratio

The current ratio, one of the most commonly cited financial ratios, measures the firm's ability to meet its short-term obligations. It is expressed as follows:

$$\text{current Ratio} = \frac{\text{Current Assets}}{\text{Current liabilities}}$$

The current ratio for Bartlett Company in 2003 is

$$\frac{\$1,223,000}{\$620,000} = 1.97$$

Generally, the higher the current ratio, the more liquid the firm is considered to be. A current ratio of 2.0 is occasionally cited as acceptable, but a value's acceptability depends on the industry in which the firm operates. For example, a current ratio of 1.0 would be considered acceptable for a public utility but might be unacceptable for a manufacturing firm. The more predictable a firm's cash flows, the lower the acceptable current ratio. Because Bartlett Company is in a business with a relatively predictable annual cash flow, its current ratio of 1.97 should be quite acceptable.

- **Quick (Acid-Test) Ratio**

The quick (acid-test) ratio is similar to the current ratio except that it excludes inventory, which is generally the least liquid current asset. The generally low liquidity of inventory results from two primary factors: (1) many types of inventory cannot be easily sold because they are partially completed items, special-purpose items, and the like; and (2) inventory is typically sold on credit, which means that it becomes an account receivable before being converted into cash. The quick ratio is calculated as follows:

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current liabilities}}$$

The quick ratio for Bartlett Company in 2003 is

$$\frac{\$1,223,000 - \$289,000}{\$620,000} = \frac{\$934,000}{\$620,000} = 1.51$$

A quick ratio of 1.0 or greater is occasionally recommended, but as with the current ratio, what value is acceptable depends largely on the industry. The quick ratio provides a better measure of overall liquidity only when a firm's inventory cannot be easily converted into cash. If inventory is liquid, the current ratio is a preferred measure of overall liquidity.

- **Activity Ratio**

Activity ratios measure the speed with which various accounts are converted into sales or cash—inflows or outflows. With regard to current accounts, measures of liquidity are generally inadequate because differences in the composition of a firm's current assets and current liabilities can significantly affect its "true" liquidity. It is therefore important to look beyond measures of overall liquidity and to assess the activity (liquidity) of specific current accounts. A number of ratios are available for measuring the activity of the most important current accounts, which include inventory, accounts receivable, and accounts payable.⁷ The efficiency with which total assets are used can also be assessed.

Inventory Turnover

Inventory turnover commonly measures the activity, or liquidity, of a firm's inventory. It is calculated as follows:

$$\text{Inventory Turnover} = \frac{\text{Cost of goods sold}}{\text{Inventory}}$$

Applying this relationship to Bartlett Company in 2003 yields

$$\text{Inventory turnover} = \frac{\$2,088,000}{\$289,000} = 7.2$$

The resulting turnover is meaningful only when it is compared with that of other firms in the same industry or to the firm's past inventory turnover. An inventory turnover of 20.0 would not be unusual for a grocery store, whereas a common inventory turnover for an aircraft manufacturer is 4.0. Inventory turnover can be easily converted into an average age of inventory by dividing it into 360—the assumed number of days in a year.⁸ For Bartlett Company, the average age of inventory in 2003 is 50.0 days ($360/7.2$). This value can also be viewed as the average number of days' sales in inventory.

- **Average Collection Period**

The average collection period, or average age of accounts receivable, is useful in evaluating credit and collection policies.⁹ It is arrived at by dividing the average daily sales¹⁰ into the accounts receivable balance:

$$\begin{aligned} \text{Average collection period} &= \frac{\text{Account receivable}}{\text{Average sales per day}} \\ &= \frac{\text{Account receivable}}{\frac{\text{Annual sales}}{360}} \end{aligned}$$

The average collection period for Bartlett Company in 2003 is

$$\frac{\$503,000}{\frac{\$3,074,000}{360}} = \frac{\$503,000}{\$8,539} = 58.9 \text{ days}$$

On the average, it takes the firm 58.9 days to collect an account receivable. The average collection period is meaningful only in relation to the firm's credit terms. If Bartlett Company extends 30-day credit terms to customers, an average collection period of 58.9 days may indicate a poorly managed credit or collection department, or both. It is also possible that the lengthened collection period resulted from an intentional relaxation of credit-term enforcement in response to competitive pressures. If the firm had extended 60-day credit terms, the 58.9-day average collection period would be quite acceptable. Clearly, additional information is needed to evaluate the effectiveness of the firm's credit and collection policies.

Average Payment Period

The average payment period, or average age of accounts payable, is calculated in the same manner as the average collection period:

$$\begin{aligned} \text{Average payment period} &= \frac{\text{Accounts payable}}{\text{Average Purchase per day}} \\ &= \frac{\text{Accounts Payable}}{\frac{\text{Annual purchases}}{360}} \end{aligned}$$

The difficulty in calculating this ratio stems from the need to find annual purchases,¹¹ a value not available in published financial statements. Ordinarily, purchases are estimated as

a given percentage of cost of goods sold. If we assume that Bartlett Company's purchases equalled 70 percent of its cost of goods sold in 2003, its average payment period is

$$\frac{\$382,000}{\frac{0.70 * \$2,088,000}{360}} \frac{\$382,000}{\$4,060} = 94.1 \text{ days}$$

This figure is meaningful only in relation to the average credit terms extended to the firm. If Bartlett Company's suppliers have extended, on average, 30-day credit terms, an analyst would give Bartlett a low credit rating. Prospective lenders and suppliers of trade credit are most interested in the average payment period because it provides insight into the firm's bill-paying patterns.

- **Total Asset Turnover**

The total asset turnover indicates the efficiency with which the firm uses its assets to generate sales. Total asset turnover is calculated as follows:

$$\text{Total asset turnover} = \frac{\text{sales}}{\text{total assets}}$$

The value of Bartlett Company's total asset turnover in 2003 is

$$\frac{\$3,074,000}{\$3,597,000} = 0.85$$

This means the company turns over its assets 0.85 times a year.

Generally, the higher a firm's total asset turnover, the more efficiently its assets have been used. This measure is probably of greatest interest to management, because it indicates whether the firm's operations have been financially efficient.

- The higher the cost of the new assets, the larger the denominator and thus the smaller the ratio. Therefore, because of inflation and the use of historical costs, firms with newer assets will tend to have lower turnovers than those with older assets.