www.masomomsingi.com

FINANCIAL ACCOUNTING AND FINANCIAL STATEMENT ANALYSIS

PRINCIPLES AND STANDARDS

Copyright © 2017, AZEK

www.masomomsingi.com

FINANCIAL ACCOUNTING AND FINANCIAL STATEMENT ANALYSIS

Copyright © 2017, AZEK
All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of AZEK.

www.masomomsingi.com

Table of contents

1. The financial reporting environment 1

1.1 The financial statements 1

1.1.1 The balance sheet (or statement of financial position) 2
1.1.2 The statement of comprehensive income 3
1.1.3 The cash flow statement 8
1.1.4 The statement of changes in equity 9
1.1.5 The notes to financial statements 10
1.1.6 The relation between business activities and financial statements 11

1.2 Financial reporting issues 12

1.2.1 Uses of financial statements 12
1.2.2 International differences in accounting 13
1.2.2.1 The two accounting models 13
1.2.2.2 Accounting harmonisation and the IASB 15

1.3 Appendix 15

2. Framework for the preparation and presentation of financial statements 28

2.1 Objective of financial statements 28

2.2 Accounting conventions 28

2.2.1 Accrual basis of accounting 29
2.2.2 Going concern 29
2.2.3 Prudence 29
2.2.4 Comparability 30
2.2.5 Substance over form 30

2.3 Fundamental definitions 31

2.3.1 Assets 31
2.3.2 Liabilities 31
2.3.3 Equity 32
2.3.4 Income 32
2.3.5 Expenses 32

2.4 Criteria for accounting recognition 33

2.5 APPENDIX: Consolidated financial statements 34

2.5.1 Louis Vuitton Moët Hennessy (France) 34
2.5.2 Fiat (Italy) 39
2.5.3 Sony (Japan) 42

3. Statement of cash flows 47

3.1 Rationale for the statement of cash flows 47

3.2 Relation between income flows and cash flows 49

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

1. The financial reporting environment

1.1 The financial statements

Financial accounting is considered to be the language of business. It is a medium by which the business activities of an organisation are made known to the external world. It is not possible to explain in detail every activity of a business succinctly. Hence, financial statements are used to disseminate information about the organisation. The main objective of financial statements is to provide a 'true and fair view' of the operations of the business to their readers. Thus, all organisations make their activities known through their financial statements.

Please note that this is an introductory chapter. The entire gamut of financial accounting is like a telescope. The initial chapters contain a crisp introduction to the terminology and later chapters explain these terms in detail. The reader is therefore requested to read through the terms such as balance sheet, etc. and be comfortable with them. For a better understanding of balance sheet, income statement, cash flow statement etc., the financial statements of the Bosch Group (a German industrial company) are provided in an appendix at the end of this chapter. You may go through this appendix and try to understand various items. Do not worry too much if you do not understand some things. They will be explained in detail in later chapters.

There are three principal financial statements: the balance sheet, the statement of comprehensive income and the statement of cash flows. These are also known as the basic financial statements. Apart from these, there is also the statement of changes in equity, as well as explanatory notes. Preparation of these statements is governed by different rules. These rules are of a generic nature. However, the specific rules may vary from country to country.

The rules for the preparation of these statements are governed by the following three broad sets of codes:

1. Laws governing corporate reporting.
2. Regulations of the body controlling the securities market.
3. Guidelines of the professional accounting bodies.

As an analyst, you will be looking at the statements as presented by the firm. It is assumed that you will not be playing any major role in the detailed preparation of these statements. It is therefore necessary to be aware of the various items found in these statements as well as the rules for presentation and the underlying principles used in their preparation. We will examine these, one after the other.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

1.1.1 The balance sheet (or statement of financial position)

Among the financial statements, the balance sheet is considered to be the most important financial statement. It is prepared at the end of the financial year. The financial year is also known as the fiscal year, the accounting period, the accounting year, etc. However, the entire process of capturing the financial information is done with a view to facilitating the preparation of this statement. A balance sheet has two sides, or two main parts, namely the asset side and the liabilities and stockholders' equity side. The liabilities and stockholders' equity side is further divided into liabilities and stockholders' equity.

Assets represent the resources owned or controlled by the firm. They are classified into two categories: fixed and current assets.

Fixed (or non-current) assets are those permanently used by the firm in its activities. They include buildings, equipment, investments in associates, etc. These assets are long-lived. They were acquired for the purpose of using them in the production of goods or services. As such, they are generally not resold and stay in the firm until they are out of service.

Current assets are composed of inventories, short-term (less than 1 year) claims, and cash. These assets are generated by the firm's activity. They do not stay a long time in the enterprise but are permanently replaced by other similar assets in the course of the business.

Liabilities represent the claims of individuals who do not have an ownership relationship with the firm such as, for example, banks. They include borrowings and debts to suppliers. Liabilities may be classified into financial liabilities, operating liabilities and provisions.

- **Financial liabilities** are debts resulting from a financing decision (borrowings).
- **Operating liabilities** include debts to suppliers. They result from the functioning of the enterprise. Depending on business practices, debt to suppliers may be more or less important. In many countries payments to suppliers are deferred by several weeks or months. Debts to suppliers are significant in such countries.
  Short-term (less than 1 year) liabilities and long- and medium-term liabilities (more than 1 year) are generally presented separately.
- **Provisions** are liabilities of uncertain timing or amount. They are recognised to cover future outflows that will probably result from risks and uncertainties.

Equity is the residual claim against the firm's assets after deducting liabilities. It represents wealth put into the firm by the stockholders plus what has been generated as surplus by the business in the past.

Equity is a measure of the owners' wealth invested in the enterprise:

Equity = Assets - Liabilities

The balance sheet is thus a numerical representation of the basic accounting equation, which is given by:

Assets (A) = Liabilities (L) + Equity (E)

Assets and liabilities are reported using the generally accepted accounting principles (GAAP). There are rules like reporting at cost, providing for drop in value of assets, etc. which are governed by various principles. The rules and regulations governing them will be discussed in greater detail in later chapters.

© 2017 AZEK

 Solomon Ngahu - Reg No. 49000007 www.masomomsingi.com

Thus we find that the balance sheet is a financial statement that gives the relationship between assets, liabilities and stockholders' equity. The values of the different assets, in the balance sheet, are reported at a given point in time. These values change from moment to moment, but the basic accounting equation is maintained. Thus, balance sheet is a point concept.

The balance sheet is prepared at the end of specified time periods. Every business has to prepare this, usually at the end of each year. Apart from the annual balance sheet, many countries require that firms prepare balance sheets more frequently and report them to authorities.

One may also find that most firms prepare a statement of proposal for the appropriation of the available earnings. The main purpose of this statement is to explain how the accounting surplus generated by the firm will be distributed between the various stockholders and what amount is going to be retained within the business.

Given below is a sample balance sheet of a company. Note that this is an abridged balance sheet that is given here only for the reader's understanding. A detailed balance sheet along with other schedules will be given in the appendix to this chapter.

Assets	Millions CU	**Liabilities & stockholders' equity**	Millions CU
Current assets		**Current liabilities**	
Cash & equivalents	8.83	Trade & other payables	15.08
Other liquid assets	5.28	Notes payable	18.68
Trade & other receivables	19.47	Taxes payable	1.46
Inventories	12.31	Accrued liabilities & deferred income	4.80
Prepayments & accruals	1.38	**Total current liabilities**	**40.02**
Total current assets	**47.27**		
		Long-term liabilities	
Fixed assets		Long-term debt	7.17
Property, plant & equipment	32.65	Employee benefit liabilities	3.76
Other fixed assets	9.32	Deferred taxes	2.64
Intangible assets	10.76	Provisions	4.60
Total fixed assets	**52.73**	**Total long-term liabilities**	**18.17**
		Equity attributable to the parent	
		Share capital	10.00
		Retained earnings	30.81
			40.81
		Minority interest	**1.00**
		Total equity	**41.81**
Total assets	**100.00**	**Total liabilities & equity**	**100.00**

1.1.2 The statement of comprehensive income

The second important financial statement prepared by a firm is the statement of comprehensive income. This statement aims to report the impact of the operations of the organisation during a particular period. To a lay person, this represents the net effect of the operations of the business. It conveys whether the organisation has earned a surplus during a particular period or not. It also explains the performance of the firm during a particular period. This is a flow concept.

 © 2017 AZEK

 Solomon Ngahu - Reg No. 49000007 www.masomomsingi.com

The statement of comprehensive income is composed of two parts:

- the income statement,
- the statement of other comprehensive income.

The income statement includes "revenues" and "expenses". Revenues are wealth increases generated by the activities of the enterprise, which meet the necessary conditions for recognition in the profit or loss of the period. Examples of revenues are sales, interest received... Expenses are wealth decreases that were incurred to earn these revenues. They include consumptions of raw materials, employee costs, depreciation, interest paid, taxes, etc.

The basic principle contained in an income statement is that the profit or loss is the difference between the revenues and expenses of the period. This is known as the matching principle. Here, revenues[1] are matched with all the expenses[2] that were incurred to earn them. The profit or loss of the period is also called "net income".

Profit (loss) or Net income = Revenues - Expenses

Some wealth increases and decreases that occurred during the period are not recognized in the income statement because they don't meet the conditions necessary to be included in the profit or loss of the period. An example of such wealth increase is the revaluation surplus. International accounting standards allow companies to revalue their tangible fixed assets periodically[3]. The resulting revaluation surplus cannot be recognized in the profit or loss of the period because of its lack of reliability (the revalued amount does not result from a transaction, it is estimated by the company or by an expert). Such wealth variations are included in the "statement of other comprehensive income".

After adding other comprehensive income to the profit or loss, we obtain the "total comprehensive income".

Total comprehensive income = Profit or loss + Other comprehensive income.

Until 2008, generally accepted accounting principles did not require the preparation of the statement of comprehensive income. Only the first part of this statement (the income statement) was presented as a component of the company's financial statements. Items that form part of other comprehensive income were included in the statement of changes in equity, together with changes resulting from transactions with the company's owners.

Since 2009, only owner changes are included in the statement of changes in equity. Non-owner changes must be presented in the statement of comprehensive income.

Owing to the continuing nature of a business, it is imperative that the performance is reported to the various stakeholders at regular intervals. Because of the need for a reporting period, the concept of the matching principle has been introduced. This means that revenues, expenses and other comprehensive income of a particular period are matched to arrive at the surplus generated during the reporting period. The reporting period is normally one year.

---

1 Strictly speaking, revenues are income generated by the activities of the enterprise (sales of goods and services, interest received, etc.). Other components of income are "gains" (*cf.* Chapter 2).

2 Expenses are outflows from delivering or producing goods, providing services, or carrying out other activities that constitute the entity's ongoing major or central operations.

3 Revaluation of fixed assets will be studied in “Balance sheet” (§ 1.1.3).

 © 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

According to international accounting standards (IFRS), the statement of comprehensive income can be presented:

- either in a single statement,
- or in two statements: an income statement + a statement of other comprehensive income.

Below are examples of the two presentations.

Presentation in a single statement

	Millions CU
Sales	80'000
Cost of sales	(45'000)
Gross profit	35'000
Other income	8'000
Distribution costs	(15'000)
Administrative expenses	(8'000)
Other expenses	(5'000)
Finance costs	(3'000)
Profit before tax	12'000
Income taxes	(3'000)
Profit for the year (net income)	**9'000**
Exchange differences	(800)
Change in revaluation surplus	2'500
Gains on property investments	400
Other comprehensive income	**2'100**
Total comprehensive income	**11'100**

Presentation in two statements

	Millions CU
Sales	80'000
Cost of sales	(45'000)
Gross profit	35'000
Other income	8'000
Distribution costs	(15'000)
Administrative expenses	(8'000)
Other expenses	(5'000)
Finance costs	(3'000)
Profit before tax	12'000
Income taxes	(3'000)
Profit for the year (net income)	**9'000**

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

	Millions CU
Profit for the year	**9'000**
Exchange differences	(800)
Change in revaluation surplus	2'500
Gains on property investments	400
Other comprehensive income	**2'100**
Total comprehensive income	**11'100**

In many countries Generally Accepted Accounting Principles (GAAP) do not specify any particular format for the presentation of revenues and expenses. But, owing to the customs of various enterprises, some sample formats have come into effect. Below are examples of such formats.

		N	N-1
	Sales		
–	Cost of goods sold		
=	*Gross Profit*		
+	Other operating revenues		
–	Operating expenses		
=	*Operating income or Earnings before interests and taxes – EBIT*		
–	Interest		
=	*Earnings before taxes*		
–	Income taxes		
=	*Earnings before exceptional items*		
±	Exceptional items		
=	*Profit for the year*		

		N	N-1
	Sales		
–	Cost of goods sold		
=	*Gross Profit*		
+	Other operating revenues		
–	Operating expenses		
=	*Operating income or Earnings before interests and taxes – EBIT*		
–	Income taxes		
=	*Net operating profit after taxes – NOPAT*		
–	Interest		
=	*Earnings before exceptional items*		
±	Exceptional items		
=	*Profit for the year*		

In the statement of comprehensive income,, expenses are classified either by nature or by function.

The first method consists in aggregating expenses according to their nature (purchase of goods, transport costs, salaries, depreciation...). This presentation is traditionally used in Continental Europe.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

With presentation by function, expenses are classified as part of cost of sales, distribution costs or administrative expenses. This presentation is traditional in Anglo-Saxon countries. It may provide more relevant information than classification by nature but, in many cases, the allocation of expenses to functions requires considerable judgment.

Below are examples with both presentation formats.

Operating expenses classified by nature			**Operating expenses classified by function**		
	N	**N-1**		**N**	**N-1**
Revenue	X	X	**Revenue**	X	X
Other operating income	X	X	Cost of sales	(X)	(X)
Changes in inventories of finished goods and work in progress	(X)	X	**Gross profit**	X	X
Work performed by the enterprise and capitalised	X	X	Other operating income	X	X
Raw material and consumables used	(X)	(X)			
Staff costs	(X)	(X)	Distribution costs	(X)	(X)
Depreciation and amortisation expense	(X)	(X)	Administrative expenses	(X)	(X)
Other operating expenses	(X)	(X)	Other operating expenses	(X)	(X)
Profit from operations	X	X	Profit from operations	X	X
Finance cost	(X)	(X)	Finance cost	(X)	(X)
Income from associates	X	X	Income from associates	X	X
Profit before tax	X	X	**Profit before tax**	X	X
Income tax expense	(X)	(X)	Income tax expense	(X)	(X)
Net profit or loss before exceptional items	X	X	**Net profit or loss before exceptional items**	X	X
Exceptional items	X	(X)	Exceptional items	X	(X)
Profit for the year	X	X	**Profit for the year**	X	X

When analysing the statement of comprehensive income, it is very important to identify recurring and non-recurring items. Recurring items represent operations that will continue. Non-recurring items are the items that may not continue. There are broadly three categories of non-recurring items:

- exceptional items
- discontinued operations
- changes in accounting estimates.

1) **Exceptional** items are unusual or infrequent. Consider for example an enterprise whose main customer goes bankrupt. In the income statement of the purchaser, the resulting loss will be classified as exceptional because of its unusual size.

2) An income (loss) from discontinued operations arises when the enterprise decides to discontinue a segment of the business. This part is then sold off. Once the decision to sell off is taken then the income and expenses of that division are computed and reported separately.

© 2017 AZEK

 Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

Example: Income statement presentation for discontinued operations

Income from continuing operations	10'000
Provision for taxes	-2'000
Income from continuing operations	8'000
Discontinued operations:	
Income from discontinued operations (net of taxes)	2'000
Loss on disposal of division, including provision for operating losses during the phase out period	-1'000
Profit for the year	9'000

3) The third major non-recurring item is the effect of changes in accounting estimates or accounting policies. This may happen either owing to a change in accounting principles or to a change in the method of applying them. An example of such a change is a change in the rates and method of depreciation and amortisation. Sometimes enterprises change the method of depreciation from straight-line to diminishing balance method or vice-versa. In those cases also the effect of such a change should be clearly disclosed. The accounting treatment of such changes will be presented in detail in "Data analysis". Please note that, generally, accounting changes do not affect the consolidated cash flow.

Thus the analyst has to look into the nature of the income model to really determine the long-term implication of a particular item of revenue or expense.

1.1.3 The cash flow statement

The cash flow statement is the third financial statement prepared by a business entity. It explains where the cash has come from during a particular period, how that cash has been utilised and what has been the residual effect of all these transactions on the cash balance of the firm.

The cash flow statement also provides information on the various financing means and investing activities undertaken during a particular period. It starts with the cash from operations. This is called the internal source of cash. This is normally reported on a net basis. The other disclosures are carried out on a gross basis. In other words, all the financing and investing activities are reported in full detail, without netting out.

The cash flow statement will be studied in detail in Chapter 3.

 © 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

1.1.4 The statement of changes in equity

According to the IASB and several standard setting bodies, firms must prepare a statement of changes in equity.

Prior to 2009, this statement included all changes in equity that occurred during the period, in particular:

- capital transactions with owners,
- distributions to owners (dividends),
- net income for the period,
- gains or losses recognised directly into equity,
- etc.

Since 2009, the statement of changes in equity shows only changes arising from transactions with owners (mainly capital increases/repayments and dividends). These changes are monetary (i.e. they result in a cash inflow or outflow).

All other changes (i.e. net income and gains or losses recognized directly into equity) are shown in the statement of comprehensive income and no longer included in the statement of changes in equity. These changes are non-monetary (they have no impact on cash flow).

Below is an example of this statement:

in millions of CU	Share capital	Share premium	Retained earnings	Currency translation differences	**Total**	Minority interest	**Total equity**
Stockholders' equity at 1.1.N-1	363	1,308	480	4	**2,155**	**645**	**2,800**
Issue of share capital	100	420			**520**		**520**
Total comprehensive income for year N-1			120	-57	**63**	**60**	**123**
Dividends			-75		**-75**		**-75**
Stockholders' equity at 31.12.N-1	463	1,728	525	-53	**2,663**	**705**	**3,368**
Effect of accounting policy change			-33		**-33**	**-17**	**-50**
Stockholders' equity at 31.12.N-1 (restated)	463	1,728	492	-53	**2,630**	**688**	**3,318**
Capital repayment	-73				**-73**		**-73**
Dividends			-50		**-50**		**-50**
Total comprehensive income for year N			160	178	**338**	**80**	**418**
Stockholders' equity at 31.12.N	390	1,728	602	125	**2,845**	**768**	**3,613**

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

The relationship between comprehensive income and other changes in equity can be described as follows:

	Changes in equity		Financial statement
	Increases	**Decreases**	
Transactions with owners (monetary changes)	Issue of share capital (new contributions)	Capital repayment Dividends	Statement of changes in equity
Total comprehensive income (non-monetary changes)	Net income (if profit) + Increases of equity with no effect on net income : • increase of the revaluation surplus • some currency translation differences • etc.	Net income (if loss) + Decreases of equity with no effect on net income : • decrease of the revaluation surplus • some currency translation differences • etc.	Statement of comprehensive income

1.1.5 The notes to financial statements

As we have seen earlier, the main purpose of financial statements is proper disclosure of accounts. Notes to financial statements, sometimes known as *notes to accounts or footnotes,* therefore assume great importance. In all the statutes that govern disclosure requirements, notes to financial statements are considered to be an integral part of those financial statements. These notes to financial statements normally have three sub-divisions.

- description of accounting policies;
- information required by accounting standards;
- additional information necessary for a fair presentation of financial statements.

The notes to financial statements deal with the accounting policies used when preparing the financial statements. Typically, they specify the methods used in valuation of fixed assets, depreciation, treatment of items such as pension plans, etc. Sometimes they also provide information on the changes in the valuations of marketable securities, changes due to debt parameters, treatment of taxes, tax credits, deferred commitments, etc.

This statement is very useful for the analyst carrying out a time series or cross sectional analysis of performance. It is very important to ensure that the accounting policies followed by different organisations that are being evaluated are comparable, and that such policies remain unchanged through time. Prior adjustments will have to be made to financial statements to bring them onto a common basis. Only then is any meaningful analysis possible.

© 2017 AZEK

 Solomon Ngahu - Reg No. 49000007 www.masomomsingi.com

The notes to financial statements must in particular provide information on contingencies. Contingencies represent the events that may occur and affect the earnings of the firm. As we have seen, the liabilities in the balance sheet are based on past events that have given rise to a claim on the firm. There may be future events that may give rise to a claim on the firm. There may be items where the actual claim may not be clear. Let us take an example. The firm has given a guarantee for a loan taken by an employee from a bank. If the employee pays back the loan then there is no liability for the firm. If the employee defaults, then the firm has to pay the loan. Thus, until the loan is repaid this claim will exist, but it is not a definite event. If, for example, the employee happens to default, then the firm becomes liable. This is a simple example of a contingent liability.

Contingencies are expected to represent the losses that have a significant chance of occurring but that are not probable. International accounting standards (IFRS) include disclosure requirements on such contingencies. Nevertheless firms have discretion in reporting these contingent liabilities. One major item that is expected to be reported in such notes is the exposure of the firm to derivatives trading. If the firm has an exposure to derivatives, it is expected to report the maximum possible loss in the case of an adverse movement in the price of the underlying security or commodity. Apart from this, certain significant risks and uncertainties must be disclosed.

For any analyst, this section represents potential landmines for the organisation, which can change the entire picture about it. The notes to the accounts also provide additional information that is not presented in other financial statements but which is necessary for a fair presentation of the financial situation of the enterprise. Disclosure requirements are defined by accounting standards and by bodies that regulate capital markets.

The annual report also includes various statements such as the auditors’ report, directors' report on the firm, schedules regarding its employees, time series data on the firm, etc. You will therefore find that the financial statements, along with other data, form the most important information required by any analyst.

1.1.6 The relation between business activities and financial statements

Financial statements are indispensable documents that are used to analyse the performance of any firm. These statements represent the ‘true and fair view’ of the operations of the firm. There must therefore be a direct link between the financial statements and the business activities.

The balance sheet gives the relationship between the investing activities and the financing activities of the business. Any firm first gets money from stockholders and creditors, and then buys assets. It then proceeds to produce goods or generate services. These products or services earn revenues. The firm buys raw materials, the services of labour and incurs other expenses. From the revenues or from other financing activities it pays the claims of the creditors, buys more machinery and distributes part of the surplus to the stockholders.

 © 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

The first part of business activities is called the financing and investing activities. The balance sheet therefore tells us the details of where the money has come from (sources of funds) and where it has gone (application of funds). In other words, it tells us which are the sources of financing of the firm's assets and where the firm has invested the funds. The liabilities and stockholders' equity side represents the financing activities. The asset side represents the investing activities of the firm. Although the financial statements do not provide details of the machinery, machines are reported in convenient groups to facilitate analysis.

The income statement is the statement of the firm's operating activities. The revenues generated by the various activities of the business are therefore given in some detail here. These revenues are matched with the expenses incurred to earn these revenues. The operating activities are therefore captured in monetary terms in the income statement. When we add the statement of gains and losses from non-operating activities, the picture is complete.

So, we now have the complete picture of the financing activities, investing activities, and operating activities as well non-operating activities, captured in monetary terms in these financial statements.

1.2 Financial reporting issues

1.2.1 Uses of financial statements

Financial statements are mainly used by external entities. There are a large number of entities wanting to use accounting information. Important users are employees, government, investors, creditors, banks and special interest groups.

Equity investors are mainly interested in finding out the risk – return relationship of their proposed or existing investment. As the financial statements provide an authentic picture of the past, equity investors use these for all their major decisions. Equity investors and analysts not only use the basic financial statements but also make extensive use of notes to accounts and other supplementary schedules to read between the lines. In Anglo-American countries, standard setting bodies generally recognise equity investors as the primary users of accounting information, and therefore all their rules are made to fit the needs of this group. In other countries, the pre-eminence of investors is not recognised so clearly, but in practice the financial statements of large companies are primarily directed to serve the needs of this category.

Creditors form another important group of users of financial information. They do not own the firm and are only interested in ensuring it will meet their claims. They may run a certain risk of default, but do not gain if the firm makes a huge surplus. Creditors therefore analyse financial information in detail to assess the creditworthiness of the business. They may consider the firm's profitability as well as its cash flows.

Nowadays firms study the financial statements of competing business entities in depth. These give them some idea of the financial muscle of their competitors. How much competition can this business take? Can it survive a price war? Can it withstand a take-over bid? What are its strengths and weaknesses? Answers to these questions can be obtained by studying its financial statements.

© 2017 AZEK

 Solomon Ngahu - Reg No. 49000007 www.masomomsingi.com

Recent years have seen a lot of activity in the area of mergers and acquisitions. If anything, their numbers will only go up. To identify a target, the initial analysis is done using the target's financial statements only.

Once the decision to go ahead with the process is taken, other issues like the swap ratio, price, valuation, etc. will follow. The first step is a 'what if' analysis to project the merged entity's financial statements. The second step is to work out whether the merger will actually benefit the stockholders of the acquiring firm. For this purpose, present financial statements are the basic building blocks.

Apart from these major interest groups, governments as well as regulatory bodies such as the capital market regulators, banking sector regulators, and anti-monopoly commissions also use financial statements for their decision-making. These financial statements are also widely used by labour unions to negotiate with firms.

1.2.2 International differences in accounting

Accounting encompasses two dimensions: recognition and valuation. Recognition is the process by which the effects of transactions and events are incorporated into financial statements, whereas valuation is the process of assigning an amount to a particular item in the financial statements.

Accounting techniques and basic principles are the same throughout the world. Nevertheless, there are differences among countries in the way these principles, especially those relating to valuation, are applied.

1.2.2.1 The two accounting models

Most specialists agree that there are two main accounting models:

- the Anglo-American model,
- the Continental European model.

These two models result from several factors that influence accounting:

- **The prevailing mode of financing**

  In Anglo-American countries, the main purpose of accounting is to provide information useful to the financial market, whereas in Continental Europe the tradition is to give higher importance to the needs of other users, such as banks, employees, the state and the public in general. For many authors, this difference is a consequence of different financing modes: In the US and the UK firms are financed mainly by stockholders, while banks are the main suppliers of funds in Continental Europe.

- **The legal system**

  There are two types of legal system:

  - the common law system,
  - the code law system.

 © 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

The common law system is in use in Anglo-American countries. In this system, legal rules are developed case by case; there is no general regulation that must be applied to all cases. Company law is kept to a minimum and there is no legal provision about accounting. Accounting regulation is generally in the hands of professional organisations in the private sector.

By contrast, the code law system in use in most countries of Continental Europe is characterised by a wide set of detailed rules. Accounting regulation is in the hands of the government or one of its agencies and accounting rules are often embodied in the law.

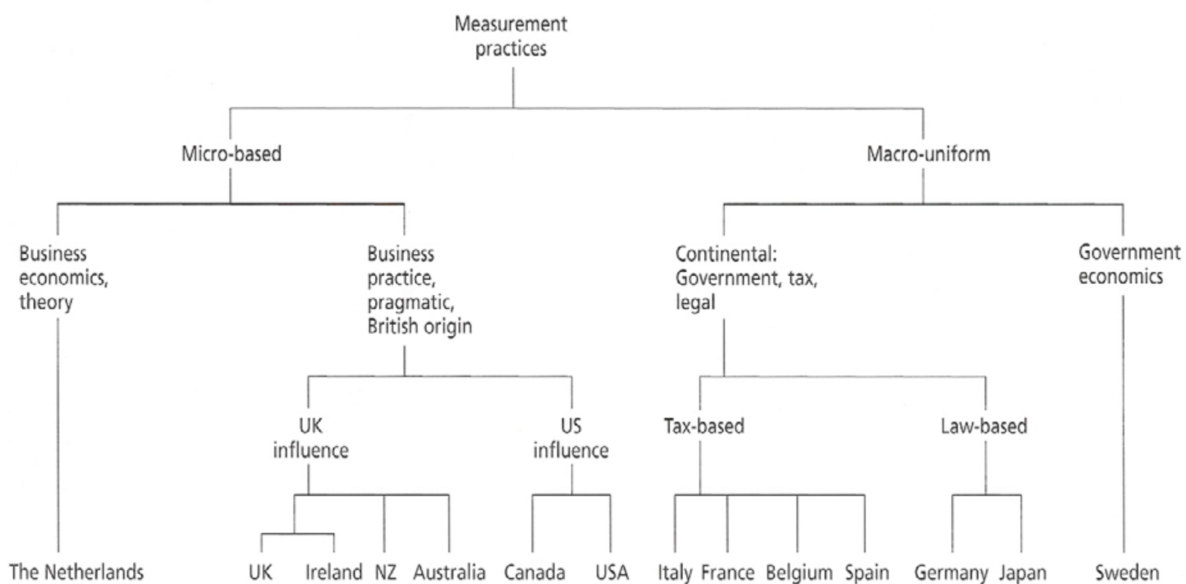
- **The influence of taxation**

  In most countries of the Continental European model, taxes are based on accounting income. Only expenses that have been recognised in the income statement can be deducted from taxable income. If, for example, a company depreciates an asset over 10 years in its financial statements, it cannot use a shorter period for fiscal purposes. The consequence is that companies tend to underestimate earnings in order to avoid taxes.

By contrast, in the Anglo-American world, accounting and taxation are generally clearly separated. A company can perfectly well depreciate an asset over 10 years in its financial statements and over 5 years for fiscal purposes, provided that fiscal authorities admit these periods. In these countries, firms do not need to align accounting choices to fiscal rules; they can report higher accounting profits without incurring additional taxes.

This difference must be kept in mind when comparing performances of companies located in countries that belong to different accounting models.

The two accounting models are reflected in the Nobes' classification of accounting systems, which opposes "micro-based" (i.e. Anglo-American) to "macro-uniform" (Continental European) countries.



© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Adapted from Nobes C., *International classification of financial reporting*, Croom Helm, London, 1984.

1.2.2.2 Accounting harmonisation and the IASB

Accounting regulation has, for a long time, been specific to each country. Things began to change in the last decades of the twentieth century, with the globalisation of financial markets and economies. As large companies developed internationally, they became more and more dependent on foreign sources of finance. This made apparent the need for some harmonisation of accounting practices throughout the world.

The harmonisation process began with the creation of the International Accounting Standards Committee (IASC) in 1973. The IASC was created by the professional accounting organisations of 9 countries. Its objective was to formulate and publish accounting standards and, more generally, to work for the improvement and harmonisation of accounting regulations. In 2000, the IASC changed its structure and became the **International Accounting Standards Board (IASB)**. The growth of the IASC/IASB has been rapid as the IASB now has about 120 members from almost all countries in the world.

The IASB publishes the **International Financial Reporting Standards (IFRS)**. Those published before 2000 are still called International Accounting Standards (IAS), although officially, the term "IFRS" designates both categories. Each standard is devoted to a particular issue as, for example, inventories (IAS 2), intangible assets (IAS 38) or stock-options (IFRS 2).

Despite its international nature, the IASB remains under the influence of organisations from Anglo-Saxon countries (especially the US). This explains why the IFRS is representative of the Anglo-American model of accounting.

As a private organisation, the IASB does not have the power to enforce its standards. Nevertheless its influence on accounting regulation has been considerable, owing to several factors:

1) national standard setters generally take the IFRS as the model when they elaborate their own standards,

2) a number of developing and newly-industrialised countries have adopted the IFRS as their national accounting standards,

3) the European Union has decided to make the IFRS mandatory for all listed companies from 2005 onwards.

Because of this process, national differences in accounting tend to fade, at least for large listed companies. The next harmonisation step will consist in achieving the convergence of IFRS and US standards (US GAAP).

1.3 Appendix

Note: Below is an extract from the annual report of the Bosch Group (a German industrial company).

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

The financial statements refer to the year 2007, i.e. before the implementation of revised IAS 1 that requires the separation of comprehensive income and other changes in equity.

	Note	2010	2009
Sales revenue	1	**47,259**	**38,174**
Cost of sales		–31,064	–27,518
Gross profit		**16,195**	**10,656**
Distribution and administrative cost	2	–9,010	–7,819
Research and development cost	3	–3,810	–3,603
Other operating income	4	1,195	1,084
Other operating expenses	5	–1,389	–1,469
EBIT		**3,181**	**–1,151**
Financial income	6	1,912	1,370
Financial expenses	6	–1,608	–1,416
Profit before tax		**3,485**	**–1,197**
Income taxes	7	–996	–17
Profit after tax		**2,489**	**–1,214**
of which attributable to non-controlling interests	8	112	46
of which attributable to parent company		2,377	–1,260

	2010	2009
Profit after tax	**2,489**	**–1,214**
Change from marketable financial instruments		
recognized in other comprehensive income	635	1,102
of which attributable to non-controlling interests		
transferred to profit or loss	–216	62
of which attributable to non-controlling interests	7	3
Change in actuarial gains and losses for pension provisions	–525	49
of which attributable to non-controlling interests	–1	
Adjustment item from currency translation of entities outside the euro zone	885	178
of which attributable to non-controlling interests	48	4
Other comprehensive income	**779**	**1,391**
Comprehensive income	**3,268**	**177**
of which attributable to non-controlling interests	166	53
of which attributable to parent company	3,102	124

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Assets	Note	12/31/2010	12/31/2009
Current assets			
Cash and cash equivalents	10	3,821	2,937
Marketable securities	11	872	467
Trade receivables	12	8,017	6,840
Income tax receivables		218	234
Other assets	13	1,856	1,737
Inventories	14	6,780	5,432
		21,564	**17,647**
Non-current assets			
Financial assets	15	9,858	9,200
Income tax receivables		117	130
Property, plant, and equipment	16	13,000	12,572
Intangible assets	17	6,267	6,205
Deferred taxes	7	1,877	1,755
		31,119	**29,862**
Total assets		**52,683**	**47,509**

Figures in millions of euros

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Equity and liabilities	Note	12/31/2010	12/31/2009
Current liabilities			
Financial liabilities	18	250	740
Trade payables	19	3,895	2,916
Income tax liabilities		216	106
Other liabilities	20	4,226	3,587
Income tax provisions		422	197
Other provisions	20	3,155	3,305
		12,164	**10,851**
Non-current liabilities			
Financial liabilities	18	3,397	3,445
Other liabilities	20	441	429
Pension provisions	21	6,503	5,786
Income tax provisions		237	200
Other provisions	20	2,842	2,873
Deferred taxes	7	856	856
		14,276	**13,589**
Equity	22		
Issued capital		1,200	1,200
Capital reserve		4,557	4,557
Retained earnings		19,886	16,862
Unappropriated earnings		82	67
Non-controlling interests		518	383
		26,243	**23,069**
Total equity and liabilities		**52,683**	**47,509**

Figures in millions of euros

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

			Retained earnings			Other comprehensive income						
	Issued capital	Capital reserve	Earned profit	Treasury stock	Currency translation	Securities	Other changes	Total	Unappropriated earnings	**Equity parent company**	Non-controlling interests	**Total equity**
January 1, 2009	**1,200**	**4,557**	**17,212**	**−62**	**−479**	**231**	**−118**	**−366**	**75**	**22,616**	**393**	**23,009**
Comprehensive income					174	1,161	49	1,384	−1,260	**124**	53	**177**
Dividends									−75	**−75**	−20	**−95**
Change in retained earnings			−1,327						1,327			
Other changes					22		−1	21		**21**	−43	**−22**
December 31, 2009	**1,200**	**4,557**	**15,885**	**−62**	**−283**	**1,392**	**−70**	**1,039**	**67**	**22,686**	**383**	**23,069**
Comprehensive income					837	412	−524	725	2,377	**3,102**	166	**3,268**
Dividends									−67	**−67**	−28	**−95**
Change in retained earnings			2,295						−2,295			
Other changes							4	4		**4**	−3	**1**
December 31, 2010	**1,200**	**4,557**	**18,180**	**−62**	**554**	**1,804**	**−590**	**1,768**	**82**	**25,725**	**518**	**26,243**

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Note 23	2010	2009
Profit before tax	3,485	−1,197
Depreciation and amortization[1]	2,812	3,424
Decrease in pension provisions	−41	−68
Decrease in non-current provisions	−67	−195
Gains on disposal of non-current assets	−220	−92
Losses on disposal of non-current assets	119	157
Gains on disposal of securities	−236	−172
Losses on disposal of securities	111	238
Financial income	−669	−511
Financial expenses	578	600
Interest and dividends received	405	328
Interest paid	−298	−197
Income taxes paid	−519	−405
Cash flow	**5,460**	**1,910**
Change in inventories	−1,069	1,626
Change in receivables and other assets	−391	62
Change in liabilities	775	−712
Change in current provisions	−384	26
Cash flows from operating activities (A)	**4,391**	**2,912**
Acquisition of subsidiaries and other business units	−14	−397
Additions to non-current assets	−2,839	−2,380
Proceeds from disposal of non-current assets	564	262
Purchase of securities	−7,072	−6,073
Disposal of securities	6,443	5,030
Cash flows from investing activities (B)	**−2,918**	**−3,558**
Acquisition of non-controlling interests	−3	−84
Borrowing	244	2,185
Repayment of financial liabilities	−830	−712
Dividends paid	−95	−95
Cash flows from financing activities (C)	**−684**	**1,294**
Increase in liquidity (A+B+C)	**789**	**648**
Liquidity at the beginning of the period (January 1)	**2,937**	**2,267**
Exchange-rate related increase in liquidity	87	18
Increase in liquidity due to changes in the consolidated group	8	4
Liquidity at the end of the period (December 31)	**3,821**	**2,937**

Figures in millions of euros
[1] After offsetting write-ups of EUR 36 million (previous year: EUR 17 million)

© 2017 AZEK

 Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

Notes to the consolidated financial statements
Principles and methods

Basis of presentation

The consolidated financial statements of the Bosch Group for the year ended December 31, 2010, have been prepared according to the standards issued by the ***I**nternational **A**ccounting **S**tandards **B**oard* (IASB), London. The ***I**nternational **F**inancial **R**eporting **S**tandards* (IFRSs) and the Interpretations of the ***I**nternational **F**inancial **R**eporting **I**nterpretations **C**ommittee* (IFRIC) applicable in the EU at the end of the reporting period have been applied. The prior-year figures have been determined using the same principles.

The consolidated financial statements are in line with the provisions of Sec. 315a HGB ["Handelsgesetzbuch": German Commercial Code] and Regulation (EC) No 1606/2002 of the European Parliament and of the Council of July 19, 2002, on the application of international accounting standards.

The following IFRSs or ***I**nternational **A**ccounting **S**tandards* (IASs) are applied:

- IAS 1: Presentation of Financial Statements
- IAS 2: Inventories
- IAS 7: Statement of Cash Flows
- IAS 8: Accounting Policies, Changes in Accounting Estimates, and Errors
- IAS 10: Events after the Reporting Period
- IAS 11: Construction Contracts
- IAS 12: Income Taxes
- IAS 16: Property, Plant, and Equipment
- IAS 17: Leases
- IAS 18: Revenue
- IAS 19: Employee Benefits
- IAS 20: Accounting for Government Grants and Disclosure of Government Assistance
- IAS 21: The Effects of Changes in Foreign Exchange Rates
- IAS 23: Borrowing Costs
- IAS 24: Related Party Disclosures
- IAS 26: Accounting and Reporting by Retirement Benefit Plans
- IAS 27: Consolidated and Separate Financial Statements
- IAS 28: Investments in Associates
- IAS 29: Financial Reporting in Hyperinflationary Economies
- IAS 31: Interests in Joint Ventures
- IAS 32: Financial Instruments: Presentation
- IAS 36: Impairment of Assets
- IAS 37: Provisions, Contingent Liabilities, and Contingent Assets
- IAS 38: Intangible Assets
- IAS 39: Financial Instruments: Recognition and Measurement
- IAS 40: Investment Property
- IFRS 1: First-Time Adoption of International Financial Reporting Standards
- IFRS 3: Business Combinations
- IFRS 5: Non-Current Assets Held for Sale and Discontinued Operations
- IFRS 7: Financial Instruments: Disclosures
- IFRS 8: Operating Segments

The Bosch Group has elected not to early adopt the changes endorsed by the EU to IAS 24 *Related Party Disclosures* (mandatory application for fiscal years beginning on or after January 1, 2011) and to IAS 32 *Financial Instruments: Presentation* (mandatory application for fiscal years beginning on or after February 1, 2010).

To enhance the clarity and transparency of the consolidated financial statements, individual items of the consolidated income statement and the consolidated statement of financial position have been combined. These items are explained separately in the notes to the consolidated financial statements. The income statement has been prepared using the function of expense method.

 © 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

The preparation of consolidated financial statements in accordance with IFRS requires that assumptions be made for some items. These assumptions have an effect on the amount of the assets and liabilities, income and expenses, and contingent liabilities disclosed in the consolidated statement of financial position.

The group currency is the euro (EUR). Unless otherwise stated, all figures are in millions of euros (EUR million).

The consolidated financial statements prepared as of December 31, 2010, were authorized for disclosure by management on March 8, 2011. The consolidated financial statements and group management report will be filed with the electronic Federal Gazette [Bundesanzeiger] and published there.

Basis of consolidation

Besides Robert Bosch GmbH, the consolidated financial statements include all subsidiaries for which Robert Bosch GmbH fulfills the criteria pursuant to IAS 27 *Consolidated and Separate Financial Statements*, or to which the interpretation of the *Standing Interpretations Committee* SIC 12 *Consolidation – Special Purpose Entities* apply. These entities are included in the consolidated financial statements from the date on which the Bosch Group obtains control. Conversely, subsidiaries are no longer included when control of the entity is lost.

The capital of the companies consolidated in the fiscal year for the first time is consolidated pursuant to IFRS 3 *Business Combinations* using the purchase method of accounting. At the time of combination, the purchase cost of the shares acquired is offset against pro-rata revalued equity. Assets, liabilities, and contingent liabilities are carried at fair value. Remaining debit differences are accounted for as goodwill. Any credit differences are recognized through profit or loss. Any difference resulting from the purchase of additional non-controlling shares is offset against equity.

Joint ventures as defined by IAS 31 *Interests in Joint Ventures* are consolidated proportionately.

Pursuant to IAS 28 *Investments in Associates*, investments are included in consolidation using the equity method if significant influence can be exercised. At present, no entity has been accounted for using the equity method.

Within the consolidated group, intercompany profits and losses, sales, expenses and other income, as well as all receivables and liabilities or provisions are eliminated. In the case of consolidation measures with an effect on income, the effects for income tax purposes are considered and deferred taxes disclosed.

Currency translation

In the separate financial statements of the group companies, all receivables and liabilities denominated in currencies other than the euro are measured at the closing rate at the end of the reporting period, regardless of whether they are hedged or not. Exchange-rate gains and losses from revaluations are recorded in profit or loss.

The financial statements of the consolidated companies outside the euro zone are translated into euros in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Assets and liabilities are translated at the closing rate at the end of the reporting period, while equity is translated at historical rates. The positions of the income statement are translated into euros at the annual average exchange rate. Any resulting exchange-rate differences are recorded as other comprehensive income until the disposal of the subsidiaries, and disclosed as a separate position in equity.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

For the most important non-euro currencies of the Bosch Group, the following exchange rates apply:

		Closing rate		Average rate	
	EUR 1 =	12/31/2010	12/31/2009	2010	2009
Australia	AUD	1.31	1.60	1.44	1.77
Brazil	BRL	2.22	2.51	2.33	2.77
China	CNY	8.81	9.80	8.98	9.53
Czech Republic	CZK	25.06	26.47	25.30	26.44
Hungary	HUF	278.75	270.84	275.47	280.59
India	INR	59.76	67.04	60.59	67.38
Japan	JPY	108.65	133.16	116.24	130.33
Korea	KRW	1,499.06	1,666.97	1,531.82	1,773.20
Switzerland	CHF	1.25	1.48	1.38	1.51
United Kingdom	GBP	0.86	0.89	0.86	0.89
USA	USD	1.34	1.44	1.33	1.39

Accounting policies

Cash and cash equivalents consist of cash, reserve bank deposits, bank balances with an original maturity of less than 90 days, and checks. Measurement is at amortized cost.

Trade receivables, income tax receivables, other assets (current), and other financial assets (non-current) are measured at amortized cost. All discernible specific risks and general credit risks are accounted for by appropriate valuation allowances. This does not apply to derivative financial instruments. For finance leases under which the Bosch Group is the lessor, a receivable is disclosed equivalent to the net investment value. Leases under which substantially all risks and rewards in connection with ownership have been transferred to the lessee are classified as finance leases.

Inventories include raw materials, consumables, and supplies, work in process, finished goods and merchandise, and prepayments. Inventories are stated at purchase cost or cost of conversion using the average cost method. In addition to direct cost, cost of conversion includes an allocable portion of necessary materials and production overheads as well as depreciation that can be directly allocated to the production process. Appropriate allowance is made for risks associated with holding and selling inventories due to obsolescence. Inventories are devalued further when the net selling price of the inventories has fallen below cost.

Property, plant, and equipment are measured at cost of purchase or production cost less depreciation and, if necessary, impairment losses. Depreciation is charged on a straight-line basis over the economic useful life.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

Depreciation is based on the following ranges of useful lives:

	Useful life
Buildings	10 – 33 years
Plant and equipment	6 – 14 years
Other equipment, fixtures, and furniture	3 – 12 years

In accordance with IAS 36 *Impairment of Assets*, impairment losses are recorded on property, plant, and equipment if the recoverable amount has fallen below the carrying amount. Impairment losses are reversed if the reasons for the impairment loss from previous years no longer apply. Repair costs are recognized in the income statement.

In accordance with IAS 17 *Leases*, leased items of property, plant, and equipment which for economic purposes are deemed to be purchases of assets with long-term financing (finance leases) are recognized at the time of addition at the lower of cost or present value of the minimum lease payments. Depreciation is charged over the economic useful life. If it is uncertain whether title to the leased asset will be transferred, the asset is depreciated over the term of the lease agreement (if shorter than the economic useful life). The finance expense from these leases is disclosed under other financial expenses.

Government grants are only recognized pursuant to IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* if it is sufficiently certain that the assistance will be granted. Grants related to assets are deducted in order to calculate the carrying amount of the asset. Grants related to income are recognized in the income statement of the period in which the expenses are incurred.

Investment property is measured at depreciated cost in accordance with IAS 40 *Investment Property*.

Purchased and internally generated intangible assets are capitalized pursuant to IAS 38 *Intangible Assets* if a future economic benefit will flow to the entity from the use of the asset and the cost of the asset can be reliably determined. These assets are generally carried at cost and amortized using the straight-line method over their economic useful life. As a rule, the useful life is four years. Intangible assets accounted for in the course of business combinations have a useful life of up to 20 years.

Borrowing costs incurred in connection with the acquisition, construction, or production of qualifying assets are included in the cost of this asset for the period of time until the asset is commissioned and subsequently written off with the asset concerned. Other borrowing costs are recorded as expenses.

Goodwill from business combinations represents the difference between the purchase price on the one hand and the pro-rata fair value of the equity at the time of acquisition on the other. Goodwill is allocated to the cash-generating units and tested annually for impairment. If the recoverable amount of the cash-generating unit does not cover the carrying amount of the net asset, impairment losses are charged in accordance with the requirements of IAS 36.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Pursuant to IFRS 1 *First-time Adoption of International Financial Reporting Standards*, goodwill existing as of January 1, 2004 (date of transition) was transferred at the carrying amount in accordance with the provisions of the German Commercial Code. Goodwill is also tested for impairment pursuant to the provisions of IAS 36.

Intangible assets with an indefinite useful life are tested annually for impairment. Intangible assets subject to wear and tear are only tested for impairment if there is any indication that they may be impaired. In accordance with IAS 36 *Impairment of Assets*, impairment losses are recorded if the recoverable amount has fallen below the carrying amount. Impairment losses are reversed if the reasons for the impairment loss from previous years no longer apply.

Financial instruments

A financial instrument is any contract that gives rise to a financial asset of one entity on the one hand and to a financial liability or equity instrument of a second entity on the other. As a rule, financial instruments are determined as of the settlement date. Financial instruments are accounted for at amortized cost or fair value. In the case of a financial asset or financial liability not accounted for at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability are taken into account. Fair value is the market value. If it is not possible to reliably determine a market value, the fair value is determined using actuarial methods based on available market information (the most common methods are the discounted cash flow method and the Black-Scholes model). The fair values needed to present the market values required by IFRS 7 are determined in the same way. The fair value of current financial assets and liabilities corresponds to the carrying amount.

Under IAS 39 *Financial Instruments: Recognition and Measurement*, the following categories of financial instruments are used in the Bosch Group:

- Held-to-maturity investments
- Loans and receivables
- Financial liabilities measured at amortized cost
- Assets and liabilities held for trading
- Available-for-sale financial assets

The fair-value option pursuant to IAS 39 is not exercised.

Financial investments held to maturity, loans and receivables, and current and non-current financial liabilities are measured at amortized cost using the effective interest method. These are mainly loans, trade receivables, and current and non-current other financial assets and liabilities. Impairments of loans and receivables to allow for anticipated credit risks are recognized in the form of specific and general doubtful debt allowances. When determining valuation allowances for the general credit risk, financial assets that could potentially be impaired are grouped together by similar credit risk characteristics and collectively tested for impairment and, if necessary, written down.

Financial assets and liabilities held for trading are measured at fair value. Changes in value are recognized in profit or loss. These are derivative financial instruments which are mainly used to limit currency and interest risks in accordance with internal risk management. Hedge accounting is not used in the Bosch Group.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Available-for-sale financial assets are those non-derivative financial assets that cannot be allocated to any of the preceding categories. They are carried at fair value. Unrealized gains and losses from changes in market value are disclosed in equity, net of deferred taxes, until they are realized. Interest received is generally recognized through profit and loss using the effective interest method. Dividends are recognized through profit and loss as soon as payment is legally enforceable. If impairment losses are necessary, the accumulated net loss is eliminated from equity and disclosed in profit or loss. If an impairment loss recorded on equity instruments is reversed in accordance with IAS 39, this is offset directly against equity. Reversals of impairment losses on debt instruments are recognized in profit or loss. They may not exceed the amount for which the impairment loss was recorded.

If the fair value of available-for-sale financial assets cannot be reliably determined, they are accounted for at acquisition cost. These are investments for which there is no active market. Necessary impairment losses are recognized in profit or loss and are not reversed.

As of the end of every reporting period, the carrying amounts of the financial assets which are not measured at fair value through profit or loss are examined for substantial objective indications that an asset may be impaired. Such indications may, for instance, be serious financial difficulties suffered by the debtor, the high probability that insolvency proceedings will be instituted against the debtor, the loss of an active market for the financial asset, a permanent drop in the fair value of the financial asset below amortized cost, or significant changes in the technological, economic, or legal environment, or in the market of the issuer. A possible impairment loss is given if the fair value of the asset is lower than the carrying amount. The fair value of loans and receivables is the present value of the estimated future cash flows discounted using the original effective interest rate.

In accordance with IAS 12 *Income Taxes*, **deferred tax assets and liabilities** are recorded for temporary differences between the tax carrying amounts and the carrying amounts in the consolidated statement of financial position unless they arise from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affect neither the profit before tax nor the taxable profit. This also applies to unused tax losses and tax credits if there is assurance beyond reasonable doubt that future taxable profit will be available against which they can be utilized. The deferred tax item equals the estimated tax burden/relief in later periods. The tax rate applicable at the time of realization is taken as a basis. Tax implications from profit distributions are generally not considered until the resolution for the appropriation of profits has been adopted. If it is uncertain whether recognized deferred taxes can be realized, they are adjusted accordingly.

Liabilities are measured at amortized cost. Liabilities from finance leases are disclosed under other liabilities, at the present value of the future lease installments. The effective interest method is applied when measuring bonds.

Pursuant to IAS 19 *Employee Benefits*, **pension provisions** are recognized using the projected unit credit method, taking future estimated increases in pensions and salaries into account.

Tax provisions pertain to obligations relating to income tax and other taxes. Deferred taxes are disclosed in separate positions of the statement of financial position.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Pursuant to IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets*, **other provisions** are recognized if there is a current obligation from a past event which will probably lead to an outflow of resources in the future. In addition, it must be possible to reliably estimate the amount of this outflow. Other provisions are measured at full cost. Provisions due in more than one year are stated at their discounted settlement amount.

Revenue from the supply of products and goods or from the provision of services is recognized when title and risk is transferred to the purchaser, less sales deductions. Interest and lease income is recorded according to the contractual agreement and, where appropriate, accrued pro rata temporis. In the case of finance leases, the payments are divided up using actuarial methods.

Cost of sales contains the cost of internally manufactured goods and the cost price of resold merchandise. The production cost of internally manufactured goods contains materials and production cost that can be allocated directly, the allocable parts of indirect overheads, including the depreciation of production equipment and the amortization of other intangible assets, and the devaluation of inventories.

Development cost that cannot be recognized is charged against income in the period incurred.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

2. Framework for the preparation and presentation of financial statements

2.1 Objective of financial statements

According to IAS 1, the objective of financial statements is "*to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it*".

The users of financial statements are diverse. They include investors (present and potential), lenders, employees, suppliers, customers, governments, and the public.

All these users of financial statements have different information needs:

- Investors are mainly concerned with the risk and return of their investment. They need information to help them determine whether they should buy, sell or hold securities issued by the firm.
- Lenders are interested in information that enables them to predict whether their loans will be repaid and the interest on them will be paid.
- Employees are concerned with the stability and profitability of their employer. They are also interested in information useful in determining the ability of the enterprise to pay remuneration and pensions.
- Suppliers are interested in information about the ability of the enterprise to pay amounts owing to them.
- Etc.

Despite the variety of information needs of the different categories of users, the IASB postulates that financial statements that meet the needs of investors will also meet most of the needs of other users.

This market-orientated approach to financial reporting is typical of the Anglo-American view of accounting, as discussed in Chapter 1. It is opposed to the less market-orientated approaches that have traditionally prevailed in Continental Europe.

Consistent with this emphasis on the information needs of investors, the IASB considers that financial statements should provide information helpful in assessing the ability of enterprises to generate cash flows - with their problems of timing and uncertainty.

2.2 Accounting conventions

Accounting rules are based on a common set of principles (accounting conventions) that are universally admitted and from which all detailed accounting standards are derived. Any user of financial statements should have a good knowledge of these principles in order to properly understand information contained in financial statements. These conventions are described in the IASB framework and IAS 1.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

2.2.1 Accrual basis of accounting

Financial statements are prepared on the accrual basis of accounting. This means that the effects of transactions and other events are recognised **when they occur** (and not when cash is received or paid).

According to this convention, a sale of goods taking place on December 20, N is included in the revenues of year N even if the payment will only be received in January N+1.

Because many transactions originate and end in different periods, adjustments are necessary at the reporting date to respect the accrual basis convention. These adjustments give rise to the recognition of transitory assets (prepayments and accrued income) and transitory liabilities (accruals and deferred income).

2.2.2 Going concern

According to this convention, financial statements are prepared on the assumption that the enterprise will continue its activities in the foreseeable future. It is assumed that the firm has neither the intention nor the need to liquidate.

The practical consequence of this convention is that assets may be valued at an amount higher than their liquidation value.

The going concern principle must, of course, not be applied when the management of a firm either intends to liquidate it, or has no realistic alternative but to do so. When financial statements are not prepared on a going concern basis that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason why the enterprise is not regarded as a going concern.

2.2.3 Prudence

The value of assets and the amount of provisions depend on future events and circumstances, which are subject to uncertainties such as the collectability of doubtful receivables or the probable useful life of fixed assets.

This inevitably raises the question of how to deal with such uncertainties. It is universally accepted that firms should exercise prudence in the preparation of financial statements, so that assets or income are not overstated and liabilities or expenses are not understated.

Nevertheless, the IASB states that the exercise of prudence does not allow the creation of "hidden reserves", as it was the case in Germanic countries before the implementation of the IFRS. The deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses is thus prohibited for companies that comply with international accounting standards.

The practical consequence of the prudence (or conservatism) principle is that:

- an expense is recognised as soon as it is probable,
- a revenue is recognised only when it is certain.

© 2017 AZEK

 Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

Because of this asymmetry in the treatment of good news and bad news, the accounting valuation of the enterprise (as measured by stockholders' equity) is biased downwards. This must be kept in mind when analysing financial statements.

2.2.4 *Comparability*

It is fundamental for the analyst to compare the financial statements of an enterprise through time in order to identify trends in the company's financial position and performance. Unfortunately, accounting figures are highly dependent on the methods used in the preparation of accounts. For example, if a firm abandons an accelerated depreciation method for the straight-line method this generally results in an increase in profit because the depreciation expense will be lower.

Accounting changes make comparisons through time more difficult. However, it is not possible to completely prohibit such changes because they are necessary to achieve a fair presentation of the enterprise's financial position when circumstances have changed. Accordingly, IAS 8 standards do not prohibit accounting changes but regulate them very strictly by imposing conditions on such changes and by requiring disclosures about the effects that these changes have on the financial statements (*cf.* "Data analysis").

Comparisons through time would also be more complicated if the enterprise were to modify the presentation of its financial statements from one period to the next. This is why IAS 1 prohibits such changes unless the new presentation is more appropriate or imposed by a new standard.

It should also be possible to compare the financial statements of several enterprises that use different accounting policies. In order to facilitate such comparisons, the IFRS require that firms disclose the accounting policies they have used in the preparation of their financial statements. This should enable the analyst to identify differences between accounting methods for like transactions and their probable impact on the financial statements of the entities being compared.

2.2.5 *Substance over form*

Traditionally, there are two competing views of accounting:

- the legal view,
- and the economic view.

According to the legal view, accounting should reflect the legal nature of transactions, whereas under the economic view, it should reflect their economic substance.

To show the opposition between these two approaches, let us consider the case of financial leases, such as leases that give the lessee the right to acquire the leased asset by the end of the lease term:

- According to the legal view of accounting, the leased asset should be recognised in the balance sheet of the lessor because, as long as title has not been transferred, the lessor has the ownership of the asset.

 © 2017 AZEK

 Solomon Ngahu - Reg No. 49000007 www.masomomsingi.com

- According to the economic view of accounting, the relevant issue is not "who has the ownership title?" but "who bears the risks and rewards incidental to the ownership of the asset?". In a financial lease contract, these risks and rewards have been transferred to the lessee at the inception date. The leased asset should thus be recognised in the balance sheet of the lessee.

The substance-over-form convention requires that transactions be accounted for and presented in accordance with their substance and economic reality and not merely with their legal form. In other words, the economic view of accounting prevails over the legal view.

This convention, consubstantial to the Anglo-American view of accounting, is not admitted in all countries. Nevertheless, it is one of the basic principles of the IFRS.

2.3 Fundamental definitions

The IASB framework provides fundamental definitions of the basic elements of financial statements. They are very important because all the detailed rules contained in the standards are more or less derived from these definitions.

2.3.1 Assets

An **asset** is defined as "*a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity*".

The use of the word "*controlled*" rather than "*owned*" emphasises that holding an ownership title is not a necessary condition for recognising an asset. The balance sheet may thus include goods for which the enterprise has no legal ownership such as, for example, leased assets.

Future economic benefits embodied in an asset have the potential to contribute to the flow of cash to the entity. The main feature of an asset is that it should generate **future cash flows**. These cash flows will be obtained in a number of ways. For example, an asset may be:

- used in the production of goods or services to be sold by the enterprise,
- exchanged for another asset (cash in particular),
- or used to settle a liability.

2.3.2 Liabilities

A **liability** is "*a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits*".

The obligation is legally enforceable when it derives from a contract or legislation. But an obligation may also arise from business practice, the desire to maintain good business relations or act in an equitable manner. These "constructive obligations" must also be taken into account, especially when determining provisions (*cf.* “Balance sheet”).

 © 2017 AZEK

 Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

To give rise to a liability the obligation must be **present**. For example a decision to acquire an asset in the future does not, of itself, give rise to an obligation. No liability is recognised until the asset is delivered or the enterprise enters into an irrevocable agreement to acquire it.

The settlement of the obligation involves giving up resources embodying economic benefits. This differentiates liabilities from grants, for which no reimbursement is normally needed. The settlement of the obligation may occur in a number of ways:

- payment of cash,
- transfer of other assets,
- provision of services,
- etc.

2.3.3 Equity

Equity is defined as "*the residual interest in the assets of the entity after deducting all its liabilities*". In other words: **Equity = Assets – Liabilities**

This definition clearly shows that the amount of equity is dependent on the measurement of assets and liabilities, i.e. on accounting conventions and policies used by the enterprise.

Equity has two main sources:

- contributions from the owners of the enterprise (capital and additional paid-in capital),
- past earnings of the enterprise which have not yet been distributed to the owners (retained earnings).

2.3.4 Income

Income is "*increases in economic benefits during the accounting period ... that result in increases in equity, other than those relating to contributions from equity participants*".

Note that an increase in equity may result either from an increase in assets, or from a decrease in liabilities.

The IASB framework makes a distinction between two categories of income:

- **revenues**, which are generated by the ordinary activities of the enterprise (sales, interest and dividends received, royalties...),
- **gains**, which may or may not arise in the course of the ordinary activities of the enterprise. Gains include income arising from the disposal of fixed assets, as well as unrealised income resulting from the revaluation of assets.

2.3.5 Expenses

Expenses are "*decreases in economic benefits during the accounting period ... that result in decreases in equity, other than those relating to distributions to equity participants*".

Definitions of income and expenses are thus symmetrical.

 © 2017 AZEK

 Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

As for income, the IASB framework makes a distinction between:

- **expenses strictly speaking**, that result from the ordinary activities of the enterprise (cost of sales, wages, depreciation...),
- **losses**, that may or may not arise in the course of the ordinary activities of the enterprise (losses on the disposal or the revaluation of assets).

2.4 Criteria for accounting recognition

The main question an accountant is faced with is "when should an asset, a liability, an income or an expense be recognised in the financial statements?". The IASB framework provides precise answers to this question.

According to the IASB, an item that meets the definition of an element of financial statements (asset, liability, equity, income, expense) must be recognised when two conditions are met:

1) it is probable that future economic benefits (i.e. cash or cash equivalents) associated with the item will flow to or from the entity;

2) the item has a cost or value that can be measured with reliability.

It is not necessary to elaborate on these general principles for the time being because they are complemented by specific rules for each category of elements (assets, liabilities, income and expenses), which will be discussed in the coming chapters.

The following appendix provides examples of consolidated financial statements. Pay no attention to the date of these statements. These examples are just aimed at showing different presentation formats which, because of the consistency-of-presentation principle, generally do not vary over time.

In these examples, you will find an item called "minority interests". You need not worry about these at this juncture. They represent the interests of the minority shareholders in the subsidiaries of the company. You will see this in detail in “Consolidated Financial Statements”.

 © 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

2.5 APPENDIX: Consolidated financial statements

2.5.1 *Louis Vuitton Moët Hennessy (France)*

(EUR millions, except for earnings per share)	Notes	2011	2010	2009
Revenue	22	**23,659**	**20,320**	**17,053**
Cost of sales		(8,092)	(7,184)	(6,164)
Gross margin		**15,567**	**13,136**	**10,889**
Marketing and selling expenses		(8,360)	(7,098)	(6,051)
General and administrative expenses		(1,944)	(1,717)	(1,486)
Profit from recurring operations	22-23	**5,263**	**4,321**	**3,352**
Other operating income and expenses	24	(109)	(152)	(191)
Operating profit		**5,154**	**4,169**	**3,161**
Cost of net financial debt		(151)	(151)	(187)
Other financial income and expenses		(91)	763	(155)
Net financial income (expense)	25	**(242)**	**612**	**(342)**
Income taxes	26	(1,453)	(1,469)	(849)
Income (loss) from investments in associates	7	6	7	3
Net profit before minority interests		**3,465**	**3,319**	**1,973**
Minority interests		(400)	(287)	(218)
Net profit, Group share		**3,065**	**3,032**	**1,755**
Basic Group share of net earnings per share *(EUR)*	27	**6.27**	**6.36**	**3.71**
Number of shares on which the calculation is based		488,769,286	476,870,920	473,597,075
Diluted Group share of net earnings per share *(EUR)*	27	**6.23**	**6.32**	**3.70**
Number of shares on which the calculation is based		492,207,492	479,739,697	474,838,025

(EUR millions)	2011	2010	2009
Net profit before minority interests	**3,465**	**3,319**	**1,973**
Translation adjustments	190	701	(128)
Tax impact	47	89	(20)
	237	**790**	**(148)**
Change in value of available for sale financial assets	1,634	294	114
Amounts transferred to income statement	(38)	38	(11)
Tax impact	(116)	(35)	(26)
	1,480	**297**	**77**
Change in value of hedges of future foreign currency cash flows	95	(20)	133
Amounts transferred to income statement	(168)	(30)	(125)
Tax impact	21	14	(2)
	(52)	**(36)**	**6**
Change in value of vineyard land	25	206	(53)
Tax impact	(11)	(71)	18
	14	**135**	**(35)**
Gains and losses recognized in equity	**1,679**	**1,186**	**(100)**
Comprehensive income	**5,144**	**4,505**	**1,873**
Minority interests	(433)	(375)	(189)
Comprehensive income, Group share	**4,711**	**4,130**	**1,684**

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

ASSETS	Notes	2011	2010	2009
(EUR millions)				
Brands and other intangible assets - net	3	11,482	9,104	8,697
Goodwill - net	4	6,957	5,027	4,270
Property, plant and equipment - net	6	8,017	6,733	6,140
Investments in associates	7	170	223	213
Non-current available for sale financial assets	8	5,982	3,891	540
Other non-current assets		478	319	750
Deferred tax		716	668	521
Non-current assets		**33,802**	**25,965**	**21,131**
Inventories and work in progress	9	7,510	5,991	5,644
Trade accounts receivable	10	1,878	1,565	1,455
Income taxes		121	96	217
Other current assets	11	1,455	1,255	1,213
Cash and cash equivalents	13	2,303	2,292	2,446
Current assets		**13,267**	**11,199**	**10,975**
Total assets		**47,069**	**37,164**	**32,106**

LIABILITIES AND EQUITY	Notes	2011	2010	2009
(EUR millions)				
Share capital		152	147	147
Share premium account		3,801	1,782	1,763
Treasury shares and LVMH-share settled derivatives		(485)	(607)	(929)
Cumulative translation adjustment		431	230	(495)
Revaluation reserves		2,689	1,244	871
Other reserves		12,798	11,370	10,684
Net profit, Group share		3,065	3,032	1,755
Equity, Group share	14	22,451	17,198	13,796
Minority interests	16	1,061	1,006	989
Total equity		**23,512**	**18,204**	**14,785**
Long term borrowings	17	4,132	3,432	4,077
Provisions	18	1,400	1,167	990
Deferred tax		3,925	3,354	3,117
Other non-current liabilities	19	4,506	3,947	3,089
Non-current liabilities		**13,963**	**11,900**	**11,273**
Short term borrowings	17	3,134	1,834	1,708
Trade accounts payable		2,952	2,298	1,911
Income taxes		443	446	221
Provisions	18	349	339	334
Other current liabilities	20	2,716	2,143	1,874
Current liabilities		**9,594**	**7,060**	**6,048**
Total liabilities and equity		**47,069**	**37,164**	**32,106**

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

(EUR millions)	Share capital: number of shares	Share capital	Share premium account	Treasury shares and LVMH-share settled derivatives
Notes		14.1		14.2
As of December 31, 2008	**489,937,410**	**147**	**1,737**	**(983)**
Gains and losses recognized in equity				
Net profit				
Comprehensive income		-	-	-
Stock option plan and similar expenses				
(Acquisition)/disposal of treasury shares and LVMH-share settled derivatives				50
Exercise of LVMH share subscription options	557,204		30	
Retirement of LVMH shares	(88,960)		(4)	4
Capital increase in subsidiaries				
Interim and final dividends paid				
Changes in control of consolidated entities				
Acquisition and disposal of minority interests' shares				
Purchase commitments for minority interests				
As of December 31, 2009	**490,405,654**	**147**	**1,763**	**(929)**
Gains and losses recognized in equity				
Net profit				
Comprehensive income		-	-	-
Stock option plan and similar expenses				
(Acquisition)/disposal of treasury shares and LVMH-share settled derivatives				221
Exercise of LVMH share subscription options	2,012,478		120	
Retirement of LVMH shares	(1,775,900)		(101)	101
Capital increase in subsidiaries				
Interim and final dividends paid				
Changes in control of consolidated entities				
Acquisition and disposal of minority interests' shares				
Purchase commitments for minority interests				
As of December 31, 2010	**490,642,232**	**147**	**1,782**	**(607)**
Gains and losses recognized in equity				
Net profit				
Comprehensive income		-	-	-
Stock option plan and similar expenses				
(Acquisition)/disposal of treasury shares and LVMH-share settled derivatives				15
Exercise of LVMH share subscription options	1,395,835		94	
Retirement of LVMH shares	(2,259,454)		(107)	107
Acquisition of a controlling interest in Bulgari	18,037,011	5	2,032	
Capital increase in subsidiaries				
Interim and final dividends paid				
Changes in control of consolidated entities, excluding Bulgari				
Acquisition and disposal of minority interests' shares				
Purchase commitments for minority interests				
As of December 31, 2011	**507,815,624**	**152**	**3,801**	**(485)**

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

Cumulative translation adjustment	Revaluation reserves			Net profit and other reserves	Total equity		
	Available for sale financial assets	Future foreign currency cash flows	Vineyard land		Group share	Minority interests	Total
14.4						16	
(371)	136	59	623	11,456	12,804	989	13,793
(124)	77	4	(28)		(71)	(29)	(100)
				1,755	1,755	218	1,973
(124)	77	4	(28)	1,755	1,684	189	1,873
				43	43	3	46
				(57)	(7)	-	(7)
					30	-	30
					-	-	-
					-	11	11
				(758)	(758)	(176)	(934)
					-	11	11
					-	(8)	(8)
					-	(30)	(30)
(495)	213	63	595	12,439	13,796	989	14,785
725	297	(32)	108		1,098	88	1,186
				3,032	3,032	287	3,319
725	297	(32)	108	3,032	4,130	375	4,505
				41	41	3	44
				(43)	178	-	178
					120	-	120
					-	-	-
					-	1	1
				(953)	(953)	(158)	(1,111)
					-	(3)	(3)
				(83)	(83)	(104)	(187)
				(31)	(31)	(97)	(128)
230	510	31	703	14,402	17,198	1,006	18,204
201	1,480	(46)	11		1,646	33	1,679
				3,065	3,065	400	3,465
201	1,480	(46)	11	3,065	4,711	433	5,144
				49	49	3	52
				(8)	7	-	7
					94	-	94
					-	-	-
				201	2,238	772	3,010
					-	4	4
				(1,069)	(1,069)	(187)	(1,256)
				(5)	(5)	20	15
				(681)	(681)	(785)	(1,466)
				(91)	(91)	(205)	(296)
431	1,990	(15)	714	15,863	22,451	1,061	23,512

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

(EUR millions)	Notes	2011	2010	2009
I. OPERATING ACTIVITIES AND INVESTMENTS				
Operating profit		5,154	4,169	3,161
Net increase in depreciation, amortization and provisions		999	788	826
Other computed expenses		(45)	(126)	(37)
Dividends received		61	20	21
Other adjustments		(32)	(3)	(43)
Cash from operations before changes in working capital		**6,137**	**4,848**	**3,928**
Cost of net financial debt: interest paid		(152)	(149)	(185)
Income taxes paid		(1,544)	(897)	(900)
Net cash from operating activities before changes in working capital		**4,441**	**3,802**	**2,843**
Change in inventories and work in progress		(768)	(126)	69
Change in trade accounts receivable		(65)	(13)	206
Change in trade accounts payable		331	295	(362)
Change in other receivables and payables		(32)	91	178
Total change in working capital		**(534)**	**247**	**91**
Net cash from operating activities		**3,907**	**4,049**	**2,934**
Purchase of tangible and intangible fixed assets		(1,749)	(1,002)	(748)
Proceeds from sale of tangible and intangible fixed assets		31	33	26
Guarantee deposits paid and other operating investments		(12)	(7)	(7)
Operating investments		**(1,730)**	**(976)**	**(729)**
Net cash from (used in) operating activities and operating investments (free cash flow)		**2,177**	**3,073**	**2,205**
II. FINANCIAL INVESTMENTS				
Purchase of non-current available for sale financial assets	8	(518)	(1,724)	(93)
Proceeds from sale of non-current available for sale financial assets	8	17	70	49
Impact of purchase and sale of consolidated investments[a]	2	(785)	(61)	(278)
Net cash from (used in) financial investments		**(1,286)**	**(1,715)**	**(322)**
III. TRANSACTIONS RELATING TO EQUITY				
Capital increases of LVMH[a]	14	94	120	30
Capital increases of subsidiaries subscribed by minority interests	16	3	1	11
Acquisition and disposals of treasury shares and LVMH-share settled derivatives	14.2	2	155	34
Interim and final dividends paid by LVMH	14.3	(1,069)	(953)	(758)
Interim and final dividends paid to minority interests in consolidated subsidiaries	16	(189)	(158)	(175)
Purchase and proceeds from sale of minority interests	2	(1,413)	(185)	-
Net cash from (used in) transactions relating to equity		**(2,572)**	**(1,020)**	**(858)**
IV. FINANCING ACTIVITIES				
Proceeds from borrowings		2,659	564	2,442
Repayment of borrowings		(1,005)	(1,290)	(2,112)
Purchase and proceeds from sale of current available for sale financial assets		6	(32)	321
Net cash from (used in) financing activities		**1,660**	**(758)**	**651**
V. EFFECT OF EXCHANGE RATE CHANGES		60	188	(120)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS (I+II+III+IV+V)		**39**	**(232)**	**1,556**
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	13	2,042	2,274	718
CASH AND CASH EQUIVALENTS AT END OF PERIOD	13	2,081	2,042	2,274
Transactions included in the table above, generating no change in cash:				
- acquisition of assets by means of finance leases		3	6	12

(a) The impact of the amount attributable to the acquisition of Bulgari carried out by the capital increase of LVMH SA is not reflected in these line items.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

2.5.2 *Fiat (Italy)*

(€ million)	Note	2010	2009 (**)
Net revenues	(1)	35,880	32,684
Cost of sales	(2)	30,718	28,252
Selling, general and administrative costs	(3)	2,956	2,673
Research and development costs	(4)	1,013	1,010
Other income (expenses)	(5)	(81)	(13)
TRADING PROFIT/(LOSS)		**1,112**	**736**
Gains (losses) on the disposal of investments	(6)	12	3
Restructuring costs	(7)	118	168
Other unusual income (expenses)	(8)	(14)	(193)
OPERATING PROFIT/(LOSS)		**992**	**378**
Financial income (expenses)	(9)	(400)	(352)
Result from investments:	(10)	114	77
Share of the profit/(loss) of investees accounted for using the equity method		120	65
Other income (expenses) from investments		(6)	12
PROFIT/(LOSS) BEFORE TAXES		**706**	**103**
Income taxes	(11)	484	448
PROFIT/(LOSS) FROM CONTINUING OPERATIONS		**222**	**(345)**
Post tax profit/(loss) from Discontinued Operations	(A)	378	(503)
PROFIT/(LOSS)		**600**	**(848)**
PROFIT/(LOSS) ATTRIBUTABLE TO:			
Owners of the parent		520	(838)
Non-controlling interests		80	(10)
PROFIT/(LOSS) FROM CONTINUING OPERATION ATTRIBUTABLE TO:			
Owners of the parent		179	(374)
Non-controlling interests		43	29

(in €)			
BASIC EARNINGS/(LOSS) PER ORDINARY AND PREFERENCE SHARE	(13)	**0.410**	**(0.677)**
BASIC EARNINGS/(LOSS) PER SAVINGS SHARE	(13)	**0.565**	**(0.677)**
DILUTED EARNINGS/(LOSS) PER ORDINARY AND PREFERENCE SHARE	(13)	**0.409**	**(0.677)**
DILUTED EARNINGS/(LOSS) PER SAVINGS SHARE	(13)	**0.564**	**(0.677)**

(*) Pursuant to Consob Resolution No. 15519 of 27 July 2006, the effects of related party transactions on the consolidated income statement are presented in the specific Income Statement schedule provided in the following pages and are further described in Note 34.
(**) In accordance with IFRS 5 the figures for 2009 have been reclassified.
(A) Post tax profit/(loss) from Discontinued Operations is presented in the section Assets and Liabilities held for sale and Discontinued Operations.

(€ million)	Note	2010	2009
PROFIT/(LOSS) (A)		**600**	**(848)**
Gains/(Losses) on cash flow hedges	(23)	171	408
Gains/(Losses) on fair value of available-for-sale financial assets	(23)	(3)	3
Gains/(Losses) on exchange differences on translating foreign operations	(23)	769	509
Share of other comprehensive income of entities accounted for using the equity method	(23)	100	(47)
Income tax relating to components of Other comprehensive income	(23)	3	(51)
TOTAL OTHER COMPREHENSIVE INCOME, NET OF TAX (B)		**1,040**	**822**
TOTAL COMPREHENSIVE INCOME (A)+(B)		**1,640**	**(26)**
TOTAL COMPREHENSIVE INCOME ATTRIBUTABLE TO:			
Owners of the parent		1,503	(34)
Non-controlling interests		137	8

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

(€ million)	Note	At 31 December 2010	At 31 December 2009
ASSETS			
Intangible assets	(14)	**4,350**	7,199
Property, plant and equipment	(15)	**9,601**	12,945
Investments and other financial assets:	(16)	**1,653**	2,159
Investments accounted for using the equity method		**1,465**	1,884
Other investments and financial assets		**188**	275
Leased assets	(17)	**-**	457
Defined benefit plan assets		**20**	144
Deferred tax assets	(11)	**1,678**	2,580
Total Non-current assets		**17,302**	**25,484**
Inventories	(18)	**4,443**	8,748
Trade receivables	(19)	**2,259**	3,649
Receivables from financing activities	(19)	**2,866**	12,695
Financial receivables from Discontinued Operations		**5,626**	-
Current tax receivables	(19)	**353**	674
Other current assets	(19)	**1,528**	2,778
Current financial assets:		**735**	899
Current investments		**34**	46
Current securities	(20)	**185**	217
Other financial assets	(21)	**516**	636
Cash and cash equivalents	(22)	**11,967**	12,226
Total Current assets		**29,777**	**41,669**
Assets held for sale and Discontinued Operations	(A)	**34,854**	82
Elimination of financial receivables and debt due from/payable to Discontinued Operations	(A)	**(8,491)**	-
TOTAL ASSETS		**73,442**	**67,235**
Total assets adjusted for asset-backed financing transactions		**64,588**	**60,149**

(*) Pursuant to Consob Resolution No. 15519 of 27 July 2006, the effects of related party transactions on the consolidated Statement of Financial Position are presented in the specific Statement of financial position schedule provided in the following pages and are further described in Note 34.
(A) Assets held for sale and Discontinued Operations are presented in the section Assets and Liabilities held for sale and Discontinued Operations.

(€ million)	Note	At 31 December 2010	At 31 December 2009
EQUITY AND LIABILITIES			
Equity:	(23)	**12,461**	11,115
Issued capital and reserves attributable to owners of the parent		**11,544**	10,301
Non-controlling interests		**917**	814
Provisions:		**4,924**	8,432
Employee benefits	(24)	**1,704**	3,447
Other provisions	(25)	**3,220**	4,985
Debt:	(26)	**20,804**	28,527
Asset-backed financing		**533**	7,086
Debt payable to Discontinued Operations		**2,865**	-
Other debt		**17,406**	21,441
Other financial liabilities	(21)	**255**	464
Trade payables	(27)	**9,345**	12,295
Current tax payables		**181**	377
Deferred tax liabilities	(11)	**135**	152
Other current liabilities	(28)	**3,908**	5,865
Liabilities held for sale and Discontinued Operations	(A)	**29,920**	8
Elimination of financial receivables and debt due from/payable to Discontinued Operations	(A)	**(8,491)**	-
TOTAL EQUITY AND LIABILITIES		**73,442**	**67,235**
Total equity and liabilities adjusted for asset-backed financing transactions		**64,588**	**60,149**

(A) Liabilities held for sale and Discontinued Operations are presented in the section Assets and Liabilities held for sale and Discontinued Operations.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

(€ million)	Note	2010	2009 (**)
A) CASH AND CASH EQUIVALENTS AT BEGINNING OF THE YEAR	(22)	**12,226**	**3,683**
B) CASH FLOWS FROM (USED IN) OPERATING ACTIVITIES DURING THE YEAR:			
Profit/(loss) from Continuing Operations		222	(345)
Amortisation and depreciation		2,186	2,036
(Gains) losses on disposal of:			
Property plant and equipment and intangible assets		(3)	(17)
Investments		(12)	(8)
Other non-cash items	(36)	89	114
Dividends received		62	35
Change in provisions		283	50
Change in deferred taxes		(199)	(56)
Change in items due to buy-back commitments	(36)	4	(23)
Change in working capital		941	1,530
Cash flows from (used in) the operating activities of Discontinued Operations	(A)	2,537	1,285
TOTAL		**6,110**	**4,601**
C) CASH FLOWS FROM (USED IN) INVESTING ACTIVITIES:			
Investments in:			
Property plant and equipment and intangible assets		(2,864)	(2,684)
Investments in consolidated subsidiaries		(162)	(3)
Other investments		(121)	(97)
Proceeds from the sale of:			
Property plant and equipment and intangible assets		46	77
Investments in consolidated subsidiaries		-	16
Other investments		11	3
Net change in receivables from financing activities		(594)	(238)
Change in current securities		24	(44)
Other changes		150	1
Cash flows from (used in) the investing activities of Discontinued Operations	(A)	(443)	410
TOTAL		**(3,953)**	**(2,559)**
D) CASH FLOWS FROM (USED IN) FINANCING ACTIVITIES:			
New issuance of bonds		-	4,200
Repayment of bonds		(1,195)	(168)
Issuance of other medium-term borrowings		1,210	2,656
Repayment of other medium-term borrowings		(1,016)	(608)
Net change in other financial payables and other financial assets/liabilities		66	(493)
Increase in share capital		1	13
Dividends paid		(239)	(27)
Cash flows from (used in) the financing activities of Discontinued Operations	(A)	2,084	708
TOTAL		**911**	**6,281**
Translation exchange differences		359	220
E) TOTAL CHANGE IN CASH AND CASH EQUIVALENTS		**3,427**	**8,543**
F) CASH AND CASH EQUIVALENTS AT END OF THE YEAR	(22)	**15,653**	**12,226**
of which: Cash and cash equivalents included as Assets held for sale and Discontinued Operations		3,686	-
G) CASH AND CASH EQUIVALENTS AT END OF THE YEAR AS REPORTED	(22)	**11,967**	**12,226**

(*) Pursuant to Consob Resolution No. 15519 of 27 July 2006, the effects of related party transactions on the consolidated statement of cash flows are presented in the specific Statement of Cash Flows schedule provided in the following pages.
(**) In accordance with IFRS 5 the figures for 2009 have been reclassified.
(A) Cash flows from (used in) the operating activities, the investing activities and the financing activities of Discontinued Operations are presented in the section Assets and Liabilities held for sale and Discontinued Operations.

(€ million)	Share capital	Treasury shares	Capital reserves	Earning reserves	Cash flow hedge reserve	Cumulative translation adjustment reserve	Available for sale financial assets reserve	Cumulative share of OCI of entities consolidated under the equity method	Non-controlling interests	Total
At 1 January 2009	**6,377**	**(657)**	**682**	**4,661**	**(568)**	**(103)**	**(1)**	**(37)**	**747**	**11,101**
Changes in equity for 2009										
Capital increase	-	-	-	-	-	-	-	-	13	**13**
Dividends accrued or distributed	-	-	-	(25)	-	-	-	-	(2)	**(27)**
Increase in the reserve for share-based payments	-	-	-	(1)	-	-	-	-	-	**(1)**
Total comprehensive income for the period	-	-	-	(838)	349	496	3	(44)	8	**(26)**
Other changes	-	-	-	7	-	-	-	-	48	**55**
At 31 December 2009	**6,377**	**(657)**	**682**	**3,804**	**(219)**	**393**	**2**	**(81)**	**814**	**11,115**
Changes in equity for 2010										
Capital increase	-	-	-	-	-	-	-	-	1	**1**
Dividends distributed	-	-	-	(237)	-	-	-	-	(2)	**(239)**
Purchase and sale of shares in subsidiaries from/to non-controlling interests	-	-	(81)	-	-	-	-	-	(38)	**(119)**
Increase in the reserve for share-based payments	-	-	-	17	-	-	-	-	-	**17**
Total comprehensive income for the period	-	-	-	520	174	718	(4)	95	137	**1,640**
Other changes	-	-	-	41	-	-	-	-	5	**46**
At 31 december 2010	**6,377**	**(657)**	**601**	**4,145**	**(45)**	**1,111**	**(2)**	**14**	**917**	**12,461**

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

2.5.3 Sony (Japan)

Consolidated Balance Sheets

Sony Corporation and Consolidated Subsidiaries—As of March 31

	Yen in millions	
	2006	2007
ASSETS		
Current assets:		
Cash and cash equivalents	¥ 703,098	¥ 799,899
Marketable securities	536,968	493,315
Notes and accounts receivable, trade	1,075,071	1,490,452
Allowance for doubtful accounts and sales returns	(89,563)	(120,675)
Inventories	804,724	940,875
Deferred income taxes	221,311	243,782
Prepaid expenses and other current assets	517,915	699,075
Total current assets	3,769,524	4,546,723
Film costs	360,372	308,694
Investments and advances:		
Affiliated companies	285,870	448,169
Securities investments and other	3,234,037	3,440,567
	3,519,907	3,888,736
Property, plant and equipment:		
Land	178,844	167,493
Buildings	926,783	978,680
Machinery and equipment	2,327,676	2,479,308
Construction in progress	116,149	64,855
	3,549,452	3,690,336
Less—Accumulated depreciation	2,160,905	2,268,805
	1,388,547	1,421,531
Other assets:		
Intangibles, net	207,034	233,255
Goodwill	299,024	304,669
Deferred insurance acquisition costs	383,156	394,117
Deferred income taxes	178,751	216,997
Other	501,438	401,640
	1,569,403	1,550,678
Total assets	¥10,607,753	¥11,716,362

(Continued on following page)

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

	Yen in millions	
	2006	2007
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Short-term borrowings	¥ 142,766	¥ 52,291
Current portion of long-term debt	193,555	43,170
Notes and accounts payable, trade	813,332	1,179,694
Accounts payable, other and accrued expenses	854,886	968,757
Accrued income and other taxes	87,295	70,286
Deposits from customers in the banking business	599,952	752,367
Other	508,442	485,287
Total current liabilities	3,200,228	3,551,852
Long-term liabilities:		
Long-term debt	764,898	1,001,005
Accrued pension and severance costs	182,247	173,474
Deferred income taxes	216,497	261,102
Future insurance policy benefits and other	2,744,321	3,037,666
Other	258,609	281,589
Total long-term liabilities	4,166,572	4,754,836
Total liabilities	7,366,800	8,306,688
Minority interest in consolidated subsidiaries	37,101	38,970
Stockholders' equity:		
Common stock, no par value—		
2006—Authorized 3,500,000,000 shares, outstanding 1,001,679,664 shares	624,124	
2007—Authorized 3,600,000,000 shares, outstanding 1,002,897,264 shares		626,907
Additional paid-in capital	1,136,638	1,143,423
Retained earnings	1,602,654	1,719,506
Accumulated other comprehensive income—		
Unrealized gains on securities	100,804	86,096
Unrealized losses on derivative instruments	(2,049)	(1,075)
Minimum pension liability adjustment	(39,824)	–
Pension liability adjustment	–	(71,459)
Foreign currency translation adjustments	(215,368)	(129,055)
	(156,437)	(115,493)
Treasury stock, at cost		
Common stock (2006—740,888 shares)	(3,127)	
(2007—834,859 shares)		(3,639)
	3,203,852	3,370,704
Commitments and contingent liabilities		
Total liabilities and stockholders' equity	¥10,607,753	¥11,716,362

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

Consolidated Statements of Income

Sony Corporation and Consolidated Subsidiaries—Years ended March 31

	Yen in millions		
	2005	2006	2007
Sales and operating revenue:			
Net sales	¥6,565,010	¥6,692,776	¥7,567,359
Financial service revenue	537,715	720,566	624,282
Other operating revenue	88,600	97,255	104,054
	7,191,325	7,510,597	8,295,695
Costs and expenses:			
Cost of sales	5,000,112	5,151,397	5,889,601
Selling, general and administrative	1,535,015	1,527,036	1,788,427
Financial service expenses	482,576	531,809	540,097
Loss on sale, disposal or impairment of assets, net	27,994	73,939	5,820
	7,045,697	7,284,181	8,223,945
Operating income	145,628	226,416	71,750
Other income:			
Interest and dividends	14,708	24,937	28,240
Gain on sale of securities investments, net	5,437	9,645	14,695
Gain on change in interest in subsidiaries and equity investees	16,322	60,834	31,509
Other	29,447	23,039	20,738
	65,914	118,455	95,182
Other expenses:			
Interest	24,578	28,996	27,278
Loss on devaluation of securities investments	3,715	3,878	1,308
Foreign exchange loss, net	524	3,065	18,835
Other	25,518	22,603	17,474
	54,335	58,542	64,895
Income before income taxes	157,207	286,329	102,037
Income taxes:			
Current	85,510	96,400	67,081
Deferred	(69,466)	80,115	(13,193)
	16,044	176,515	53,888
Income before minority interest, equity in net income of affiliated companies and cumulative effect of an accounting change	141,163	109,814	48,149
Minority interest in income (loss) of consolidated subsidiaries	1,651	(626)	475
Equity in net income of affiliated companies	29,039	13,176	78,654
Income before cumulative effect of an accounting change	168,551	123,616	126,328
Cumulative effect of an accounting change (2005: Net of income taxes of ¥2,675 million)	(4,713)	–	–
Net income	¥ 163,838	¥123,616	¥126,328

(Continued on following page)

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Consolidated Statements of Cash Flows

Sony Corporation and Consolidated Subsidiaries—Years ended March 31

	Yen in millions		
	2005	2006	2007
Cash flows from operating activities:			
Net income	¥ 163,838	¥ 123,616	¥ 126,328
Adjustments to reconcile net income to net cash provided by operating activities—			
Depreciation and amortization, including amortization of deferred insurance acquisition costs	372,865	381,843	400,009
Amortization of film costs	276,320	286,655	368,382
Stock-based compensation	(74)	150	3,838
Accrual for pension and severance costs, less payments	22,837	(7,563)	(22,759)
Gain on the transfer to the Japanese government of the substitutional portion of employee pension fund, net	–	(73,472)	–
Loss on sale, disposal or impairment of assets, net	27,994	73,939	5,820
Gain on sale or loss on devaluation of securities investments, net	(1,722)	(5,767)	(13,387)
Gain on revaluation of marketable securities held in the financial service business for trading purpose, net	(5,246)	(44,986)	(11,857)
Gain on change in interest in subsidiaries and equity investees	(16,322)	(60,834)	(31,509)
Deferred income taxes	(69,466)	80,115	(13,193)
Equity in net (income) losses of affiliated companies, net of dividends	(15,648)	9,794	(68,179)
Cumulative effect of an accounting change	4,713	–	–
Changes in assets and liabilities:			
(Increase) decrease in notes and accounts receivable, trade	(22,056)	17,464	(357,891)
(Increase) decrease in inventories	34,128	(164,772)	(119,202)
Increase in film costs	(294,272)	(339,697)	(320,079)
Increase (decrease) in notes and accounts payable, trade	31,473	(9,078)	362,079
Increase (decrease) in accrued income and other taxes	3	29,009	(14,396)
Increase in future insurance policy benefits and other	144,143	143,122	172,498
Increase in deferred insurance acquisition costs	(65,051)	(51,520)	(61,563)
(Increase) decrease in marketable securities held in the financial service business for trading purpose	(26,096)	(35,346)	31,732
Increase in other current assets	(29,699)	(8,792)	(35,133)
Increase in other current liabilities	46,545	105,865	73,222
Other	67,790	(49,887)	86,268
Net cash provided by operating activities	¥ 646,997	¥ 399,858	¥ 561,028

(Continued on following page)

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

	Yen in millions		
	2005	2006	2007
Cash flows from investing activities:			
Payments for purchases of fixed assets	¥ (453,445)	¥ (462,473)	¥ (527,515)
Proceeds from sales of fixed assets	34,184	38,168	87,319
Payments for investments and advances by financial service business	(1,309,092)	(1,368,158)	(914,754)
Payments for investments and advances (other than financial service business)	(158,151)	(36,947)	(100,152)
Proceeds from maturities of marketable securities, sales of securities investments and collections of advances by financial service business	923,593	857,376	679,772
Proceeds from maturities of marketable securities, sales of securities investments and collections of advances (other than financial service business)	25,849	24,527	22,828
Proceeds from sales of subsidiaries' and equity investees' stocks	3,162	75,897	43,157
Other	2,728	346	(6,085)
Net cash used in investing activities	(931,172)	(871,264)	(715,430)
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	57,232	246,326	270,780
Payments of long-term debt	(94,862)	(138,773)	(182,374)
Increase (decrease) in short-term borrowings	11,397	(11,045)	6,096
Increase in deposits from customers in the financial service business	294,352	190,320	273,435
Increase (decrease) in call money and bills sold in the banking business	(40,400)	86,100	(100,700)
Dividends paid	(22,978)	(24,810)	(25,052)
Proceeds from issuance of shares under stock-based compensation plans	105	4,681	5,566
Proceeds from issuance of shares by subsidiaries	4,023	6,937	2,217
Other	(3,692)	128	(2,065)
Net cash provided by financing activities	205,177	359,864	247,903
Effect of exchange rate changes on cash and cash equivalents	8,890	35,537	3,300
Net increase (decrease) in cash and cash equivalents	(70,108)	(76,005)	96,801
Cash and cash equivalents at beginning of the fiscal year	849,211	779,103	703,098
Cash and cash equivalents at end of the fiscal year	¥ 779,103	¥ 703,098	¥ 799,899
Supplemental data:			
Cash paid during the fiscal year for—			
Income taxes	¥ 65,477	¥ 70,019	¥ 104,822
Interest	18,187	24,651	23,000
Non-cash investing and financing activities—			
Conversion of convertible bonds	¥ 282,744	¥ —	¥ —
Obtaining assets by entering into capital lease	19,049	19,682	13,784
Contribution of net assets into the joint venture with Bertelsmann AG	9,402	—	—

© 2017 AZEK

 Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

3. Statement of cash flows

3.1 Rationale for the statement of cash flows

The balance sheet and the income statement alone are not sufficient for determining the firm's health. In the short run, liquidity is essential for the survival of the enterprise. The statement fulfilling this need of the analyst is the statement of cash flows. It provides insight into the organization's ability to generate enough cash in the present and future, trends in cash components and helps in crucial decisions like financing, payout and investment.

According to IAS 7, cash includes cash on hand and demand deposits with banks or other financial institutions only. Cash equivalents include short-term highly liquid instruments, if they can be readily converted into known amounts of cash and have a maturity of less than 3 months. In most cases bank borrowings will form part of financing activities. However, in some countries, there is a concept of bank overdraft, wherein the firm has to repay the same on demand and the firm is allowed to fluctuate between a positive and negative balance, then it may be included within cash equivalents.

The most important component in cash flow analysis is the free cash flow or FCF. This is the basic analytical tool used by most analysts in valuation models. This is derived from the statement of cash flows. Hence, this statement has become a mandatory part of financial statements in most countries.

Typical means of financing for projects differ between the USA and Europe. While in the US it is predominantly through the equity route, European firms take frequent recourse to debt financing. It is for such type of financing that the statement of cash flow acquires an added importance. Specifically, this statement helps investors and creditors to analyse the ability of the firm to generate future cash flows, and thus, its ability to meet the payment obligations. Ideally, the cash flow statement should a) give an idea of the financial structure of the firm and its cash obligations, b) provide additional information about changes in assets, liabilities and working capital, which are not captured in the income statement or the balance sheet, c) improve cross sectional analysis across enterprises by eliminating the effect of different accounting policies and d) serve as an indicator of certainty, timing of future cash flows.

In a typical statement of cash flows, there are four sections. They are cash flows from:

1) operating activities;
2) financing activities;
3) investing activities;
4) cash and cash equivalents at the beginning and end of the year.

 © 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

1) Cash flow from operating activities refers to the cash generated by all the transactions, which are neither investing nor financing activities of the firm. It includes all those activities which are central to the firm's business and other extraordinary transactions.

2) Cash flow from financing activities typically deals with all those transactions, which deal with resources, long-term as well as short-term. It also includes payments to the shareholders as well as receipts from them.

3) Cash flow from investing activities deals with the asset side of the balance sheet. It also deals with the disposal of assets. Apart from that, acquisition and disposal of businesses or subsidiaries are also included.

4) Net change in cash or cash equivalents is the balancing figure or the net effect of the above three activities. By looking at these activities we can make meaningful managerial and investment decisions.

It should be noted that the statement of cash flows excludes non-cash transactions. But this will prove to be a major drawback for the analyst. Their non-inclusion may be justified by saying that the statement of cash flows deals only with cash flows. However, to be in line with the basic premise of 'a true and fair view', the standards mandate that non-cash transactions should be disclosed elsewhere in the financial statements. If we look at what constitutes non-cash transactions, we will realize how important they could be. Typical non cash transactions are conversion of debt into equity, conversion of one type of debt or equity into another type or class of equity, acquisition of assets through financial leases, acquisition of assets by issue of stocks or debt notes, interchange of non cash assets and liabilities for each other or one another of the same type, disposal of assets for stocks or debt, etc.

Let us take a look at the following cash flow statement. You may note that there is no mention of non-cash transactions. These have been mentioned only as a part of notes to accounts, which is a part of financial statements in totality.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Consolidated statement of cash flows
(in millions CU)

	N	N-1
Net income	6'659	6'010
Reversal of non-cash items		
Minority interests	27	26
Taxes	1'833	1'882
Depreciation and amortization on		
Tangible fixed assets	1'261	1'161
Intangible assets	248	227
Income from associated companies	-383	-239
Divestments gains	-288	-89
Net financial income	-793	-759
Interest and other financial receipts	1'816	2'114
Interest and other financial payments	-815	-1'366
Taxes paid	-1'690	-1'843
Cash flow before working capital changes	**7'875**	**7'124**
Restructuring payments	-488	-698
Change in net current assets and other operating cash flows	-494	-573
Cash flow from operating activities	**6'893**	**5'853**
Investment in tangible fixed assets	-1'371	-1'577
Proceeds from disposals of tangible fixed assets	286	303
Purchase of intangible and financial assets	-733	-384
Proceeds from disposals of intangible and financial assets	385	91
Acquisition/divestment of subsidiaries	239	235
Acquisition of minorities	-68	-1
Investment in marketable securities	-1'755	-2'503
Cash flow used for investing activities	**-3'017**	**-3'836**
Premium from option rights	-	2
Change in treasury shares	-1'919	722
Change in long-term financial debts	-336	-691
Change in short-term financial debts	-130	-1'583
Dividends paid	-1'935	-1'663
Cash flow used for financing activities	**-4'320**	**-3'213**
Net effect of currency translation on cash and Cash equivalents	74	-31
Net change in cash and cash equivalents	-370	-1'227
Cash and cash equivalents at the beginning of year	**6'651**	**7'878**
Cash and cash equivalents at the end of the year	**6'281**	**6'651**

This statement of cash flows (SCF) follows IAS 7. It includes cash equivalents as a part of cash while excludes the non-cash transactions.

It has to be realized that while it is easy to prepare the SCF by the accountants of the enterprise, it is rather difficult to derive the same for outsiders because it needs information which are not disclosed in the balance sheet and the income statement. However, it is possible to prepare a reasonably proper SCF by looking at the balance sheets at the beginning and end of the accounting period, corresponding statement of comprehensive income (or income statement) and notes to accounts. We will look at the preparation and use of SCF in the following section.

3.2 Relation between income flows and cash flows

In this section we will see the link between the balance sheet, the statement of comprehensive income (or the income statement) and the SCF. Apart from this, we will see the methods used for preparation of SCF, their limitation and the uses of SCF.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

As noted earlier, the CFS emerged as a need, which filled the gaps that arose by the use of the accrual concept for preparation of the balance sheet, the income statement and the statement of comprehensive income. It was clear that the balance sheet and the statement of comprehensive income (or the income statement) are affected by accounting policies. But the biggest gap was seen in their inability to provide adequate information about the solvency and liquidity of the enterprise. The term solvency refers to the ability of the firm to meet its obligations in the long term. Liquidity refers to the ability of the firm to ensure that it has enough cash and cash equivalents to run its day-to-day operations.

The biggest advantage which the cash flow analysis provides, is to adjust for differences in depreciation policies and provisions. This can be seen from the following example:

Example 1:
An equipment was acquired for CU 600'000 at the beginning of year N. Its useful life is 5 years and its residual value after 5 years will be zero. Let us assume that each of the following 5 years will generate cash inflows of CU 800'000, cash outflows (other than taxes) of 300'000 and that the tax rate of the enterprise is 30%.

Net income and net cash flow can be calculated as follows:

Useful life = 5 years	N	N+1	N+2	N+3	N+4	Total
Cash inflows	800'000	800'000	800'000	800'000	800'000	4'000'000
Cash outflows	- 300'000	- 300'000	- 300'000	- 300'000	- 300'000	- 1'500'000
Cash flow before taxes	500'000	500'000	500'000	500'000	500'000	2'500'000
Depreciation	- 120'000	- 120'000	- 120'000	- 120'000	- 120'000	- 600'000
Earnings before taxes	380'000	380'000	380'000	380'000	380'000	1'900'000
Taxes	- 114'000	- 114'000	- 114'000	- 114'000	- 114'000	- 570'000
Net income	266'000	266'000	266'000	266'000	266'000	1'330'000
Net cash flow	386'000	386'000	386'000	386'000	386'000	1'930'000

If the useful life of the asset was 3 years instead of 5, the table would be:

Useful life = 3 years	N	N+1	N+2	N+3	N+4	Total
Cash inflows	800'000	800'000	800'000	800'000	800'000	4'000'000
Cash outflows	- 300'000	- 300'000	- 300'000	- 300'000	- 300'000	- 1'500'000
Cash flow before taxes	500'000	500'000	500'000	500'000	500'000	2'500'000
Depreciation	- 200'000	- 200'000	- 200'000	0	0	- 600'000
Earnings before taxes	300'000	300'000	300'000	500'000	500'000	1'900'000
Taxes	- 90'000	- 90'000	- 90'000	- 150'000	- 150'000	- 570'000
Net income	210'000	210'000	210'000	350'000	350'000	1'330'000
Net cash flow	410'000	410'000	410'000	350'000	350'000	1'930'000

The above tables show clearly that:

- cash flow before taxes is not affected by the choice of the depreciation policy,
- the change in after-tax cash flow is due solely to the difference in the tax expense.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

	N	N+1	N+2	N+3	N+4	Total
Tax expense:						
– with u.l. = 5 years	114'000	114'000	114'000	114'000	114'000	570'000
– with u.l. = 3 years	90'000	90'000	90'000	150'000	150'000	570'000
Tax saving (increase)	24'000	24'000	24'000	(36'000)	(36'000)	0
Net cash flow:						
– with u.l. = 5 years	386'000	386'000	386'000	386'000	386'000	1'930'000
– with u.l. = 3 years	410'000	410'000	410'000	350'000	350'000	1'930'000
Difference	24'000	24'000	24'000	- 36'000	- 36'000	0

The SCF is a statement derived from two successive balance sheets and the statement of comprehensive income (or the income statement) between these dates. We will see in the following paragraphs how to prepare a cash flow statement.

Using the transactional analysis[4] as the basis for our understanding, we can reconcile the line item changes in the balance sheet with their related income statement components to derive the cash flow consequences of the reported transactions and events. These changes are grouped according to whether they are operating, investing or financing in nature. The classification and cash flow description is given below:

Changes included in Cash Flow from Operating Activities (CFO)

Balance Sheet Account	*Cash Flow Description*
Accounts receivable	*Cash received from customers*
Inventories	*Cash paid for inputs*
Prepaid expenses	*Cash expenses*
Accounts payable	*Cash paid for inputs*
Advances from customers	*Cash received from customers*
Rent payable	*Cash expenses*
Interest payable	*Interest paid*
Income tax payable	*Income taxes paid*
Deferred income taxes	*Income taxes paid*

Changes included in Cash Flow from Investing Activities (CFI)

Balance Sheet account	*Cash Flow Description*
Property, plant and equipment	*Capital expenditure*
	Proceeds from property sales
Investment in affiliates	*Cash paid for acquisitions and investments*

4 Adapted from White, Sondhi and Fried. "The Analysis and Use of Financial Statements", John Wiley, 1998, pp. 91-92.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Changes included in Cash Flow from Financing Activities (CFF)

Balance Sheet Account	*Cash Flow Description*
Notes payable	*Increase or decrease in debt*
Short-term debt	*Increase or decrease in debt*
Long-term debt	*Increase or decrease in debt*
Bonds payable	*Increase or decrease in debt*
Common stock	*Equity financing or repurchase*
Retained earnings	*Dividends paid*

In short, increases (decreases) in assets represent net cash outflows (inflows). Increase (decrease) in liabilities represents net cash inflows (outflows).

There are two methods of presenting cash flow from operating activities, namely the direct and indirect methods. The direct method consists in disclosing directly major classes of gross cash receipts and gross cash payments. With the indirect method, these flows are obtained by adjusting net income (or total comprehensive income) for the effects of non-cash transactions. It must be remembered that due to variations in dealing with some items like interests, dividends, etc. the analyst must be careful. An important advantage of the direct method is that it allows the user to understand better the relation between the company's net income and cash flow. A summary of the conversion is given below.[5]

Accrual Basis	Additions	Deductions	Cash Basis
Net Sales	Beginning accounts receivable	Ending accounts receivable	= Cash received from customers
Cost of goods sold	Ending inventory and beginning accounts payable	Beginning inventory and ending accounts payable	= Cash paid to the suppliers

It is obvious that the amounts to be included in the operating section of the SCF are the derived amounts and not the direct balances.

In the indirect method, we need to compute cash from operations by adding and subtracting various items from net income or total comprehensive income. This is the most preferred method as it is easy to prepare and understand. This method emphasizes the changes in the components of current assets and current liabilities.

The IASB encourages enterprises to report cash flows from operating activities using the direct method, but in practice most companies use the indirect method.

5 Adopted from Epstein and Mirza. "Interpretation and Application of International Accounting Standards 2000", Wiley, 2000, p. 99.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Presentation of the statement of cash flows

The direct method

Cash flows from operating activities	
Cash received from customers	(+)
Cash paid to suppliers and employees	(-)
Other operating inflows	(+)
Other operating outflows	(-)
Interests and dividends paid*	(-)
Income taxes paid	(-)
Net cash from operating activities	I
Cash flows from investing activities	
Purchase of fixed assets	(-)
Proceeds from sales of fixed assets	(+)
Acquisition of subsidiaries and affiliates	(-)
Disposal of subsidiaries and affiliates	(+)
Interests and dividends received	(+)
Net cash from investing activities	II
Cash flows from financing activities	
Issuance of share capital	(+)
Capital repayments	(-)
Issuance of bonds	(+)
Bonds repayments	(-)
Payment of finance lease liabilities	(-)
Interests and dividends paid*	(-)
Net cash from financing activities	III
Net cash flow	*IV = I + II + III*
Cash balance at beginning of period	*V*
Cash balance at end of period	*VI = V + IV*

*This item may be classified either in cash flow from operating activities or in cash flow from financing activities.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007

www.masomomsingi.com

The indirect method

Cash flows from operating activities		
Net profit before taxes	(+)	
Depreciation and provision increases	(+)	Adjustments for non-cash revenues and expenses
Reversal of provisions	(-)	
Gains or losses on sales of assets	(-) or (+)	Adjustments for non-operating cash flows
Interests paid*	(+)	
Interests and dividends received	(-)	
Changes in inventories	(+) or (-)	Adjustments for changes in working capital
Changes in accounts receivable	(+) or (-)	
Change in accounts payable	(+) or (-)	
Income taxes paid	(-)	
Cash from operating activities	I	
Cash flows from investing activities		
Purchase of fixed assets	(-)	
Proceeds from sales of fixed assets	(+)	
Acquisition of subsidiaries and affiliates	(-)	
Disposal of subsidiaries and affiliates	(+)	
Interests and dividends received	(+)	
Net cash from investing activities	II	
Cash flows from financing activities		
Issuance of share capital	(+)	
Capital repayments	(-)	
Issuance of bonds	(+)	
Bonds repayments	(-)	
Payment of finance lease liabilities	(-)	
Interests and dividends paid*	(-)	
Net cash from financing activities	III	
Net cash flow	*IV = I + II + III*	
Cash balance at beginning of period	*V*	
Cash balance at enrd of period	*VI = V + IV*	

*This item may be classified either in cash flow from operating activities or in cash flow from financing activities.

Let us see how to prepare the statement of cash flows from the given balance sheets and income statement using both the direct and indirect methods.

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Example 2:
Given below are the financial statements of ABC Co. for years 1 and 2. Prepare a statement of cash flows using both the direct and indirect method.

Balance sheets as at the end of years 1 and 2 (all figures in millions of CU)

	Year 1	Year 2
Assets		
Cash	150	200
Accounts receivable	0	200
Inventory	50	35
Current assets	**200**	**435**
Investment in affiliates	15	35
Buildings	300	350
Accumulated depreciation	-100	-125
Fixed assets	**215**	**260**
Total assets	**415**	**695**
Liabilities		
Short-term borrowings	65	120
Accounts payable	75	150
Accrued liabilities	75	50
Interest payable	0	25
Taxes payable	0	25
Dividend payable	0	50
Current liabilities	**215**	**420**
Bonds payable	100	125
Total liabilities	**315**	**545**
Common stock	50	75
Additional paid-in capital	50	50
Retained earnings	0	25
Stockholders' equity	**100**	**150**
Total liabilities and equity	**415**	**695**

Statement of comprehensive income for year 2 (all figures in million of CU)

Net sales	1'000	
Cost of goods sold	-600	
Gross margin		**400**
Operating expenses	-75	
Depreciation expense	-25	
Rent expense	-50	
Interest expense	-125	
Profit before taxes		**125**
Tax expense	-25	
Profit for the year		**100**
Other comprehensive income		**-**
Total comprehensive income		**100**

Change in retained earnings

Beginning balance	0	
Profit for the year	100	
Dividend declared	-75	
Ending balance		**25**

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Cash flow statement for year 2 (all figures in millions CU)

Direct method:

Cash flows from operating activities		
Cash received from customers	800	
Cash paid to suppliers	-510	
Other operating outflows	-150	
Interests paid	-100	
Income taxes paid	0	
Net cash from operating activities		40
Cash flows from investing activities		
Purchase of buildings	-50	
Investment in affiliates	-20	
Net cash used in investing activities		-70
Cash flows from financing activities		
Issuance of common stock	25	
Issuance of bonds	25	
Short-term borrowings	55	
Dividends paid	-25	
Net cash from financing activities		80
Net cash flow		**50**
Cash balance at beginning of year 2		**150**
Cash balance at end of year 2		**200**

Indirect method :

Cash flow from operating activities		
Profit before taxes	125	
Depreciation expense	25	
Change in inventories	15	
Change in accounts receivable	-200	
Change in accounts payable	75	
Change in accrued liabilities	-25	
Change in interests payable	25	
Change in taxes payable	25	
Tax expense	-25	
Net cash from operating activities		40
Cash flows from investing activities		
Purchase of buildings	-50	
Investment in affiliates	-20	
Net cash used in investing activities		-70
Cash flows from financing activities		
Issuance of common stock	25	
Issuance of bonds	25	
Short-term borrowings	55	
Dividends paid	-25	
Net cash from financing activities		80
Net cash flow		**50**
Cash balance at beginning of year 2		**150**
Cash balance at end of year 2		**200**

© 2017 AZEK

Solomon Ngahu - Reg No. 49000007
www.masomomsingi.com

Working notes:
Cash received from customers = net sales – increase in accounts receivable = 1'000 – 200 = 800
Cash paid to suppliers = cost of goods sold – decrease in inventories – increase in accounts payable = 600 – 15 – 75 = 510
Other operating outflows = rent expense + operating expenses + decrease in accrued liabilities = 50 + 75 + 25 = 150
Interests paid = interest expense – increase in interest payable = 125 –25 = 100
Income taxes paid = tax expense – increase in taxes payable = 25 –25 = 0
Dividends paid = dividends declared – increase in dividends payable = 75 – 50 = 25

In the case of acquisitions and divestments, the SCF should report the impact of acquisitions separately. Hence, the balance sheet, the statement of comprehensive income and the SCF need to be reconciled by the analyst. This will help the analyst to explain the distortion in trends of cash flows.

We have seen that the statement of cash flows bridges an important gap in the analysis of the performance of companies. In most countries, the statement of cash flows is an integral part of the financial statements available to stockholders. Analysts appreciate the use of this tool because of its ability to take care of most problems arising from accounting policy changes. They also realize that cash flow is as important as profitability, if not more, for an organization.

© 2017 AZEK