Interpreting Financial and Accounting Information

ICSA qualifying programme

Syllabus
Interpreting Financial and Accounting Information

Level 6, Part One Programme

Total hours study time: 200

Introduction
The aim of this module is to develop your knowledge of finance and accounting and the ability to use that knowledge to interpret financial and accounting information when providing advice to the board, or a similar decision-making body, in strategy development and/or decision-making.

This module covers the frameworks of financial reporting, providing explanation of the need and necessity of regulating financial reporting. It discusses the role of regulatory framework and conceptual framework of financial reporting in enhancing the usefulness of financial reporting intended to serve a broad group of users in making financial decisions.

The module covers a range of financial reporting topics, from the preparation and presentation of single entity financial statements and interpretation of IFRS based accounting policies and published accounts, through to group reporting and the analysis of financial reports.

It examines the financial markets, discuss how financing needs are assessed through planning, budgeting and forecasting and looks at the importance of cash and cash management. Various sources of finance (both long term and short-term) and their associated advantages and disadvantages are reviewed.

After having determined the finance required for an investment or project, businesses consider the use of various sources of finance. The module will cover the concepts of cost of capital and capital structure used in financial decision making, followed by management of working capital.

Finally, the module will provide an insight into risk assessment techniques, consider the impact of risk on investment appraisal and discuss the techniques that can be used for company analysis and business valuation. This module concludes with an in-depth look at different methods of project appraisal.
Learning outcomes
After successful completion of this module you should:

1. Be able to critically engage with the need for regulating financial reporting by entities.
2. Understand how financial statements and reports are prepared and evaluate them in order to provide insightful interpretation.
3. Be able to identify and critically evaluate sources of finance and their associated risks and returns.
4. Be able to conceptualise the nature and importance of capital structure and the cost of capital and evaluate these for decision making.
5. Be able to critically explore fundamental financial decision-making theories and evaluate these for decision making.
Module content

### Section A: The need for regulating financial reporting

**LO.1: Be able to critically engage with the need for regulating financial reporting by entities**

<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
</table>
| The regulatory framework and the role of International Financial Reporting Standards | - The need for a regulatory framework:  
  - principles-based versus rules-based systems  
  - statutory frameworks and legal requirements  
- Agency theory and the role of corporate governance:  
  - factors that have shaped financial reporting to its present state  
  - the principal-agent relationship:  
    - definition, roles and responsibilities  
    - conflict of interest  
    - monitoring processes  
- The role of financial accounting standards:  
  - key objectives including, providing transparency, reducing risk and increasing credibility  
- Arguments against accounting regulation:  
  - National and company law:  
    - Companies Act 2006  
    - UK company size limits  
- Environmental reporting:  
  - environmental audit  
  - environmental management systems  
  - the EU Eco-Management and Audit Scheme (EMAS)  
- Social accounting:  
  - recent developments in corporate social responsibility (CSR)  
  - Carrol’s CSR pyramid  
- International Financial Reporting Standards:  
  - the IFRS framework:  
    - advantages and disadvantages of adopting IFRS  
    - convergence and harmonisation  
  - the roles of the European Commission, UK GAAP and US GAAP  
- Barriers to global harmonisation:  
  - external factors that can affect convergence  
  - Principal differences between IFRS and UK GAAP |
<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
</table>
| The Conceptual Framework for financial reporting | • The need for a conceptual framework  
  - scope and purpose of the conceptual framework  
  - limitations of a conceptual framework  
  - the IASB’s conceptual framework  
• Objectives of general purpose financial reporting:  
  - users of general purpose financial reporting  
• Qualitative characteristics of financial information:  
  - fundamental qualitative characteristics:  
    - relevance  
    - faithful representation  
  - enhancing qualitative characteristics:  
    - comparability  
    - verifiability  
    - timeliness  
    - understandability  
• Financial statements and the reporting:  
  - objective and scope of financial statements  
  - reporting period and reporting entity  
• Assumptions underlying financial statements:  
  - going concern  
• Elements of financial statements:  
  - assets  
  - liabilities  
  - equity  
  - income  
  - expenses  
  - categorisation of assets and liabilities  
• Recognition and derecognition of the elements of financial statements  
• Measuring the elements of financial statements:  
  - historical cost  
  - current value basis  
• Presentation and disclosure:  
  - the statement of profit or loss  
    - other comprehensive income  
    - recycling  
• Concepts of capital and capital maintenance:  
  - financial concept of capital maintenance  
  - physical concept of capital maintenance |
## Section B: Preparing and interpreting financial statements and reports

**35% – 70 Learning hours**

**LO.2: Understand how financial statements and reports are prepared and evaluate them in order to provide insightful interpretation**

<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
</table>
| Preparation and presentation of single entity financial statements | • Objective of financial statements  
• Presentation of financial statements:  
  • comparative information  
  • consistency  
• Fair presentation and compliance with IFRS  
• Overriding concepts of financial statements:  
  • going concern  
  • accruals basis of accounting  
  • materiality and aggregation  
  • reporting period  
  • offsetting  
• Structure and content of financial statements:  
  • how items are disclosed  
  • identification of financial statements  
• Statement of financial position (balance sheet):  
  • line items to be included on the face of the statement  
  • format of the statement  
  • current/non-current classification  
  • share capital and reserves  
  • appropriate methods for valuing assets and liabilities  
• Statement of profit or loss and other comprehensive income:  
  • the concepts of profit or loss and comprehensive income  
  • choice of presentation and basic requirements  
  • profit or loss section and the minimum line items  
  • items recognised outside of profit or loss  
  • other comprehensive income section  
  • other requirements of IAS 1, including:  
    • the impact of discontinued operations  
    • separate disclosure of material items and prohibition of Extraordinary items  
• Statement of changes in equity:  
  • total comprehensive income for the period  
  • retrospective application of accounting policies or restatements  
  • reconciliations between the carrying amounts at the beginning and end of the period  
  • analysis of other comprehensive income by item  

<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
</table>
| Preparation and presentation of single entity financial statements (cont.) | • dividends recognised as distributions and the related amount per share  
• Statement of cash flows:  
  • structure of the statement of cash flows:  
    - operating activities  
    - investing activities  
    - financing activities |
| Other contents and features of published accounts    | • Content of the annual report and accounts  
• The strategic report:  
  • duty to prepare the strategic report  
  • purpose and contents of the strategic report  
    - fair review  
    - description of the principal risks and uncertainties the company faces  
    - going concern  
    - references to annual accounts  
    - signing and approval of strategic report  
    - additional information for quoted companies  
• The director’s report:  
  • purpose and contents of the strategic report  
• Notes to the accounts – structure and contents, including:  
  • the basis of preparation of the financial statements and the specific accounting policies used  
  • information required by IFRSs not presented elsewhere in the financial statements  
  • additional information relevant to understanding financial statements, e.g. off-balance sheet finance and related parties  
  • contingent assets and liabilities  
  • other disclosures, including:  
    - judgements and key assumptions  
    - dividends  
    - capital commitments  
    - equity instrument  
    - other information, e.g. country of incorporation, principal place of business, principal activities  
• Segment reporting:  
  • International Financial Reporting Standard 8  
  • operating segments  
  • IFRS 8 thresholds and reporting segments:  
    - non-reportable segments  
    - disclosures for operating segments |
<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
</table>
| Other contents and features of published accounts (cont.)       | • Reporting the substance of transactions:  
  - economic substance versus legal form of a business transaction  
• Limitations of published accounts:  
  - historical cost  
  - creative accounting or earnings management  
  - intra-group transactions  
  - ignoring non-financial matters  
  - not forward looking  
  - seasonality of trading  
  - comparability  
  - time period                                                                                                                                 |
| Interpretation of accounting policies based on IFRS             | • Accounting policies:  
  - objective of accounting policies and IAS 8  
  - selection and application of accounting policies  
  - consistency of accounting policies  
  - changes in accounting policy  
  - changes in accounting estimates  
  - prior period errors  
• Accounting for inventories:  
  - scope and objective of IAS 2  
  - measurement and cost of inventories  
  - write-down to net realisable value  
  - the matching principle and expense recognition  
  - disclosure  
• Accounting for property, plant and equipment:  
  - scope and objective of IAS 16  
  - initial recognition and measurement  
  - subsequent recognition and measurement  
  - depreciation  
  - recoverability of the carrying amount  
  - derecognition (retirements and disposals)  
  - disclosure  
  - including depreciation, impairment and revaluation  
• Accounting for events after the reporting period:  
  - scope and objective of IAS 10  
• Revenue from contracts with customers:  
  - objective and scope of IFRS 15  
  - recognition and measurement – five-step approach  
  - presentation and disclosure  
• Provisions, contingent liabilities and contingent assets:  
  - objective and scope of IAS 37 |
<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
</table>
| Interpretation of accounting policies based on IFRS (cont.) | • provisions:  
  − recognition  
  − measurement  
• contingent liability  
• contingent assets |
| Financial reporting by groups of companies | • Requirement to prepare consolidated financial statements:  
  • laws, regulations and accounting standards  
• Principles for the consolidation of financial statements:  
  • control concept  
  • group structure  
  • the basic method of consolidation  
  • content of consolidated financial statements  
• Business combinations, fair value measurement and goodwill:  
  • goodwill  
  • impairment of goodwill  
  • fair value measurement in consolidated financial statements  
• Consolidated statement of financial position (balance sheet):  
  • dividends paid by a subsidiary  
• Consolidated statement of comprehensive income  
• Investments in associates and joint ventures  
• The IAS 28 equity method:  
  • basic principle  
• A parent company’s separate financial statements  
• Exemptions from preparing consolidated financial statements:  
  • exclusion of a subsidiary from consolidation |
| Analysis and evaluation of financial statements | • The need for financial analysis:  
  • interested parties and stewardship of managers  
  • key financial indicators  
• Fundamental analysis  
• Economic analysis  
• Industry analysis  
• Company analysis  
• Trend analysis:  
  • horizontal analysis between periods  
  • vertical analysis: common-sized analysis  
• Ratio analysis |
<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analysis and evaluation of financial statements (cont.)</td>
<td>• Profitability ratios:</td>
</tr>
<tr>
<td></td>
<td>• gross profit margin ratio</td>
</tr>
<tr>
<td></td>
<td>• operating profit margin ratio</td>
</tr>
<tr>
<td></td>
<td>• net profit margin ratio</td>
</tr>
<tr>
<td></td>
<td>• return on assets ratio</td>
</tr>
<tr>
<td></td>
<td>• return on equity ratio</td>
</tr>
<tr>
<td></td>
<td>• return on capital employed ratio</td>
</tr>
<tr>
<td></td>
<td>• Limitations of ratio analysis</td>
</tr>
<tr>
<td></td>
<td>• Accounting irregularities and creative accounting</td>
</tr>
<tr>
<td></td>
<td>• errors</td>
</tr>
<tr>
<td></td>
<td>• fraudulent financial reporting</td>
</tr>
<tr>
<td></td>
<td>• misappropriation of assets (theft)</td>
</tr>
<tr>
<td></td>
<td>• creative accounting</td>
</tr>
<tr>
<td></td>
<td>• regulations to prevent creative accounting</td>
</tr>
</tbody>
</table>
### Section C: Sources of finance, their associated risks and returns

**LO.3: Be able to identify and critically evaluate sources of finance and their associated risks and returns**

<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
</table>
| Financial markets and the identification of financing needs               | • Financial markets:  
  - financial market participants  
  - types of financial markets:  
    - capital markets  
    - money markets  
    - other markets e.g. currency markets  
  - Private versus public markets:  
    - features, requirements and expectations of private versus public investors  
    - advantages and disadvantages of private and public markets  
  - The role of the Stock Exchange  
  - Efficient market hypothesis:  
    - levels of market efficiency  
  - Alternative Investment Market (AIM)  
  - Other sources of finance from the private market:  
    - institutional investors:  
      - private equity  
      - venture capital  
      - pledge funds  
      - unit trusts  
      - Enterprise Investment Scheme (EIS)  
      - pension funds  
    - banks  
  - Identification of financing needs: budgeting and forecasting:  
    - planning, budgeting and forecasting  
    - flexible versus static budgets  
    - budgetary control  
    - cash budget  
  - The need for cash and cash management:  
    - need for cash  
    - methods of dealing with cash surpluses and cash deficits  
    - models of cash management  
    - Baumol’s economic order quantity model  
    - Miller-Orr cash management model |
<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
</table>
| Sources of long-term finance     | - Features and use of sources of long term finance, including advantages and disadvantages:  
  - equity or ordinary shares:  
    - raising of equity shares  
  - retained earnings  
  - preference shares  
  - bonds and debentures:  
    - types of bonds and debentures  
    - bonds with fixed interest (coupon)  
    - deep discount and zero-coupon bonds  
    - Eurobonds  
    - share warrants (options)  
  - bank and institutional loans  
  - leasing:  
    - finance leases  
    - operating leases  
    - sale and leaseback  
  - hire purchase  
  - securitisation of assets  
  - private finance initiatives (PFIs)  
  - government grants and assistance |
| Sources of short-term finance    | - Features and use of external sources of short term finance, including advantages and disadvantages:  
  - bank and institutional loans:  
    - secured versus unsecured loans  
    - loan covenant  
  - overdrafts  
  - bills of exchange  
  - debt factoring  
  - invoice discounting  
  - alternative finance and web innovations:  
    - crowdfunding  
    - peer-to-peer lending  
    - invoice trading third-party payment  
  - Features and use of internal sources of short term finance, including advantages and disadvantages:  
    - controlling working capital  
    - reducing inventory levels  
    - tighter credit control  
    - delaying payments to payables  
    - sale of redundant assets  
    - retained profits |
## Section D: Capital structure, the cost of capital and working capital financial management

**LO.4: Be able to conceptualise the nature and importance of capital structure and the cost of capital and evaluate these for decision making**

<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The cost of capital and capital structure</strong></td>
<td>• The importance of the cost of capital</td>
</tr>
<tr>
<td></td>
<td>• Cost of equity using the capital asset pricing model:</td>
</tr>
<tr>
<td></td>
<td>• capital asset pricing model (CAPM)</td>
</tr>
<tr>
<td></td>
<td>• risk-adjusted discount rate (RADR)</td>
</tr>
<tr>
<td></td>
<td>• unsystematic and systematic risk</td>
</tr>
<tr>
<td></td>
<td>• measuring systematic risk and calculation of the RADR</td>
</tr>
<tr>
<td></td>
<td>• assumptions and criticisms of CAPM</td>
</tr>
<tr>
<td></td>
<td>• β factor, α values</td>
</tr>
<tr>
<td></td>
<td>• Cost of capital using the dividend valuation model</td>
</tr>
<tr>
<td></td>
<td>• The cost of debt</td>
</tr>
<tr>
<td></td>
<td>• irredeemable debt</td>
</tr>
<tr>
<td></td>
<td>• redeemable debt</td>
</tr>
<tr>
<td></td>
<td>• The weighted average cost of capital (WACC)</td>
</tr>
<tr>
<td></td>
<td>• Capital structure</td>
</tr>
<tr>
<td></td>
<td>• Factors affecting capital structure</td>
</tr>
<tr>
<td></td>
<td>• Financial gearing</td>
</tr>
<tr>
<td></td>
<td>• Operating gearing</td>
</tr>
<tr>
<td></td>
<td>• The traditional approach to capital structure:</td>
</tr>
<tr>
<td></td>
<td>• gearing and the cost of equity</td>
</tr>
<tr>
<td></td>
<td>• gearing and the cost of debt</td>
</tr>
<tr>
<td></td>
<td>• gearing and the cost of debt or WACC</td>
</tr>
<tr>
<td></td>
<td>• limitations of the traditional view</td>
</tr>
<tr>
<td></td>
<td>• The Modigliani-Miller theory of capital structure:</td>
</tr>
<tr>
<td></td>
<td>• without taxes</td>
</tr>
<tr>
<td></td>
<td>• with taxes</td>
</tr>
<tr>
<td></td>
<td>• criticisms of the MM trade-off theory</td>
</tr>
<tr>
<td></td>
<td>• Real world approaches:</td>
</tr>
<tr>
<td></td>
<td>• pecking order theory</td>
</tr>
<tr>
<td></td>
<td>• real world factors</td>
</tr>
<tr>
<td><strong>Working capital management</strong></td>
<td>• The nature and purpose of working capital</td>
</tr>
<tr>
<td></td>
<td>• The working capital cycle:</td>
</tr>
<tr>
<td></td>
<td>• working capital cycle and the nature of the industry</td>
</tr>
<tr>
<td></td>
<td>• calculating the working capital cycle</td>
</tr>
<tr>
<td></td>
<td>• Working capital management: profitability versus liquidity</td>
</tr>
<tr>
<td></td>
<td>• Working capital ratios:</td>
</tr>
<tr>
<td></td>
<td>• liquidity ratios</td>
</tr>
<tr>
<td></td>
<td>• efficiency ratios</td>
</tr>
<tr>
<td></td>
<td>• limitations of ratios</td>
</tr>
<tr>
<td>Topic area</td>
<td>Exemplification</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>----------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Working capital management (cont.)</td>
<td>• The management of inventories:</td>
</tr>
<tr>
<td></td>
<td>• inventory management techniques</td>
</tr>
<tr>
<td></td>
<td>• economic order quantity</td>
</tr>
<tr>
<td></td>
<td>• determining inventory levels</td>
</tr>
<tr>
<td></td>
<td>• just in time system</td>
</tr>
<tr>
<td></td>
<td>• ABC inventory control</td>
</tr>
<tr>
<td></td>
<td>• VED analysis</td>
</tr>
<tr>
<td></td>
<td>• The management of receivables:</td>
</tr>
<tr>
<td></td>
<td>• factors affecting the size of receivables</td>
</tr>
<tr>
<td></td>
<td>• credit policy</td>
</tr>
<tr>
<td></td>
<td>• The management of payables</td>
</tr>
</tbody>
</table>
### Section E: Financial decision making

**LO.5:** Be able to critically explore fundamental financial decision-making theories and evaluate these for decision making

<table>
<thead>
<tr>
<th>Topic area</th>
<th>Exemplification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk assessment in investment appraisal techniques</td>
<td>• Risk and investment decisions:</td>
</tr>
<tr>
<td></td>
<td>• risk preferences of investors</td>
</tr>
<tr>
<td></td>
<td>• Risk assessment models</td>
</tr>
<tr>
<td></td>
<td>• Sensitivity analysis, including advantages and disadvantages</td>
</tr>
<tr>
<td></td>
<td>• Scenario analysis</td>
</tr>
<tr>
<td></td>
<td>• Simulation modelling</td>
</tr>
<tr>
<td></td>
<td>• Expected value and expected net present value (ENPV):</td>
</tr>
<tr>
<td></td>
<td>• standard deviation and coefficient of variation</td>
</tr>
<tr>
<td></td>
<td>• Event tree diagrams</td>
</tr>
<tr>
<td></td>
<td>• The role of portfolio management, including:</td>
</tr>
<tr>
<td></td>
<td>• risk and return</td>
</tr>
<tr>
<td></td>
<td>• objectives and risk reduction</td>
</tr>
<tr>
<td></td>
<td>• diversification</td>
</tr>
<tr>
<td></td>
<td>• standard deviation</td>
</tr>
<tr>
<td></td>
<td>• correlation of the individual investments in a portfolio</td>
</tr>
<tr>
<td></td>
<td>• efficiency frontier</td>
</tr>
<tr>
<td></td>
<td>• portfolio theory – its application and limitations</td>
</tr>
<tr>
<td>Company analysis and business valuation methods</td>
<td>• Investment valuation ratios</td>
</tr>
<tr>
<td></td>
<td>• Earnings per share (EPS):</td>
</tr>
<tr>
<td></td>
<td>• interpretation</td>
</tr>
<tr>
<td></td>
<td>• limitations</td>
</tr>
<tr>
<td></td>
<td>• Price/earnings ratio:</td>
</tr>
<tr>
<td></td>
<td>• interpretation</td>
</tr>
<tr>
<td></td>
<td>• limitations</td>
</tr>
<tr>
<td></td>
<td>• Financial statement analysis</td>
</tr>
<tr>
<td></td>
<td>• Relative value measures:</td>
</tr>
<tr>
<td></td>
<td>• steps in relative value analysis</td>
</tr>
<tr>
<td></td>
<td>• Valuation using the dividend discount model (DDM) (also known as Gordon’s Growth Model)</td>
</tr>
<tr>
<td></td>
<td>• Valuations using discounted cash flows (DCFs)</td>
</tr>
<tr>
<td></td>
<td>• Valuations using the capital asset pricing model (CAPM), systematic risk, β factor, α values</td>
</tr>
<tr>
<td></td>
<td>• Application of efficient market hypothesis in business valuation</td>
</tr>
<tr>
<td></td>
<td>• Shareholder value analysis (SVA):</td>
</tr>
<tr>
<td></td>
<td>• value creation</td>
</tr>
<tr>
<td></td>
<td>• value drivers</td>
</tr>
<tr>
<td></td>
<td>• free cash flow</td>
</tr>
<tr>
<td></td>
<td>• calculation of shareholder value in SVA</td>
</tr>
<tr>
<td>Topic area</td>
<td>Exemplification</td>
</tr>
<tr>
<td>------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>
| Company analysis and business valuation methods | • strengths and weaknesses of SVA  
• Economic value added (EVA) as an alternative to SVA:  
  • strengths and weaknesses of EVA  
• Measuring value creation:  
  • total shareholder returns (TSRs)  
  • market value added (MVA)  
  • the effects of dividend payments on shareholder wealth  
  • stock market influences                                                                 |
| (cont.)                                        |                                                                                                                                                  |
| Project appraisal techniques                   | • Identification and analysis of projects:  
  • costs, benefits and risks  
• Factors affecting project appraisal:  
  • non-relevant factors, e.g. sunk cost, non-relevant overhead costs, depreciation  
  • relevant factors, e.g. cash flow, financing costs, timing of returns, incremental costs, working capital, taxation and inflation  
• Project appraisal techniques, including:  
  • non-discounting methods:  
    • payback period  
    • accounting rate of return (ARR)  
  • discounted cash flow (DCF) methods (based on time value of money (TVM), including:  
    • net present value (NPV)  
    • internal rate of return (IRR)  
    • discounted payback  
    • DCF models to estimate the attractiveness of an investment opportunity  
    • DCF models to estimate the market value of debt  
  • discounting annuities:  
    • annuity factors  
    • discounting a perpetuity  
    • calculation of shareholder value in SVA using the PV formula for perpetuity  
• impact of inflation and tax on project appraisal:  
  • impact of inflation on interest or discount rates  
  • impact of inflation on cash flows  
  • tax effects  
• Capital rationing and use of the profitability index:  
  • types of capital rationing  
  • dealing with single period capital rationing  
  • dealing with multi-period capital rationing  |