

Paper 1

Interpretation of financial statements

AIM

The overall aim of this paper is that candidates should be able to understand and interpret the financial statements produced by organisations for external users. Candidates should develop an understanding of the regulatory framework in which these statements are prepared and of the principles and methods which underlie their preparation.

OBJECTIVES

On completion of this paper candidates should be able to:

- describe the role and function of external financial reports and identify their users and the regulatory framework in which they are prepared
- explain the accounting concepts and conventions present in generally accepted accounting practice
- explain, supported by simple computations, the presentation, measurement and meaning of the primary financial statements and their contents
- describe the informational role of the constituent parts of a corporate annual report usually presented in addition to the primary financial statements
- compute, interpret and appraise financial performance, financial position and adaptability as revealed by financial statement analysis, in particular by the use of financial and accounting ratios.

SYLLABUS CONTENT

1 Regulation of financial statements

The regulatory framework within which financial statements are prepared.

- a the role of the International Accounting Standards Committee Foundation and constituent bodies
- b the role of the auditor and the meaning of fair presentation.

2 Financial information

- a the objectives of financial statements and the needs of users
- b the reporting entity
- c the qualitative characteristics of financial information
- d the elements of financial statements
- e measurement in financial statements including an appreciation of the limitations of historical cost and the

basic nature of current value accounting models

- f the basic features of accounting for public sector and not for profit organisations.

3 Financial statements

- a the structure, features and content of the primary financial statements:
 - i Income statement
 - ii Balance sheet
 - iii Cash flow statement
 - iv Statement of changes in equity.
- b the major features, but not detailed contents of other elements of corporate annual reports:
 - i Notes to the accounts and additional financial statements
 - ii Management report
 - iii Chairman's statement
 - iv Financial reviews
 - v Environmental reports
 - vi Interim accounts
 - vii Preliminary announcements
- c the terminology and underlying accounting methods and principles used in preparing financial statements in respect of:
 - i Tangible non-current assets, including depreciation and the impact of revaluation
 - ii Intangible non-current assets, including goodwill and research and development costs
 - iii Current assets, in particular inventories and construction contracts
 - iv Liabilities, including leases, contingencies and provisions
 - v Share capital and reserves
 - vi Events after the balance sheet date
 - vii Reporting the substance of transactions
 - viii Reporting financial performance, including segmental analysis
 - ix Business combinations and other investments
 - x Cash flow reporting
 - xi The accounting implications of taxation, in particular current and deferred taxation.

For all of the above computations may be required to

support explanation, appraisal and justification of accounting policies and treatments.

4 Analysis of financial statements

- a the computation, interpretation and appraisal of financial ratios in respect of:
 - i Profitability, earnings, operating performance and efficiency
 - ii Liquidity, solvency and working capital management
 - iii Asset and capital structures, including gearing
 - iv Cash flows and cash flow management
 - v Stock market performance including earnings, dividend and price relationships.
- b common size statements, trend analysis, inter-firm analysis and failure prediction models
- c the limitations of financial ratio analysis.

EXCLUDED TOPICS

The following topics are specifically excluded from the syllabus:

- The detailed process of double entry bookkeeping
- Foreign currency translation
- Accounting for pension costs and retirement benefits
- Related party disclosures
- Reporting for smaller entities
- SICs and IFRICs.

KEY AREAS OF THE SYLLABUS

The key topics are:

- The regulatory framework
- The principles underlying financial statements
- The structure and content of the primary financial statements
- Financial statement analysis.

RELEVANT TEXTS

M Pendlebury, R Groves **Company Accounts: Analysis, Interpretation and Understanding (5th Ed) 2001**

Thomson Learning
(ISBN 1–86152–595–8)

G Holmes, A Sugden **Interpreting Company Reports and Accounts (7th Ed) 1999** Pearson

(ISBN 0–273–64615 x)

E McLaney, P Atrill **Accounting: An Introduction (2nd Ed) 2002** Prentice Hall
(ISBN 0–273–65550)

STUDY GUIDE

1 The Regulatory Framework of Accounting

Syllabus reference 1a, b

- Outline the purpose and underlying assumptions of the IASB Framework for the Preparation and Presentation of Financial Statements ('Framework')
- Explain the requirement for an audit of published financial statements and the role of the auditor
- Explain the nature of the 'fair presentation'
- Identify those entities which do not require audited published financial statements
- Explain the role and functions of regulatory bodies
 - International Accounting Standards Committee Foundation
 - International Accounting Standards Board (IASB)
- Explain the role and functions of the International Financial Accounting Reporting Interpretations Committee

2 Objectives of Financial Statements and the Reporting Entity

Syllabus reference 2a, b

- Explain the objectives of decision usefulness and stewardship
- Identify the users of financial statements and their needs
- Explain the categories of financial information available to users and the role of general purpose financial statements
- Explain the need for information in respect of financial performance, financial position, generation of cash and financial adaptability
- Explain the principle of control in defining the boundary of the reporting entity.

3 Qualitative characteristics elements and related concepts.

Syllabus reference 2c, d

- Explain the need for relevance, reliability, comparability

and understandability of financial information and constraints on these.

- Define assets, liabilities, income, expenses, equity, contributions from owners and distribution to owners
- Explain and apply the concepts of accruals and going concern.

4 Measurement in financial statements

Syllabus reference 2e

- Explain the need for a measurement basis to be used in financial statements
- Explain and apply the basic principles of historical cost accounting
- Explain the basic principles of current cost accounting.

5 Financial statements I

Syllabus reference 3a(i), 3a(ii)

- Explain how the basic accounting equation underlies the balance sheet and income statement and the relationship between these two statements
- Explain and apply the classification of asset and liability disclosure in the balance sheet.
- Draft a balance sheet in vertical form
- Explain how and why revenue and expenses are disclosed in the income statement
- Draft an income statement in vertical form.

6 Financial statements II

Syllabus reference 3a(iii), 3a(iv)

- Explain the difference between accruals based and cash based financial statements
- Explain the relationship of a cash flow statement to the other primary financial statements
- Explain the difference between realised and unrealised gains and losses and the purpose of comprehensive disclosure
- Draft a statement of changes in equity.

7 Financial statements III

Syllabus reference 3b(i) – 3b(viii)

- Explain the need for additional information in the form of notes to the accounts and additional financial statements
- Identify the basic components of a management report

- Explain the purpose and usefulness of a chairman's statement
- Explain the need for summarised financial information and its limitations.
- Identify the basic components of an operating and financial review
- Explain the need for preliminary announcements and interim statements
- Identify the fundamental differences between accounting for public sector and private sector entities.

8 Tangible non-current assets

Syllabus reference 3c(i)

- Explain and apply accounting principles to the initial recognition and measurement of tangible assets
- Explain and apply the principal methods of depreciation and appraise their impact on the financial statements
- State and appraise the impact of the revaluation of non-current assets
- Explain the nature and effect of impairment of non-current assets.

9 Intangible non-current assets

Syllabus reference 3c(ii)

- Discuss the nature of an intangible asset and in particular goodwill
- Explain and apply the accounting treatment of internally generated and purchased goodwill
- Distinguish between research expenditure and development costs
- Explain and apply the accounting treatment of research expenditure and development costs.

10 Current assets

Syllabus reference 3c(iii)

- Explain and apply the basic inventory valuation principle of cost or net realisable value
- Explain and apply the stock valuation conventions of FIFO and weighted average
- Discuss the treatment of construction contracts
- Explain the need for assessment of receivables and receivables allowances.

11 Accounting for liabilities

Syllabus reference 3c(iv)

- Explain the distinction between current and non-current liabilities
- Explain the difference between liabilities, provisions and contingent liabilities and apply the relevant accounting treatment of these to examples
- Explain the nature of finance and operating leases
- Explain and apply the accounting treatment of finance and operating leases

12 Share capital, reserves and events after the balance sheet date

Syllabus reference 3c(v), 3c(vi)

- Distinguish between different types of share capital and explain their characteristics
- Distinguish between different types of reserve (capital, revenue; realised/unrealised) and their uses
- Explain the nature of 'off-balance sheet finance' and the concept of substance over form
- Distinguish between adjusting and non adjusting events after the balance sheet date and explain their accounting treatment.

13 Reporting financial performance

Syllabus reference 3c(vii), 3a(iv)

- Explain and appraise the meaning of a statement of financial performance (income statement) which identifies discontinuing operations, exceptional items, prior period adjustments and non-current assets held for resale
- Identify the items in the income statement which might be included in reported earnings per share
- Calculate reported earnings per share
- Explain the significance of earnings per share as a measure of performance
- Explain the link between the income statement and the statement of changes in equity
- Explain the purpose of segmental information (class of business, geographical) and appraise the usefulness of this information for interpretation of financial statements.

14 Accounting for investments, in particular groups including subsidiaries, associates and joint ventures.

Syllabus reference 3c(viii), 3c(ii)

- Explain the treatment of investments held for resale
- Distinguish between subsidiaries, associates and joint ventures
- Describe the concept of a group and explain the terminology of accounting for groups
- Explain and apply consolidation accounting, equity accounting and the gross equity method
- Explain and apply the treatment of goodwill arising on acquisition
- Explain and apply impairment of goodwill.

15 Cash flow reporting

Syllabus reference 3c(ix)

- Prepare a cash flow statement
- Appraise the usefulness of the information in a cash flow statement
- Interpret the information in a cash flow statement.

16 Accounting for Taxation

Syllabus reference 3c(x)

- Explain and apply the accounting treatment of current taxation
- Explain and apply the effect of timing differences on accounting and taxable profits
- Explain and apply the full provision method of accounting for deferred taxation
- Appraise the impact of current and deferred taxation on financial performance and financial position.

17 Analysis of financial statements: profitability, earnings, operating performance and efficiency

Syllabus reference 4a(i)

- Outline the basic methods of financial statement analysis, in particular common size statements and ratio analysis
- Calculate and interpret ratios which provide insights into financial performance
- Assess a company's financial performance in comparison with previous periods' financial statements, inter firm comparisons and industry averages
- Discuss the effect of accounting policy choice on the interpretation and assessment above.

18 Liquidity, solvency and working capital management

Syllabus reference 4a(ii)

- Calculate and interpret ratios which provide insights into financial position and operating performance in respect of working capital
- Assess a company's financial position and working capital management in comparison with previous periods' financial statements, inter firm comparisons and industry averages
- Discuss the effect of accounting policy choice on the interpretation and assessment performance.

19 Assets and capital structure

Syllabus reference 4a(iii)

- Calculate and interpret ratios which provide insights into financial position, financing and investment strategy and utilisation of resources
- Calculate and interpret ratios which indicate financial risk, in particular gearing
- Assess a company's financial position and financial risk in comparison with previous periods' financial statements, inter firm comparisons and industry averages
- Discuss the effect of accounting policy choice on the interpretation and assessment performance.

20 Cash flow and investment analysis

Syllabus reference 4a(iv), 4a(v)

- Calculate and interpret ratios which provide insights into financial adaptability and generation and use of cash
- Calculate and interpret ratios which give an insight into earnings, dividend and price relationships which would be useful to an investor
- Assess a company's financial performance in relationship to its market price and in comparison with market averages and other market based data
- Discuss the effect of accounting policy choice on the interpretation and assessment above.

21 Comprehensive application of financial statement appraisal and analysis

Syllabus reference all of 1, 2, 3 and 4

- Explain the usefulness of multivariate ratio models, in particular with respect to failure prediction
- Discuss the limitations of financial statement ratio analysis techniques.

- Analyse and interpret a comprehensive set of financial statements including all of those identified in 3(a) and (b)
- Critically evaluate the impact on the financial statements of accounting policies in respect of the items included in 3(c)
- Present an appraisal of the results of the financial statement analysis in a given context.