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ID: 6913
SUBJECT: Financial Reporting & Analysis

Q No. 1

Answer:

1) Inventories

Inventories is an international financial reporting standard produced and disseminated by the International Accounting Standards Board to provide guidance on the valuation and classification of inventories. IAS 2 requires that those assets that are considered inventory should be recorded at the lower of cost or net realizable value. Cost not only includes the purchase cost but also the conversion costs which are the costs involved in bringing inventory to its present condition and location such as direct labour. IAS 2 also allows for the capitalization of variable overheads and fixed overheads so long as the fixed overheads are allocated on a systematic and consistent basis and in respect to usual output levels. Where output is lower than expected the resultant excessive overhead should be considered an expense and not capitalized but when output is abnormally high the fixed overhead allocated to each unit must be decreased so as not to overvalue the inventory. In the event of there being multiple products produced from one process such as a main product and a by-product where the costs are not clearly separated the costs should be allocated on a rational and consistent basis such as based on the market value of each unit once the two products become separate. IAS 2 does not allow for the capitalization of the valuation of work in progress on construction and service contracts falls outside IAS 2 IFRS 15 applies instead similarly for financial instruments IAS 32 and IFRS 9 apply and for biological assets arising from agricultural activity IAS 41 applies instead of IAS 2. For the capitalization of borrowing costs in inventories consult IAS 23 Borrowing Costs. IAS 2 allows for two methods of costing the standard technique and the retail technique. The standard technique requires that inventory be valued at the standard cost of each unit that is the usual cost per unit at the normal level of output and efficiency. The retail technique values the inventory by taking its sales value and then reducing it by the relevant gross profit margin.

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2) Statement of Cash Flows

In financial accounting a cash flow statement also known as statement of cash flows is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents and breaks the analysis down to operating investing and financing activities. Essentially the cash flow statement is concerned with the flow of cash in and out of the business. As an analytical tool the statement of cash flows is useful in determining the short term viability of a company particularly its ability to pay bills. International Accounting Standard 7 (IAS 7) is the International Accounting Standard that deals with cash flow statements. People and groups interested in cash flow statements include Accounting personnel who need to know whether the organization will be able to cover payroll and other immediate expenses Potential lenders or creditors who want a clear picture of a company's ability to repay Potential investors who need to judge whether the company is financially sound Potential employees or contractors who need to know whether the company will be able to afford compensation Company Directors who are responsible for the governance of the company and are responsible for ensuring that the company does not trade while insolvent Shareholders of the business. Purpose The cash flow statement was previously known as the flow of funds statement. The cash flow statement reflects a firm's liquidity. The statement of financial position is a snapshot of a firm's financial resources and obligations at a single point in time and the income statement summarizes a firm's financial transactions over an interval of time. These two financial statements reflect the accrual basis accounting used by firms to match revenues with the expenses associated with generating those revenues. The cash flow statement includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not directly affect cash receipts and payments. These non-cash transactions include depreciation or write-offs on bad debts or credit losses to name a few. The cash flow statement is a cash basis report on three types of financial activities: operating activities investing activities and financing activities.

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3) Research and development

Assets in long-term GDP growth has been recognized by economists. IAS 38 requires any project that results in the generation of a resource to the entity be classified into two phases: a research phase and a development phase. The classification of research and development expenditure can be highly subjective and it is important to note that organizations may have an ulterior motive in its classification of research and development expenditure. Less scrupulous directors may manipulate financial statements through their classification of research and development expenditure. An example of research (as defined as the original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding): a company can carry a research on one of its products which it will use in the entity of which results in future economic income. Development is defined as the application of research findings to a plan or design for the production of new or substantially

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4) Revenue

In accounting revenue is the income that a business has from its normal business activities usually from the sale of goods and services to customers. Revenue is also referred to as sales or turnover. Some companies receive revenue from interest royalties or other fees. Revenue may refer to business income in general or it may refer to the amount in a monetary unit earned during a period of time as in Last year Company X had revenue of $42 million. Profits or net income generally imply total revenue minus total expenses in a given period. In accounting in the balance statement it is a subsection of the Equity section and revenue increases equity it is often referred to as the top line due to its position on the income statement at the very top. This is to be contrasted with the bottom line which denotes net income gross revenues minus total expenses. In general usage revenue is income received by an organization in the form of cash or cash equivalents. Sales revenue is income received from selling goods or services over a period of time. Tax revenue is income that a government receives from taxpayers. Fundraising revenue is income received by a charity from donors etc. to further its social purposes. In more formal usage revenue is a calculation or estimation of periodic income based on a particular standard accounting practice or the rules established by a government or government agency. Two common accounting methods cash basis accounting and accrual basis accounting do not use the same process for measuring revenue. Corporations that offer shares for sale to the public are usually required by law to report revenue based on generally accepted accounting principles or International Financial Reporting Standards. In a double-entry bookkeeping system revenue accounts are general ledger accounts that are summarized periodically under the heading Revenue or Revenues on an income statement. Revenue account names describe the type of revenue such as Repair service revenue Rent revenue earned or Sales.

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Q No.2
Answer:

1) Consolidated financial statement

Are the Financial statements of a group in which the assets liabilities equity income expenses and cash flows of the parent company and its subsidiaries are presented as those of a single economic entity according to International Accounting Standard 27 Consolidated and separate financial statements and International Financial Reporting Standard 10 Consolidated financial statements While preparing a consolidated financial statement there are two basic procedures that need to be followed: first you cancel out all the items that are accounted as an asset in one company and a liability in another and then add together all cancelled items.

Consolidated Statement of Financial Position

There are two main type of items that cancel each other out from the consolidated statement of financial position. Investment in subsidiary companies which is treated as an asset in the parent company will be cancelled out by share capital account in subsidiary's statement. Only the parent company's share capital account will be included in the consolidated statement. If trading between different companies in one group happen then the payables of one company will be cancelled by the receivables of another company.

Goodwill arising on consolidation

Goodwill is treated as an intangible asset in the consolidated statement of financial position. It arises in cases where the cost of purchase of shares is not equal to their par value. For example if a company buys shares of another company worth $40000 for $60000 we conclude that there is a goodwill worth or $20000. Proforma
For calculating goodwill is as follows

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Goodwill

Fair value of consideration transferred Plus fair value of non-controlled interest at acquisition Less ordinary share capital of subsidiary company Less share premium of subsidiary company Less retained earnings of subsidiary company at acquisition date Less fair value adjustments at acquisition data.

2) Fair value

In accounting and in most schools of economic thought fair value is a rational and unbiased estimate of the potential market price of a good service or asset. The derivation takes into account such objective factors as the costs associated with production or replacement market conditions and matters of supply and demand. Subjective factors may also be considered such as the risk characteristics the cost of and return on capital and individually perceived utility.

Vs market price

There are two schools of thought about the relation between the market price and fair value in any form of market but especially with regard to tradable assets: The efficient-market hypothesis asserts that in a well-organized reasonably transparent market the market price is generally equal to or close to the fair value as investors react quickly to

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Economic understanding

incorporate new information about relative scarcity utility or potential returns in their bids; see also rational pricing. Behavioral finance asserts that the market price often diverges from fair value because of various common cognitive biases among buyers or sellers. However even proponents of behavioral finance generally acknowledge that behavioral anomalies that may cause such a divergence often do so in ways that are unpredictable chaotic or otherwise difficult to capture in a sustainable profitable trading Strategy especially when accounting for transaction costs.

Vs market value

the latest edition of International Valuation Standards (IVS 2017) clearly distinguishes between fair value (now referred to as equitable value) as defined in the IVS and market value as defined in the IVS: So as the term is generally used Fair Value can be clearly distinguished from Market Value. It requires the assessment of the price that is fair between two specific parties taking into account the respective advantages or disadvantages that each will gain from the transaction. Although Market Value may meet these criteria this is not necessarily always the case. Fair Value is frequently used when undertaking due diligence in corporate transactions where particular synergies between the two parties may mean that the price that is fair between them is higher than the price that might be obtainable on the wider market. In other words Special Value may be generated. Market Value requires this element of Special Value to be disregarded but it forms part of the assessment of Fair Value. In accounting fair value is used as a certainty of the market value of an asset (or liability) for which a market price cannot be determined (usually because there is no established market for the asset). Under US GAAP (FAS 157) 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. This is used for assets whose carrying value is based on mark-to-market valuations; for assets carried at historical cost the fair value of the asset is not used

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Q No.3

Answer:

Financial statement

Are formal records of the financial activities and position of a business person or other entity Relevant financial information is presented in a structured manner and in a form which is easy to understand They typically include four basic financial statements accompanied by a management discussion and analysis

1) Income statement

An income statement or profit and loss account (also referred to as a profit and loss statement (P&L) statement of profit or loss revenue statement statement of financial performance earnings statement statement of earnings operating statement or statement of operations is one of the financial statements of a company and shows the company's revenues and expenses during a particular period. It indicates how the revenues (also known as the top line) are transformed into the net income or net profit (the result after all revenues and expenses have been accounted for). The purpose of the income statement is to show managers and investors whether the company made money (profit) or lost money (loss) during the period being reported. An income statement represents a period of time (as does the cash flow statement). This contrasts with the balance sheet which represents a single moment in time. Charitable organizations that are required to publish financial statements do not produce an income statement. Instead they produce a similar statement that reflects funding sources compared against program expenses administrative costs and other operating commitments. This statement is commonly referred to as the statement of activities. Revenues and expenses are further categorized in the statement of activities by the donor restrictions on the funds received and expended. The income statement can be prepared in one of two methods. The Single Step income statement totals revenues and subtracts expenses to find the bottom line. The Multi-Step income statement takes several steps to find the bottom line starting with the gross profit then calculating operating expenses. Then when deducted from the gross profit yields income from operations.

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Operating section

Revenue

Cash inflows or other enhancements of assets (including accounts receivable) of an entity during a period from delivering or producing goods rendering services or other activities that constitute the entity's ongoing major operations. It is usually presented as sales minus sales discounts returns and allowances. Every time a business sells a product or performs a service it obtains revenue. This often is referred to as gross revenue or sales revenue.

Expenses

Cash outflows or other using-up of assets or incurrence of liabilities (including accounts payable) during a period from delivering or producing goods rendering services or carrying out other activities that constitute the entity's ongoing major operations.

Non-operating section

Other revenues or gains

Revenues and gains from other than primary business activities (e.g. rent income from patents goodwill). It also includes unusual gains that are either unusual or infrequent but not both (e.g. gain from sale of securities or gain from disposal of fixed asset

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2) Balance sheet

In financial accounting a balance sheet or statement of financial position or statement of financial condition is a summary of the financial balances of an individual or organization whether it be a sole proprietorship a business partnership a corporation private limited company or other organization such as Government or not-for-profit entity. Assets liabilities and ownership equity are listed as of a specific date such as the end of its financial year. A balance sheet is often described as a snapshot of a company's financial condition of the four basic financial statements the balance sheet is the only statement which applies to a single point in time of a business' calendar year. A standard company balance sheet has two sides: assets on the left and financing on the right–which itself has two parts; liabilities and ownership equity. The main categories of assets are usually listed first and typically in order of liquidity. Assets are followed by the liabilities. The difference between the assets and the liabilities is known as equity or the net assets or the net worth or capital of the company and according to the accounting equation net worth must equal assets minus liabilities. Another way to look at the balance sheet equation is that total assets equals liabilities plus owner's equity. Looking at the equation in this way shows how assets were financed: either by borrowing money (liability) or by using the owner's money (owner's or shareholders' equity). Balance sheets are usually presented with assets in one section and liabilities and net worth in the other section with the two sections balancing. A business operating entirely in cash can measure its profits by withdrawing the entire bank balance at the end of the period plus any cash in hand. However many businesses are not paid immediately; they build up inventories of goods and they acquire buildings and equipment. In other words: businesses have assets and so they cannot even if they want to immediately turn these into cash at the end of each period. Often these businesses owe money to suppliers and to tax authorities and the proprietors do not withdraw all their original capital and profits at the end of each period. In other words businesses also have liabilities

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3) Retained earnings

The retained earnings of a corporation is the accumulated net income of the corporation that is retained by the corporation at a particular point of time such as at the end of the reporting period. At the end of that period the net income (or net loss) at that point is transferred from the Profit and Loss Account to the retained earnings account. If the balance of the retained earnings account is negative it may be called accumulated losses retained losses or accumulated deficit or similar terminology. Any part of a credit balance in the account can be capitalized by the issue of bonus shares and the balance is available for distribution of dividends to shareholders and the residue is carried forward into the next period. Some laws including those of most states in the United States require that dividends be only paid out of the positive balance of the retained earnings account at the time that payment is to be made. This protects creditors from a company being liquidated through dividends. A few states however allow payment of dividends to continue to increase a corporation's accumulated deficit. This is known as a liquidating dividend or liquidating cash dividend. In accounting the retained earnings at the end of one accounting period is the opening retained earnings in the next period to which is added the net income or net loss for that period and from which is deducted the bonus shares issued in the year and dividends paid in that period. If a company is publicly held the balance of retained earnings account that is negatively referred to as accumulated deficit may appear in the Accountant's Opinion in what is called the Ongoing Concern statement located at the end of required SEC financial reporting at the end of each quarter. Retained earnings are reported in the shareholders' equity section of the corporation's balance sheet. Corporations with net accumulated losses may refer to negative shareholders' equity as positive shareholders' deficit. A report of the movements in retained earnings are presented along with other comprehensive income and changes in share capital in the statement of changes in equity. Due to the nature of double-entry accrual accounting retained earnings do not represent surplus cash available to a company. Rather they represent how the company has managed its profits (i.e. whether it has distributed them as dividends or reinvested them in the business). When reinvested those retained earnings are reflected as increases to assets (which could include cash) or reductions to liabilities on the balance sheet

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4) Cash flow statement

It is also known as statement of cash flows is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents and breaks the analysis down to operating investing and financing activities. Essentially the cash flow statement is concerned with the flow of cash in and out of the business. As an analytical tool the statement of cash flows is useful in determining the short term viability of a company particularly its ability to pay bills. International Accounting Standard 7 (IAS 7) is the International Accounting Standard that deals with cash flow statements. People and groups interested in cash flow statements include: Accounting personnel who need to know whether the organization will be able to cover payroll and other immediate expenses Potential lenders or creditors who want a clear picture of a company's ability to repay Potential investors who need to judge whether the company is financially sound Potential employees or contractors who need to know whether the company will be able to afford compensation Company Directors who are responsible for the governance of the company and are responsible for ensuring that the company does not trade while insolvent Shareholders of the business.

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Q No.4
Answer:

Financial statement analysis

It is the process of reviewing and analyzing a company's financial statements to make better economic decisions to earn income in future. These statements include the income statement balance sheet statement of cash flows notes to accounts and a statement of changes in equity if applicable. Financial statement analysis is a method or process involving specific techniques for evaluating risks performance financial health and future prospects of an organization. It is used by a variety of stakeholders such as credit and equity investors the government the public and decision makers within the organization. These stakeholders have different interests and apply a variety of different techniques to meet their needs. For example equity investors are interested in the long-term earnings power of the organization and perhaps the sustainability and growth of dividend payments. Creditors want to ensure the interest and principal is paid on the organizations debt securities (e.g. bonds) when due. Common methods of financial statement analysis include fundamental analysis DuPont analysis horizontal and vertical analysis and the use of financial ratios. Historical information combined with a series of assumptions and adjustments to the financial information may be used to project future performance. The Chartered Financial Analyst designation is available for professional financial analysts. Benjamin Graham and David Dodd first published their influential book Security Analysis in 1934. A central premise of their book is that the market's pricing mechanism for financial securities such as stocks and bonds is based upon faulty and irrational analytical processes performed by many market participants. This results in the market price of a security only occasionally coinciding with the intrinsic value around which the price tends to fluctuate. Investor Warren Buffett is a well-known supporter of Graham and Dodd's philosophy.

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Financial ratio analysis

Financial ratios are very powerful tools to perform some quick analysis of financial statements.

Liquidity ratios

Are used to determine how quickly a company can turn its assets into cash if it experiences financial difficulties or bankruptcy. It essentially is a measure of a company's ability to remain in business. A few common liquidity ratios are the current ratio and the liquidity index. The current ratio is current assets/current liabilities and measures how much liquidity is available to pay for liabilities. The liquidity index shows how quickly a company can turn assets into cash and is calculated by

(Trade receivables x
Days to liquidate) + (Inventory x Days to
liquidate)/Trade Receivables +
Inventory.

Activity ratios

Are meant to show how well management is managing the company's resources. Two common activity ratios are accounts payable turnover and accounts receivable turnover. These ratios demonstrate how long it takes for a company to pay off its accounts payable and how long it takes for a company to receive payments respectively.