STUDY SESSION

# 8

# Financial Reporting and Analysis

## Inventories, Long-lived Assets, Income Taxes, and Non-current Liabilities

The readings in this study session examine financial reporting for specific categories of assets and liabilities. Analysts must understand the effects of alternative financial reporting policies on financial statements and ratios and be able to execute appropriate adjustments to enhance comparability between companies. In addition, analysts must be alert to differences between a company's reported financial statements and economic reality.

The description and measurement of inventories require careful attention because inventories are frequently the largest current asset for merchandising and manufacturing companies. For these companies, the measurement of inventory cost (i.e., cost of sales) is a critical factor in determining gross profit and other measures of profitability. Long-lived operating assets are often the largest category of assets on a company's balance sheet. The analyst needs to scrutinize management's choices with respect to recognizing expenses associated with these operating assets because of the potentially large effect such choices can have on reported earnings and the opportunities for financial statement manipulation.

A company's accounting policies (such as depreciation choices) can cause differences in taxes reported in financial statements and taxes reported on tax returns. Issues relating to deferred taxes are discussed.

Non-current liabilities affect a company's liquidity and solvency and have consequences for its long-term growth and viability. The notes to the financial statements must be carefully reviewed to ensure that all potential liabilities (e.g., leasing arrangements and other contractual commitments) are appropriately evaluated for their conformity to economic reality. Adjustments to the financial statements may be required to achieve comparability when evaluating several companies.

**Note**: New rulings and/or pronouncements issued after the publication of the readings on financial reporting and analysis may cause some of the information in these readings to become dated. Candidates are expected to be familiar with the overall analytical framework contained in the study session readings, as well as the implications of alternative accounting methods for financial analysis and valuation, as provided in the assigned readings. Candidates are not responsible for changes that occur after the material was written.

## READING ASSIGNMENTS

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| **Reading 28** | Inventories<br>by Michael Broihahn, CPA, CIA, CFA |
| **Reading 29** | Long-lived Assets<br>by Elaine Henry, PhD, CFA, and Elizabeth A. Gordon, PhD, MBA |
| **Reading 30** | Income Taxes<br>By Elbie Louw, CFA, CIPM, and Michael A. Broihahn, CPA, CIA, CFA |
| **Reading 31** | Non-current (Long-term) Liabilities<br>by Elizabeth A. Gordon, PhD, MBA, and Elaine Henry, PhD, CFA |

## LEARNING OUTCOMES

### READING 28. INVENTORIES

The candidate should be able to:

**a** distinguish between costs included in inventories and costs recognised as expenses in the period in which they are incurred;

**b** describe different inventory valuation methods (cost formulas);

**c** calculate and compare cost of sales, gross profit, and ending inventory using different inventory valuation methods and using perpetual and periodic inventory systems;

**d** calculate and explain how inflation and deflation of inventory costs affect the financial statements and ratios of companies that use different inventory valuation methods;

**e** explain LIFO reserve and LIFO liquidation and their effects on financial statements and ratios;

**f** convert a company's reported financial statements from LIFO to FIFO for purposes of comparison;

**g** describe the measurement of inventory at the lower of cost and net realisable value;

**h** describe implications of valuing inventory at net realisable value for financial statements and ratios;

**i** describe the financial statement presentation of and disclosures relating to inventories;

**j** explain issues that analysts should consider when examining a company's inventory disclosures and other sources of information;

**k** calculate and compare ratios of companies, including companies that use different inventory methods;

**l** analyze and compare the financial statements of companies, including companies that use different inventory methods.

## READING 29. LONG-LIVED ASSETS

The candidate should be able to:

**a** distinguish between costs that are capitalised and costs that are expensed in the period in which they are incurred;

**b** compare the financial reporting of the following types of intangible assets: purchased, internally developed, acquired in a business combination;

**c** explain and evaluate how capitalising versus expensing costs in the period in which they are incurred affects financial statements and ratios;

**d** describe the different depreciation methods for property, plant, and equipment and calculate depreciation expense;

**e** describe how the choice of depreciation method and assumptions concerning useful life and residual value affect depreciation expense, financial statements, and ratios;

**f** describe the different amortisation methods for intangible assets with finite lives and calculate amortisation expense;

**g** describe how the choice of amortisation method and assumptions concerning useful life and residual value affect amortisation expense, financial statements, and ratios;

**h** describe the revaluation model;

**i** explain the impairment of property, plant, and equipment and intangible assets;

**j** explain the derecognition of property, plant, and equipment and intangible assets;

**k** explain and evaluate how impairment, revaluation, and derecognition of property, plant, and equipment and intangible assets affect financial statements and ratios;

**l** describe the financial statement presentation of and disclosures relating to property, plant, and equipment and intangible assets;

**m** analyze and interpret financial statement disclosures regarding property, plant, and equipment and intangible assets;

**n** compare the financial reporting of investment property with that of property, plant, and equipment;

**o** explain and evaluate how leasing rather than purchasing assets affects financial statements and ratios;

**p** explain and evaluate how finance leases and operating leases affect financial statements and ratios from the perspective of both the lessor and the lessee.

## READING 30. INCOME TAXES

The candidate should be able to:

**a** describe the differences between accounting profit and taxable income and define key terms, including deferred tax assets, deferred tax liabilities, valuation allowance, taxes payable, and income tax expense;

**b** explain how deferred tax liabilities and assets are created and the factors that determine how a company's deferred tax liabilities and assets should be treated for the purposes of financial analysis;

**c** calculate the tax base of a company's assets and liabilities;

- **d** calculate income tax expense, income taxes payable, deferred tax assets, and deferred tax liabilities, and calculate and interpret the adjustment to the financial statements related to a change in the income tax rate;
- **e** evaluate the impact of tax rate changes on a company's financial statements and ratios;
- **f** distinguish between temporary and permanent differences in pre-tax accounting income and taxable income;
- **g** describe the valuation allowance for deferred tax assets—when it is required and what impact it has on financial statements;
- **h** explain recognition and measurement of current and deferred tax items;
- **i** analyze disclosures relating to deferred tax items and the effective tax rate reconciliation and explain how information included in these disclosures affects a company's financial statements and financial ratios;
- **j** identify the key provisions of and differences between income tax accounting under International Financial Reporting Standards (IFRS) and US generally accepted accounting principles (GAAP).

## READING 31. NON-CURRENT (LONG-TERM) LIABILITIES

The candidate should be able to

- **a** determine the initial recognition, initial measurement and subsequent measurement of bonds;
- **b** describe the effective interest method and calculate interest expense, amortisation of bond discounts/premiums, and interest payments;
- **c** explain the derecognition of debt;
- **d** describe the role of debt covenants in protecting creditors;
- **e** describe the financial statement presentation of and disclosures relating to debt;
- **f** explain motivations for leasing assets instead of purchasing them;
- **g** distinguish between a finance lease and an operating lease from the perspectives of the lessor and the lessee;
- **h** determine the initial recognition, initial measurement, and subsequent measurement of finance leases;
- **i** compare the disclosures relating to finance and operating leases;
- **j** compare the presentation and disclosure of defined contribution and defined benefit pension plans;
- **k** calculate and interpret leverage and coverage ratios.