Financial Statements Framework

- FS Reporting: The way companies depict their financial performance & health to investors
  - Income statement: financial performance in terms of operational gains / losses over a period of time
  - Balance sheet: financial health of a firm in terms of assets & liabilities as on date. Owners' equity = Assets - Liabilities
  - Cash flow statement: cash inflow & outflow for a period of time. Cash flow = operating + investing + financing cash flow
  - Footnotes: disclosures to provide detailed information like accounting methods, assumptions, legal actions, contingencies, sales to related parties
  - Management Discussion & Analysis:
    - assessment of financial performance
    - discussion on industry trends, capital resources, general business overview
    - discussion on accounting policies requiring significant judgments
  - Auditor's opinion: unqualified opinion by auditor indicates statements are free from material omissions & errors

- Reporting Standards
- Reporting Quality
- International Standards Convergence
**Principles for preparing FS:**
- **Fair representation:** faithful representation of transactions
- **Going concern:** based on the assumption that firm will continue to exist
- **Accrual basis:** transactions are recorded when they occur irrespective of cash flow
- **Consistency:** consistency in presentation of a/cs between periods
- **Materiality:** free of misstatements or omissions

**International Accounting Standard Board (IASB) goals:**
- Global accounting standards with transparency, compatibility, & higher reporting quality
- Promote the use of global accounting standards
- Convergence between national GAAP standards and global accounting standards
- Needs of emerging nations & small firms in implementation of global accounting standards

**IFRS** is a largely principle based approach with following characteristics:
- **Understandability:** easy to comprehend and
- **Comparability:** comparable among firms and across time periods
- **Relevance:** sufficiently detailed & relevant information
- **Reliability:** should reflect economic reality

**Q. Which of the following characteristics least likely to contribute to the relevance?**
- A. Detailed footnotes
- B. Qualified opinion by auditor
- C. Annual report available on request

**Ans.** Annual report available on request act as a barrier in information dissipation and hence does not contribute towards relevance

**Q. Which of the following is least likely to be true in case of a company which report its earnings according to IFRS?**
- a) Interest received Interest paid
- b) Dividends paid Interest paid
- c) Dividend received Dividend paid

**Ans.** In case of IFRS dividend paid cannot be classified under Cash flow from financing and hence answer is B
Principles for preparing FS:
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Financial Accounting Standards Board (FASB) has similar framework, but its rule based approach and differ in some aspects
- FASB defines assets as a future economic benefit, IASB defines it as a resource for future economic benefit
- FASB does not allow upward revision of asset prices

**Q.** Which of the following is least likely to be true in case of a company which report its earnings according to US GAAP?

**a)** Interest paid Dividends paid

**b)** Dividends received Interest paid

**c)** Interest received Dividend paid

**Ans.** In case of US GAAP interest paid cannot be classified under Cash flow from financing and hence answer is B
Financial Statements Framework

Fraud Triangle:
- Incentive to commit fraud
- Opportunity provided by weak internal control
- Attitudes which justifies fraudulent behavior

Risk factors related to incentive to commit fraud:
- Threat to financial profitability due to external factors
- Excessive third party pressure on mgmt
- Threat to personal net worth of management
- Pressure to meet internal financial targets

Risk factors related to opportunities that exist:
- Ineffective mgmt monitoring
- Complex or unstable organizational structure
- Deficient internal controls
- Nature of the firm’s industry or operations

Risk factors related to attitudes:
- Inappropriate ethical standards
- Known history of violations of law
- Management’s obsession with increasing stock price
- Making commitment to third parties regarding earning performance

Warning signs:
- Aggressive revenue recognition
- Abnormal growth rate compared to industry
- Abnormal inventory growth compared to sales growth
- Delaying expense recognition
- LIFO liquidation
- Extending useful lives of long term assets
- Aggressive pension assumptions
- Off balance sheet special purpose entities
- Higher use of operating leases
Convergence of IFRS & US GAAP is ongoing process, but material differences in their accounting standards are listed below:

- LIFO method is allowed under US GAAP but not allowed under IFRS
- IFRS allows upward revaluation of PP&E, but US GAAP does not allow upward revision
- US GAAP recommends equity method of accounting for joint ventures, whereas IFRS uses proportionate consolidation
- US GAAP doesn’t permit upward revaluation of intangible assets like goodwill
- US GAAP allows capitalization of construction interest, IFRS allows capitalization of acquisition, construction interest
- US GAAP – interest received & paid – CFO
  IFRS flexible in terms of classification