

## Topics

- **Introduction**
  - Financial Statement: BS, CF, IS, CI=NI + OCI
  - Other: notes, MD&A, proxy statements, interim reports
  - Audit (independent review, reasonable assurance)
  - Audit Opinion (Unqualified/clean, qualified, adverse, disclaimer)
- **Financial Reporting Mechanics**
  - Business activity (operating, investing, financing)
  - Accounts: normal and contra-accounts
  - Elements: assets, liabilities, equity, revenues, expenses
  - Accounting equation (asset = liability + equity)
  - Accounting accrual (accrued revenue/expense, unearned revenue, prepared expense)
  - Accounting System (general journal, general ledger, trial balance, financial statement)
- **Financial Reporting Standards**
  - Standard-Setting Bodies (IASB, FASB)
  - Standards (IFRS/IAS, GAAP)
  - Regulatory Authorities (US: SEC, UK: FCA, IOSCO)
  - Standards Convergence (IFRS and GAAP)
  - Framework
    - Characteristics: relevance, faithful representation
    - Elements: assets, liability, equity, income, expense
    - Measure: historical/amortized/current cost, net realizable value, present value, fair value
  - Monitor & Disclosure

## Introduction

### Introduction

- Financial Reporting
  - Show financial performance to investors
- Financial Analysis
  - Use financial statements to make economic decisions
  - Evaluate past performance

### Financial Statements

- Balance Sheet (BS)
  - $\text{Asset} = \text{liability} + \text{owner's equity}$
- Comprehensive Income
  - All changes in equity except for **shareholder** transaction (issue/repurchase stock, pay dividend)
  - $\text{CI} = \text{NI} + \text{OCI}$
  - Comprehensive income = income statement + **other comprehensive income** (OCI)
  - Can be combined or separated with income statement
- Income statement (statement of **operation**, P&L, IS)
  - Financial performance
  - Revenues, expenses, gains, losses
- Change in equity
  - Amount and sources of change in equity investor's investment
- Cash flow (CF)
  - Cash receipts and payments
  - Types
    - Operating: normal business
    - Investing buy/sell assets (PP&E), securities, investment
    - Financing: issuance/retirement of debt/stock, cash dividend

### Financial Statement Note (footnotes) 附注

- Further details about information in FS.
- Allow users to improve the assessment of **amount**, **timing**, and **uncertainty** of estimates in FS.
- a **comprehensive** description of all of **the entity's** accounting policies, irrespective of whether judgment was required or whether the policies are important in understanding the financial statements. 全面的
- Should be **audited**
- Examples
  - Basis: fiscal period, inclusion of consolidated entities
  - **Accounting**: methods, assumptions, estimates
  - Additional: buy/sell, legal, employee benefit plan, contingencies and commitments, significant customers, segments of the firm

### Management's Commentary (discussion & analysis MD&A)

- Part of annual reports

- Management discuss a variety issue
- IFRS
  - Natural of business, objective, past performance, measures used
  - Key relationships, resources, and risks
  - May be unaudited
- SEC
  - Discuss trends and identify **significant events and uncertainties** that affect liquidity, resource, operations.
  - Also
    - Effects of inflation and changing prices
    - Purchase **commitments** (off-balance-sheet obligation)
    - **Accounting policies that require significant judgement by management**
    - **Forward-looking** expenditures and divestitures
  - information on **capital expenditures** and how they support the entity's strategic direction.
  - aspects of accounting policy choices most **important** to understanding the financial statements. 重要的

#### Proxy Statement 代理 – 股东投票

- Issued to shareholders when there are matters that require a **shareholder** vote.
- Information: **election** of board members, **compensation**, management qualification, issuance of **stock** options.

#### Interim reports

- Interim reports, either **quarterly or semi-annual**, contains updated information on a company's performance and financial position since last annual report

#### Audit

- **Independent review** of financial statements
- Objective
  - Provide an **opinion** on the **fairness** and **reliability** of FS
- Range
  - **Accounting** and **internal control** systems
  - Confirm assets and liabilities
  - Determine there is no **material** errors
- Opinion parts
  - Financial statements are **prepared** by management and auditors have performed an **independent** view
  - General audit standards were followed, provide **reasonable assure** in FS
    - Not fraud or illegal acts
  - Satisfied FS prepared in accordance with accounting principles. Explain when methods have not been **consistently** between periods.
  - About firm's **internal controls**
- Opinion Types
  - Unqualified (Clean): free from material omissions and errors

- Qualified: **exceptions** to accounting **principles**
- Adverse: not **fairly** or materially **nonconforming** with standards 负面
- Disclaimer of opinion: unable to express 保留

### Financial Analysis Framework

- State the objective and context
  - what questions to answer, what resources, how much time
- Gather data
- Process data
  - make adjustments, calculate ratios, prepare common-size balance sheets
- Analyse and interpret data
- Report the conclusions or recommendations
- Update the analysis

## Financial Reporting Mechanics

### Important

- Business activity (operating, investing, financing)
- Accounts: normal and contra-accounts
- Elements: assets, liabilities, equity, revenues, expenses
- Accounting equation (asset = liability + equity)
- Accounting accrual (accrued revenue/expense, unearned revenue, prepared expense)
- Accounting system (general journal, general ledger, trial balance, financial statement)

### Business Activity

- Operating: ordinal course of business
- Investing: buy/sell long-term assets
- Financing: issue/redeem debt, issue/repurchase stock, cash dividend

### Elements & Accounts

- Elements: asset, liability, equity, revenue, expense
- Accounts: specific records within statements 账户
- Contra accounts: offset part of the value in another account 备抵账户
  - Accumulated depreciation: asset (capitalized expense)
  - Bad debt: account receivable
  - Valuation allowance: DTA (deferred tax asset)
- Assets
  - Cash and cash equivalents: < 90 maturities
  - Inventory
  - Accounts receivable
    - Contra account: **Bad debt, warranty**
  - Financial assets: market securities
  - Prepared expense: will be converted to expense
  - PP&E
    - Contra account: **accumulated depreciation**
  - Investment in affiliates
  - Deferred tax assets
    - Contra account: **valuation allowance**
  - Intangible assets: goodwill, patents, licenses, trademark
    - Contra account: **accumulated depreciation** (except goodwill)
- Liabilities
  - Accounts payable
  - Financial liabilities: short-term notes payable
  - Unearned revenue: will be converted to revenue
  - Long-term debt: bonds payable
  - Income tax payable
  - Deferred tax liabilities
- Equity
  - **Capital** 资本公积 (stock issue/repurchase)

- Capital: par value of common stock 平价
  - Additional paid-in capital: **proceeds** from the sale stocks in **excess** of its par value. 多余价
    - Contra account: **treasury stock** (repurchases) 库存股
- Retained Earning 留存收益
  - Net income – **declared** dividend
- **Other Comprehensive income (OCI)**
  - Foreign currency **translation** 外汇转换
  - Minimum **pension** liability adjustments 养老
  - **Unrealized** gains & losses on investment 非实现的
  - Revaluation surplus (IFRS)
  - Valuation adjustment sometimes
- Revenues
  - Sales: revenue from firm's activities
  - **Gains**: increase in **assets** from transactions incidental to activities 资产升值
  - Investment income: interest and dividends
- Expense
  - COGS: Cost of goods sold
  - SG&A: selling, general, administrative expenses
  - **Depreciation and amortization**: reflect the using up of assets
    - Offset capitalized expenses
  - Interest expense
  - Tax expense
  - **Losses**: decrease in **assets** from transactions incidental to activities 资产贬值

### Accounting Equations

- **BASE: beginning + addition – subtraction = ending**
- **Balanced: double-entry accounting (at least two)**
- Asset = liability + equity
- Equity = **contributed capital** + ending retained earnings
- Retained earnings: ending = beginning + change
- Change in retained earnings = net income - declared dividend
- Net income = revenues - expenses
- **Assets = liabilities + contributed capital + beginning retained earning**
  - **+ revenues – expenses – dividends**

### Accounting Accruals 权责发生制 vs 实收实付制

- Revenues & expenses are not always the same with cash receipts & payments
- Accrual
  - revenue is **recorded** when the firm **earns** it, and expenses are recorded when they **occur**.
- **Four categories**
  - Accrued revenues: asset, will receive cash in the future
    - Revenues increase, asset (receivable) increase 应收账款
    - Once received: asset (cash) increase, asset (receivable) decrease

- Accrued expenses: liability, will pay cash in the future
  - **Expense** increase, liability increase (payable) 应付账款
  - Once paid: **asset (cash) decrease**, liability (payable) decrease
- Unearned revenues: liability, will deliver goods in the future 负债
  - Liability (unearned revenue) increase, asset (cash) increase
  - Once delivered: liability (unearned revenue) decrease, **revenue** increase
- Prepaid expenses: asset, will receive goods in the future 资产
  - Asset (prepaid expense) increase, **asset (cash) reduce**
  - Once received: asset (prepaid expense) decrease, **expense** increase

### Valuation Adjustments – Equity 估值调整

- Adjust **historical** costs to **market** values
- Most assets are recorded in **historical** costs.
- Some assets should use **market** values
- The update in values are called **valuation adjustments**.
- Changes in assets values -> changes in equity
  - Income: gains & losses
  - Or other comprehensive income

### Accounting System – Information Flow

- General journal 普通日记账 – order by date
  - A **journal entry** records a transaction
  - **Adjusting entries** are a type of journal entry typically made at the end of the accounting period to record such items as **accruals** that are **not yet** reflected in the accounting system.
- General ledger 总分类账户 – order general journal by **account**
  - 分类账 Ledger
  - 明细分类账 Subsidiary Ledger
- Trial balance 试算平衡表
  - Initial trial balance and adjusted trial balance
  - List all **account balances** at particular **point in time**
- Financial statements: account balances are represented in trial balance

### Security Analyst

- Make **adjustments** to reflect items not reported in financial statements
- Aid in the **assessment** of management's judgment in **accruals** and valuations
- Identify statement entries that appear to be out of line
- Identify earning manipulation

### Examples

- Deprecation -> expense, accumulated -> contra asset

## Financial Reporting Standards

### Topics

- Objective
- Standard-Setting Bodies (IASB, FASB)
- Standards (IFRS/IAS, GAAP)
- Regulatory Authorities (US: SEC, UK: FCA)
- International organization: IOSCO
- Standards Convergence (IFRS and GAAP)
- Framework
  - Characteristics: **relevance**, **faithful** representation
  - Elements: assets, liability, equity, income, expense
  - Measure: historical/amortized/current cost, net realizable value, present value, fair value
- Monitor & Disclosure

### Objective

- Consistency
  - Narrow the range of acceptable responses
- Comparable (similarity)
- Flexible
  - Allow discretion to management to properly describe the economics of the firm

### Private Standard-Setting Bodies

- Professional organizations of accountants
- IASB: International Accounting Standards Board
- FASB: Financial Accounting Standards Board

### Foundation-Oversee

- **Financial Accounting Foundation**
  - oversees FASB
- **IFRS Foundation trustees**
  - do appoint the members of the IASB
- Monitoring Board that oversees the IASB includes
  - representatives from the European Commission, IOSCO, the Japan Financial Services Agency, and the US SEC.

### Standards

- IASB
  - IFRS: International Financial Reporting Standards
  - IAS: internal Accounting Standards (old)
- FASB
  - GAAP: Generally accepted Accounting Principles

### Government Regulatory Authorities



- Government agencies who have the authority to **enforce** compliance
- US
  - SEC: Securities and Exchange Commission
    - Oversee the Public Companies Accounting Oversight Board (PCAOB) under the Sarbanes–Oxley Act of 2002
  - Filing
    - S-1: registration statement
    - 10-K: annual filing
      - Business and management, audited financial statements and disclosures, and legal matters
      - Similar to **annual report** but not
    - 10-Q: quarterly
    - DEF-14A: proxy statement
- UK
  - FCA: Financial Conduct Authority

### International and most national

- IOSCO: International Organization of Securities Commissions
- Goal
  - Uniform financial **regulation** across countries
- Objective
  - Protect investors
  - Ensure fairness, efficiency, transparent of markets
  - Reduce systemic risk

### Standards Convergence

- Convergence
  - European Union requires IFRS
  - Most convergence with IFRS
  - GAAP and IFRS converged
- SEC
  - No longer reconcile IFRS with GAAP
- Barriers
  - Standard-setting bodies and regulatory authorities do **not disagree** on best treatment of a particular item or issue.
  - Political pressure

### IASB Framework - Qualitative Characteristics

- **Fundamental**
  - **Relevance** 相关: make economic decisions. Materiality
  - **Faithful Representation** 可靠: complete, **neutral**, and free from errors
- **Other**
  - **Comparability** 可比较: among firms and across time periods
  - **Verifiability** 可验证: independent observers obtain similar results
  - **Timeliness** 时效性: available to decision makers before information stale
  - **Understandability** 易理解: easy to understand

## IASB Framework - Elements

- Assets: expected to provide future economic benefits
- Liabilities: expected to require an **outflow** of economic **resources**
- Equity:
- Income: increase in economic benefits. Revenues and gains.
- Expense: decrease in economic benefits. Expenses and losses.

## IASB Framework - Recognition 确认

- An item should be recognized if a future economic benefit is **probable** and the value or cost can be measured **reliably**.

## IASB Framework - Measurement Base 测量

- Historical cost 历史成本: originally paid for an asset
- Amortized cost 摊销成本: historical cost adjusted for depreciation, amortization, depletion, and impairment
- Current cost 购买价格: current buying cost
- Net realizable value 净变现价值: selling price – selling cost
- Present value 使用现值 (现金流) : discounted expected future cash flow
- Fair value 公允价值/卖: the price at which an asset could be **sold**, or a liability **transferred**, in an orderly transaction between willing parties
- **Actions**: Buy, sell, use, exchange

## IASB Framework - Constraints and Assumptions

- Constraints
  - Benefit > cost of presenting it
  - Non-quantifiable information cannot be captured directly in financial statements
- **Assumptions**
  - Accrual accounting 权责发生制: reflect transaction when they occur
  - Going concern 持续经营: continue to exist

## IAS - IFRS

- Financial statements: BS, IS, CF, ES, explanatory notes
- **Features** for preparing FS
  - **Fair** representation
  - **Going concern** basis
  - **Accrual basis** for statements other than cash flow
  - **Consistency** in how items are presented and classified
  - **Materiality**: free from misstatements or omissions
  - **Aggregation** of similar items and separation of dissimilar items
  - **No offsetting** of assets against liabilities or income against expense unless it is permitted or required
  - Reporting **frequency**: **annually**
  - **Comparative** information for prior periods
- **Structure and Content**

- **Classified** balance sheet: **current/noncurrent** assets/liabilities
- **Minimum** information
- **Comparative** information for prior periods

### IFRS and GAAP

- Firms do not comply with GAAP or IASB should use GAAP
- Firms use IASB no longer need to prepare **reconciliation statement**
- SEC: publicly advocating for **global accounting standards** and convergence.

Items	FASB/GAAP	IASB/IFRS
<b>Performance</b> Income Statement	Revenues, expenses, gains, losses, comprehensive income	Income, expenses
<b>Comprehensive</b>		Begin with <b>net income</b> (profit or loss) from income statement
Asset	Future economic benefit	Resource future economic benefit is expected to flow
Upward valuation	No for most cases	yes

### Joint Coherent Framework

- Principle-based or objective-oriented
- **Coherent**
  - Transparency
  - Comprehensiveness
  - Consistency
    - **limit** the range of acceptable approaches 减少可选范围
- Significant differences still exist between IFRS and US GAAP, and in most cases, analysts will lack the information necessary to make specific adjustments to address these differences. As such, comparisons must be interpreted cautiously
- **Barriers**
  - Valuation
  - Standard Setting
    - Principle-based: a **board** framework
    - Rule-based: give **specific** guidance on how to classify transaction
    - Objective-oriented: blends the two
  - IFRS & GAAP
    - IFRS: principle-based
    - GAAP: rule-based in the past, now the common conceptual more **objective-based**
  - Measurement
    - Value **one** point in time (balance sheet, Asset/liability, largely used)
    - Value **changes** between points in time (income statement, revenue/expense)

### Monitor

- New products -> new transactions ->
  - By understanding the economic purpose of a transaction
  - And then apply framework
- Keep up to date on evolving **standards**, can monitor professional journals and other sources.
- Monitor **company** disclosures for significant accounting standards and estimates

### Disclosure

- GAAP & IFRS
  - **Footnotes:** Disclosure accounting **policies** and **estimates**
  - **MD&A: significant** require management judge
- The likely **impact** of implementing **recently** issued accounting standards.
- The impact of adopting a new standard, conclude that
  - the new standard **does not apply** or **will not affect** the financial statements materially,
  - or state that they are still **evaluating** the effects of the new standards.