

Financial Reporting Course Review

Basic Reading of Income Statement, Balance Sheet, and Cash Flow Statement

Book Keeping (Journal Entries)

	Debit	Credit
Balance Sheet	Asset	Liability / Equity
Profit / Loss Account	Expense	Revenue

Revenues and profits can be negative. BS receives assets and gives liabilities and equity in return. IS receives expenses from accounts and gives revenue to the cash flow statement.

Balance Sheet :

Assets = Liabilities + Owner's Equity

Balance Sheet	
Assets	Liabilities
	Owners' Equity + Reserves

Balance Sheet	
Tangible fixed assets (Net Book Value)	
Intangible fixed Assets	
Current Assets (Stocks, Debtors, Cash)	
Current Liabilities (Creditors, Accruals)	
Net Current Assets	
Long term liabilities	
Total Net Assets	
=	
Equity (shares + premium)	
Retained profit	
Revaluation Reserves	

Income Statement (P&L) :

Revenue = Expenses + Profit

Profit and Loss Account	
Expenses	Revenue
Profit	

Income Statement (P&L)	
Turnover (Sales)	
Cost of Sales	
Gross profit	
Expenses	
Exceptional Items	
Operating Profit (EBITDA)	
Other Income	
Interest	
Profit Before Tax	
Tax	
Profit After Tax	
Extraordinary Items	
Dividends	
Retained Profits (Earnings)	

Cash Flow Statement :

Revenues, financing, assets, expenses

Cash Flow Statement	
Net Cash Inflow from Operating Activity	
Returns from Investment and Finance	
Taxation	
Capital Expenditure	
Equity Dividends Paid	
Management of Liquid Resources	
Financing	
Net Increase in Cash	

Cash Flow from Operating Activities – indirect method

Net Operating Profit	
+ Depreciation Expense	
+/- Increase (minus) or decrease (plus) stocks (inventory)	
+/- Increase (minus) or decrease (plus) debtors (receivable)	
+/- Increase (plus) or decrease (minus) creditors (payable)	
= Net cash flow from operating activities	

Accounting Concept (Lemonade Example)

Journal Entries			
	Debit (Left)	Credit (Right)	
Start business with 50	Cash	50	SH Equity 50
Bought lemon and sugar (increase in assets)	Lemons	30	Cash 38
	Sugar	8	
Used lemons and sugar (decrease in assets)	Cost of Sales	24	Lemons 20
			Sugar 4
Sales (50% of lemonade)	Cash	20	Sales 20
Adjustment of Cost of Sales	Lemonade	12	Cost of Sales 12

Income Statement		
	Expenses	Revenue
Cost of Sales	12	Sales 20
Income	8	Total 20
Total	20	

Balance Sheet			
	Assets	Liabilities	
Cash	32		
Lemons	10	SH Equity	
Sugar	4	SH Equity	50
Lemonade	12	Ret. Earnings	8
Total	58	Total	58

Matching Principle - try to match revenue reported with expenses to generate that revenue in same time period

Consistency - except as noted, same accounting policies/procedures have been followed from period to period

Inventory - FIFO (first in, first out), LIFO (last in, first out)

Deferred Tax Assets

Financial Reporting	Tax
Revenue 100	Taxable Revenue 110
Expenses (ex. tax) 80	Tax Deductible Exp. 60
Income 20	Taxable Income 50
Taxes (40%) 8	Taxes (40%) 20

Difference £30 between two methods, some may be permanent (£10 in income, £4 in taxes) as one-off expense (parking ticket) while rest may be temporary (£20 in income, £8 in assets). Journal entry be:
 Dr. Tax 12 Cr. Tax Payable 20
 Deferred Tax Asset 8
 DTA are intangible and can't be realized; can artificially inflate a firm's assets.

Bad Debt Provision - 3 ways: Write it off (sure wont get it back), specific provision (exceptional circumstance), general provision %

--subtract from total debt: Total Debt - BPD Write Off - BPD Specific = Remaining Debt Remaining * BPD% = new BDP

Business Combinations

Goodwill - when investment in subsidiary company exceeds value of the company (or portion) acquired, goodwill accounts for difference

Minority Interest - if owning majority of subsidiary, remaining part is considered MI, included in Liabilities section of combined firm BS

100 % of Subsidiary		60% of Subsidiary	
Dr. Shareholders' Equity	Cr. Investment in Subsidiary	Dr. Shareholders' Equity	Cr. Investment in Subsidiary
Dr. Goodwill			Cr. Minority Interests

Ratio Analysis

Ratios

Ratio	Calculation	Type	Ratio	Calculation	Type
Return on Equity	Profit after tax / SH Funds (average funds)	Profit	Stock Turnover	Stock / Cost of Sales * 365	Liquidity Efficiency
Asset turnover	PBIT / FA+CA-CL (2yr average)	Profit	Debtors Collection Period	Debtors / Sales * 365	Liquidity Efficiency
Profit Margin	PBIT / Sales	Profit	Creditors Collection Period	Creditors / Cost of Sales * 365	Liquidity Efficiency
Return on Assets	Profit Margin * Asset Turnover	Profit	Gearing	Debt / Debt + Equity	Capital
Asset turnover	Sales / FA+CA-CL	Profit Efficiency	Interest cover	PBIT / Interest	Liquidity
Current Ratio	Current Assets / Current Liabilities	Liquidity	Dividend cover	PBIT / Dividends	Liquidity
Acid Test	Current Assets - Stock / Current Liabilities	Liquidity	Working Capital	CA - CL	

Financial Analysis:

4 areas to evaluate:
 Profitability - generating cash from inv.
 Efficiency - resource management
 Liquidity - financial position, obligations
 Capital structure - examines financing

Analysis Framework:

1. Identify industry economic characteristics
2. Examine firm strategy
3. Relevant financial statement data
4. Profitability and risk assessment
5. Explain from specific viewpoint

Using Averages = calculating (e.g. ROA), year end figure for assets may be meaningless, can be mitigated by calculating average value of assets for the year

Segmental Information and Analysis

Depreciation can be calculated in various ways, all require Cost (C), Scrap Value (S) and life of the asset in years (N)

Method	Straight-line	Reducing balance	Double declining	Sum of years digits	Units of production	Annuity method
Formula	(cost-scrap)/years	$\sqrt{(1-scrap/cost)}$	$2(1/y)$	$\frac{3+2+1=6}{\rightarrow 3/6+2/6+1/6}$ of (cost-scrap)	Production this period / total lifetime asset capacity	Based on time-value of money
Comments	Fixed annual charge Most common	Declining annual charge	Scrap value will be adjusted at the end	Can be increasing (3/6, 2/6, 1/6) or decreasing (1/6, 2/6, 3/6)		Almost never used

Leases - if an asset is leased, and control of it for the majority of its economic life is gained or risks and rewards of ownership are transferred; should be capitalised on balance sheet and shown as asset. Corresponding liability created as NPV of future payments. At present 90% test: if PV of minimum lease payments > 90% of the FV of the asset = Finance Lease

Creative compliance: Regulations say if asset leased for 75% of its life it should be on the balance sheet - so lease for 74.9%!

GAAP - Generally Accepted Accounting Principles

IASB - International Accounting Standards Board