International Finance Corporation
World Bank Group

IFRS Financial Reporting Reference Manual

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CHAPTER 1

Introduction to International Financial Reporting Standards

Today's financial landscape—with its dynamic markets, evolving market conditions, and fierce competition among corporations—is filled with challenges for the risk-averse investor. Perhaps the greatest challenge is to assess an organization's current and expected economic performance. An essential part of this task is to scrutinize financial statements for compliance with regulatory accounting standards. The complexities of this endeavor and of the financial landscape point to a strong need for International Financial Reporting Standards (IFRS). This manual provides the International Finance Corporation's (IFC's) managers, investment officers, portfolio officers, and clients with an overview of the general principles widely applied in financial reporting. The manual's objectives are threefold:

1. Outline best practices as reflected in IFRS concepts.
2. Explain how to prepare, collect, and analyze financial statements in accordance with IFRS.
3. Review IFC's general policies on financial reporting submitted by the client's auditor.

International Financial Reporting Standards

IFRS have become the backbone of financial reporting, capturing best practices throughout the world. These standards have been adopted universally by transnational corporations; are enforced unilaterally by the European Union stock exchange; and are used by most capital providers that expect financial information to be presented in a comprehensive, transparent, and easily understood reporting framework. Previously known as the International Accounting Standards (IAS), IFRS rapidly are becoming a lens through which providers of debt and equity capital examine their investment choices (see table 1.1).

International Accounting Standards Board

IFRS are established by the International Accounting Standards Board (IASB). The board's mission is to develop a single set of high quality global standards. The board is composed of 12 full-time and 2 part-time independent international accounting standards-setters. Figure 1.1 shows the board's structure and function.

Table 1.1 Benefits of IFRS

Valuation	Transparency	Comparability
IFC and many lenders find that IFRS improve the key metrics that analysts use to measure and evaluate clients' performance and price shares. Under IFRS, all equity and quasi-equity instruments are fair valued.	The extensive requirements under IFRS lead to greater transparency—a new feature for many organizations, especially in emerging markets. Transparency will give small companies in underdeveloped and developing nations a better chance of raising capital.	With widespread use, the common standards of IFRS will enable capital providers throughout the world to analyze and compare companies, making the process of raising capital less expensive and more competitive.

Entities complying with IFRS

IFRS have a wide following, ranging from global-market participants and IFC clients to agencies involved in regulatory exchanges, such as the European Union (see table 1.2). As a result, IFC's board of directors approved the use of IFRS in preparing the organization's financial statements starting in fiscal 2008. IFC strongly urges all its client companies to comply with IFRS. Clients reporting under IFRS also may be asked to comply with some specific reporting requirements in investment agreements.

Sector coverage

IFC finances projects in many sectors, including general manufacturing, extraction industries, commercial banking, leasing and housing finance, agriculture, and in many subsectors. The client companies in which IFC invests range from large manufacturing corporations to small and medium-sized businesses. This manual covers IFC's general financial reporting

Figure 1.1 Composition of the IASB

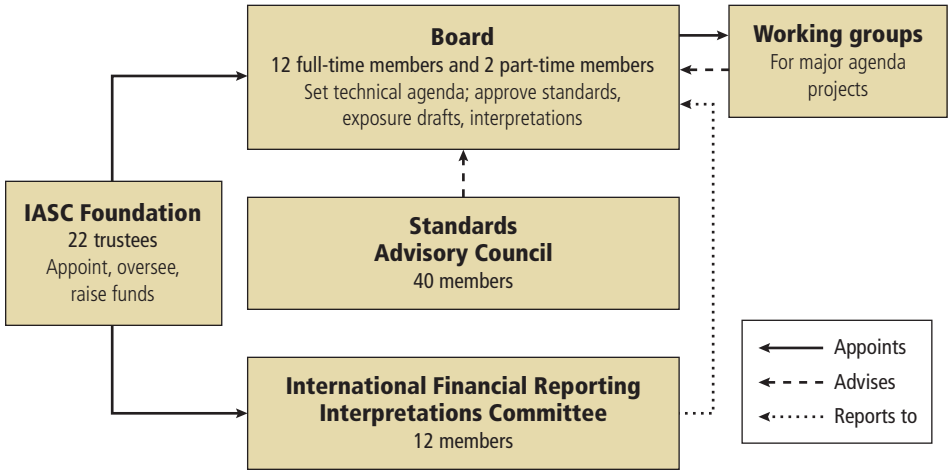


Table 1.2 IFRS Use Around the World

Location	IFRS not permitted	IFRS permitted	Required for some domestic listed companies	Required for all domestic listed companies
Albania	No stock exchange; companies use Albanian GAAP			
Argentina	■			
Armenia				■
Aruba		■		
Australia				■[b]
Austria				■[a]
Bahamas, The				■
Bahrain			Banks	
Bangladesh				■
Barbados				■
Belgium				■[a]
Belize	No stock exchange; companies may use IFRS			
Benin	■			
Bermuda		■		
Bolivia		■		
Botswana		■		
Brazil	■			
Brunei Darussalam		■		
Bulgaria				■
Burkina Faso				
Cambodia	No stock exchange; companies may use IFRS			
Canada	■			

Table 1.2 IFRS Use Around the World *(Continued)*

Location	IFRS not permitted	IFRS permitted	Required for some domestic listed companies	Required for all domestic listed companies
Cayman Islands		■		
Chile	■			
China			■	
Colombia	■			
Costa Rica				■
Côte d'Ivoire	■			
Croatia				■
Cyprus				■[a]
Czech Republic				■[a]
Denmark				■[a]
Dominica		■		
Dominican Republic				■
Ecuador				■
Egypt, Arab Rep.				■
El Salvador		■		
Estonia				■[a]
Fiji	■			
Finland				■[a]
France				■[a]
Georgia				■
Germany				■[a]
Ghana	■			

Table 1.2 IFRS Use Around the World *(Continued)*

Location	IFRS not permitted	IFRS permitted	Required for some domestic listed companies	Required for all domestic listed companies
Gibraltar		■		
Greece				■[a]
Guam	No stock exchange; companies use U.S. GAAP			
Guatemala				■
Guyana				■
Haiti				■
Honduras				■
Hong Kong, China				■[c]
Hungary				■[a]
Iceland				■[a]
India	■			
Indonesia	■			
Ireland				■[a]
Israel	■			
Italy				■[a]
Jamaica				■
Japan	■			
Jordan				■
Kazakhstan			Banks	
Kenya				■
Korea, Rep. of	■			
Kuwait				■

Table 1.2 IFRS Use Around the World *(Continued)*

Location	IFRS not permitted	IFRS permitted	Required for some domestic listed companies	Required for all domestic listed companies
Kyrgyz Republic				■
Lao PDR		■		
Latvia				■[a]
Lebanon				■
Lesotho		■		
Liechtenstein				■[a]
Lithuania				■[a]
Luxembourg				■[a]
Macedonia, FYR				■
Malawi				■
Malaysia	■			
Mali	■			
Malta				■[a]
Mauritius				■
Mexico	■			
Moldova	■			
Myanmar		■		
Namibia		■		
Netherlands				■[a]
Netherlands Antilles		■		
Nepal				■
New Zealand				2007[b]
Niger	■			

Table 1.2 IFRS Use Around the World *(Continued)*

Location	IFRS not permitted	IFRS permitted	Required for some domestic listed companies	Required for all domestic listed companies
Norway				■[a]
Oman				■
Pakistan	■			
Panama				■
Papua New Guinea				■
Peru				■
Philippines				■[c]
Poland				■[a]
Portugal				■[a]
Romania			All large companies	
Russian Federation			■	Proposed phase-in starting 2006
Saudi Arabia	■			
Singapore				■[c]
Slovenia				■[a]
Slovak Republic				■[a]
South Africa				■
Spain				■
Sri Lanka		■		
Swaziland		■		
Sweden				■[a]
Switzerland		■		
Syria	■			

Table 1.2 IFRS Use Around the World *(Continued)*

Location	IFRS not permitted	IFRS permitted	Required for some domestic listed companies	Required for all domestic listed companies
Taiwan, China	■			
Tajikistan				■
Tanzania				■
Thailand	■			
Togo	■			
Trinidad and Tobago				■
Tunisia	■			
Turkey		■		
Uganda		■		
Ukraine				■
United Arab Emirates			Banks and some others	
United Kingdom				■[a]
United States	■			
Uruguay	■[d]			
Uzbekistan	■			
Venezuela				■
Vietnam	■			
Yugoslavia, Fed. Rep. (Serbia/ Montenegro)				■
Zambia		■		
Zimbabwe		■		

a. Audit report refers to IFRS as adopted by the European Union.
b. Compliance with IFRS is stated in a note.
c. IFRS adopted virtually in full as national GAAP.
d. By law, all companies must follow IFRS existing on May 19, 2004. The auditor's report refers to conformity with Uruguayan generally accepted accounting principles (GAAP).

requirements for all sectors. For projects that may have substantially different reporting requirements, such as unincorporated joint ventures, leasing or extraction industries, IFC may provide the companies and their auditors with additional materials to address their specific reporting needs.

Accounting and Financial Reporting Covenants in Investment Agreements

IFC staff should make sure that financial reporting requirements (financial statements, ratios, and applicable standards) are incorporated in contract and investment agreements. Investment staff (officers and analysts), IFC client companies, and their auditors are urged to abide by the covenants in the signed investment agreements. If the covenants differ from those in this manual, the covenants in the agreements should take precedence. Detailed examples of accounting and financial reporting covenants are provided in chapter 5.

Key challenges

Although IFRS facilitate comparability between companies, the resulting performance figures likely will differ from those reported under local GAAP. Such differences may affect the outcomes of the metrics commonly used to evaluate business performance, such as earnings per share, operating income, and earnings before interest taxes depreciation and amortization, which may include larger noncash items compared with other standards.

IFC's existing accounting and financial reporting covenants in investment agreements may have to be reviewed and adjusted for client companies adopting IFRS for the first time. IFC's investment staff is encouraged to impose or suggest the use of IFRS in new or restructured contractual agreements. Conversion to IFRS also represents a cultural change for companies whose national accounting standards may have evolved out of legal or tax rules and are thus less comprehensive than IFRS or U.S. GAAP, which are geared to the needs of capital markets.

Issues in Financial Reporting

Financial reporting is governed by many factors. Among the more notable are the political environment, the expectations gap, the extent of international standards, and ethical considerations.

Political environment

Accounting standards are influenced by the political action of user groups, for example:

- Government agencies, such as the Securities and Exchange Commission and Internal Revenue Service
- The financial community (analysts and bankers)
- Chartered public accountants and accounting firms
- Academicians.

Expectations gap

Standards also are affected by what the public thinks accountants should do and what accountants think they can do, especially in the critical area of fraud.

International accounting standards

Global standards are needed to harmonize the financial reporting process.

Ethics

One of the most difficult challenges is to do the right thing and make the right decision while trying to "maximize the bottom line, withstand competition, and focus on short-term results."

Client Year-End Financial Reporting

IFC requires all client companies to supply financial statements and auditors' reports at the end of each year, unless otherwise stated in the investment agreement between the partner (the client company) and IFC. The documents to be provided by the client company are annual financial statements prepared in accordance with IFRS; notes and schedules, in accordance with IFRS disclosure policies; and supplementary information and any other disclosures required by IFC pertinent to the interim and annual financial statements. The chief financial officer must certify the financial statements. The documents to be prepared by the client company's auditor are the auditor's long-form report; the summary of principal auditing procedures, if reporting to the IFC for the first time; the management letter; and the auditor's certificate indicating that the company has complied with all contractual covenants.

Purpose of financial statements

Annual financial statements are a structured representation of an entity's financial position and financial performance. The information they provide on the financial position, financial performance, and cash flows is essential in making economic and investment decisions. Lenders and stakeholders often rely on these documents as primary sources of information when evaluating an entity.

Reporting entity and responsibility for financial statements

An entity's board of directors, governing bodies, or both are responsible for preparing and presenting its financial statements. The statements are an expression of the client company's management. Management should disclose all information pertinent to a fair presentation of the company's financial and operating results in conformity with generally accepted accounting principles. IFC requires these statements to abide by IFRS.

Components of IFRS financial statements include:

- Cash flow statement
- Income statement
- Balance sheet
- Statement of changes in shareholders' equity
- Accounting policies and notes to the financial statements.

IFC encourages its clients to supplement financial statements with a financial review by management. This review should present the main details of the entity's financial performance and financial position and should explain the principal uncertainties the organization faces. Any such reports or reviews accompanying the financial statements are outside of IFRS scope.

Identifying financial statements

Financial statements should be identified clearly as such and should be distinguished from other information in the document. Each component of the financial statement should be labeled clearly. IFRS apply only to financial statements and their notes, not to other information in an annual report or other document. Users must be able to distinguish information prepared using IFRS from other information that may be helpful but is not subject to those requirements.

The following information must be displayed prominently and repeated when necessary, to ensure that the contents of a financial statement are understood:

- Name of the reporting entity, or other means of identification, and any change in that information from the date of the preceding balance sheet
- Nature of the entity, whether an individual business or a group of businesses
- Date of the balance sheet or the period covered by the financial statements, whichever is appropriate to that component of the financial statements
- Relevant currency
- Level of rounding applied to amounts in the financial statements.

These details usually are presented as page headings and abbreviated column headings on each page of the financial statement. The entity must decide the best way to present such information. When financial statements are presented electronically, for example, separate pages are not always used. In that case, the details must appear frequently enough to ensure that the information in the financial statements is clear.

It may be helpful to present amounts in thousands or millions of units of the relevant currency. This is acceptable as long as the level of rounding is specified, material information is not omitted, and the rounding does not misrepresent the facts.

Consolidated financial statements

For a variety of legal, tax, and other reasons, companies generally conduct their activities through several subsidiaries controlled by the parent company, rather than through a single

legal entity. However, separate financial statements for those activities would not present a full picture of the parent company's economic activities or financial position.

Consolidated financial statements integrate a parent company's financial statements with those of its subsidiaries, both domestic and foreign, as long as the parent has more than 50 percent voting rights. IAS 27 establishes the requirements for the presentation of consolidated financial statements. Consolidated financial statements include not only subsidiaries but also all joint ventures in which the parent has joint control (IAS 31), and all associate ventures in which the parent exercises significant influence (IAS 28).

Comparative financial statements

Comparative information on the balance sheet, income statement, cash flow statement, statement of changes in shareholders' equity, and notes to the financial statements should be disclosed, unless the standards require or permit otherwise. Comparative information should include, in addition to quantitative data, narrative and descriptive information relevant to the current period's financial statements.

In hyperinflationary economies, such as Turkey, financial data from a prior period may have to be adjusted to equivalent current-year amounts, in accordance with IAS 29 (Accounting for Hyperinflation) before they are included in comparative statements. Greenfield projects and newly formed companies issuing their first set of financial statements are not required to provide comparative financial statements.

Annual Financial Reporting

A company's management is expected to prepare financial statements annually, as of the last day of the financial year. Financial reports of a parent company must be consolidated statements. Whether separate or consolidated, all financial statements must give a fair presentation of the entity's financial position, results of operations, and cash flows. In other words, they must represent faithfully the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income, and expenses set out in the IFRS framework. If a company adopts IFRS and provides additional disclosure when necessary, its financial statements should achieve a fair presentation.

Adoption of IFRS

An entity preparing its first IFRS financial statements will apply IFRS 1, which pertains to the first-time adoption of financial reporting standards. The main principle of IFRS 1 is retrospective application of all IFRS and IAS standards.

Opening balance sheet

The entity must prepare an opening IFRS balance sheet at the beginning of the earliest period covered by its first IFRS financial statements. For example, if the closing balance sheet date is December 31, 2005, the opening IFRS balance sheet will be January 1, 2004. The opening IFRS balance sheet serves as the starting point for subsequent accounting under

IFRS. The opening IFRS balance sheet need not be published in the first IFRS financial statements. To satisfy IAS 1, an entity's first IFRS financial statements must include at least one year of comparatives under IFRS.

If the first IFRS financial statements contain more than one year of comparative figures, that information should comply with IFRS. A company's IFRS opening balance sheet should restate the recognition and measurement of every asset and liability to comply fully with the IFRS requirements at the closing balance sheet date.

Unless specific exemptions apply, an entity should report all assets and liabilities that IFRS require to be recognized, and not report items that IFRS do not recognize as assets and liabilities. The entity must reclassify items into the correct IFRS category and apply IFRS in measuring its assets and liabilities.

The adjustments as a result of applying IFRS 1 are recorded in retained earnings of the opening balance sheet. The opening balance sheet need not be a published statement but should reconcile to equity of the previous GAAP.

Optional exemptions from retrospective application of IFRS

IFRS 1 grants limited exemption in specified areas in which the cost of retrospective application likely would exceed the benefits of financial statements. An entity may elect to use one or more of the following exemptions:

- Business combinations
- Fair value or revaluation as deemed cost
- Employee benefits
- Cumulative translation differences
- Compound financial instruments
- Assets and liabilities of subsidiaries, associates, and joint ventures.

Mandatory exceptions to retrospective application

IFRS 1 prohibits retrospective application of some aspects of other IFRS relating to derecognition of financial assets and liabilities, hedge accounting, and estimates.

Disclosure Requirements

IFRS 1 requires disclosures to explain the effect of the transition to IFRS. The first IFRS financial statements should:

1. Reconcile equity from local GAAP to IFRS at the date of transition (opening balance sheet date) and at the end of the last period presented in the entity's most recent financial statements under local GAAP
2. Reconcile net income from local GAAP to IFRS for the last period in the entity's most recent financial statements under local GAAP
3. Ensure that reconciliations give sufficient detail to enable users to understand material adjustments to the balance sheet and income statement.

Some financial statements contain historical summaries of data selected from periods before the first period for which they provide full comparative information. IFRS require disclosures of the principal adjustments needed to recognize that historical summaries are included in financial statements. Historical summaries published outside of annual financial statements or interim reports fall outside the scope of IFRS.

Interim Financial Reports

IFRS 1 requirements also apply to each interim financial report, if any, that an entity includes under IAS 34 in the annual report covered by its first IFRS financial statements. In addition to meeting the reconciliation requirements of its first IFRS annual financial statements (see disclosure requirements outlined in Box 1.1), an entity must reconcile its equity under previous GAAP at the end of a comparable interim period, to its equity under IFRS for that period. In addition, the entity must reconcile its profit or loss under previous GAAP for a comparable interim period (current and year-to-date), to its profit or loss under IFRS for that period.

Although IFRS do not call for interim financial information, many regulators require interim financial reports. Because IFC believes that financial information is more useful if it is frequent and timely, IFC financial reporting covenants also require interim reports from its clients. These reports are expected to provide either a complete set of financial statements (as described in IAS 1) or a set of condensed financial statements (as described in IAS 34) for the specified interim period. Entities that prepare interim financial statements in accordance with IFRS must submit a statement of compliance, as indicated by IAS 34. It is comparable to the statement of compliance for annual financial statements required by IAS 1. Table 1.3 shows the minimum information needed in a condensed interim financial report.

Condensed statements should include each of the headings and subtotals from the latest annual financial statement, with the comparatives. IFC may call for additional information in clients' interim reporting statements.

Disclosures

The minimum information required in a disclosure appears in Box 1.1. An entity also should disclose any events or transactions that are material to understanding of the current interim period.

Table 1.3 Components of an Interim Financial Report

Condensed balance sheet	Condensed income statement	Condensed statement of changes in shareholders' equity	Condensed cash flow statement
Shows comparative information as of the end of the previous full financial year	Shows comparatives for the comparable interim periods	Shows comparatives for the comparable interim periods	Shows comparatives for the comparable interim periods

Box 1.1 Minimum Disclosure Information

- State whether the accounting policies and methods of computation in the interim financial statements are the same as those used in the most recent annual financial statements; or, if those policies or methods have changed, describe the nature and effect of the change.
- Explain the seasonality or cyclic structure of interim operations.
- Describe the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence.
- Specify the nature and amount of changes in the estimates of amounts reported in prior interim periods of the current financial year, or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period.
- Note issuance, repurchases, and repayments of debt and equity securities.
- Report separately dividends paid (on an aggregate or per share basis) for ordinary shares and other shares.
- Indicate revenue and result for each business or geographical segment, whichever is the enterprise's primary basis of segment reporting (disclosure of segment data is required in an enterprise's interim financial report only if IAS 14, Segment Reporting, requires an enterprise to disclose segment data in its annual financial statements).
- Include material events occurring after the end of the interim period that have not been reflected in the financial statements.
- Note the effect of changes in the composition of the enterprise during the interim period, such as business combinations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and operations being discontinued.
- Report changes in contingent liabilities or contingent assets since the last annual balance sheet date.
- Present basic and diluted earnings per share on the face of the income statement for an interim period (including comparative period).

Measurement

An entity should apply the same accounting policies in its interim financial statements as it applies in annual financial statements. If a new accounting policy is adopted in an interim period, that policy is to be applied as required either by the transitional provisions in the relevant IFRS or in accordance with IAS 8.

Summary of Current IAS/IFRS

Table 1.4 summarizes current IAS/IFRS standards and their amendments as of August 2006. Readers should refer to these standards for further details on financial reporting and disclosure requirements as published by the IASB. The IASB is working aggressively on developing new pronouncements. Any updates will be available through the IFC Controller's Department. Details of all the IFRS pronouncements listed in table 1.4 are available on Corporate Portfolio Management and Controller's Department websites.

Table 1.4 IAS/IFRS Standards and Amendments as of August 2006

Standard	Description
IFRS 1	First-time adoption of International Financial Reporting Standards
IFRS 2	Share-based payment
IFRS 3	Business combinations

Table 1.4 IAS/IFRS Standards and Amendments as of August 2006 *(Continued)*

Standard	Description
IFRS 4	Insurance contracts
IFRS 5	Noncurrent assets held for sale and discontinued operations
IFRS 6	Exploration for and evaluation of mineral assets
IFRS 7	Financial instruments: disclosures, effective on or after 1/1/2007
IAS 1	Presentation of financial statements
IAS 2	Inventories
IAS 3	Consolidated financial statements, superseded in 1989 by IAS 27 and IAS 28
IAS 4	Depreciation accounting, replaced by IAS 16, 22, and 38
IAS 5	Information to be disclosed in financial statements, superseded by IAS 1 in 1997
IAS 6	Accounting responses to changing prices, superseded by IAS 15, which was withdrawn in December 2003
IAS 7	Cashflow statements
IAS 8	Accounting policies, changes in accounting estimates, and errors
IAS 9	Accounting for research and development activities, superseded by IAS 38 effective January 1999
IAS 10	Events after the balance sheet date
IAS 11	Construction contracts
IAS 12	Income taxes
IAS 13	Presentation of current assets and current liabilities, superseded by IAS 1
IAS 14	Segment reporting
IAS 15	Information reflecting the effects of changing prices, withdrawn December 2003
IAS 16	Property, plant, and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee benefits

Table 1.4 IAS/IFRS Standards and Amendments as of August 2006 *(Continued)*

Standard	Description
IAS 20	Accounting for government grants and disclosure of government assistance
IAS 21	Effects of changes in foreign exchange rates
IAS 22	Business combinations, effective March 31, 2004, superseded by IFRS 3
IAS 23	Borrowing costs
IAS 24	Related party disclosures
IAS 25	Accounting for investments, superseded by IAS 39 and IAS 40 effective 2001
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 30	Disclosures in the financial statements of banks and similar financial institutions, superseded by IFRS 7 effective 2007
IAS 31	Interests in joint ventures
IAS 32	Financial instruments: disclosure and presentation, disclosure provisions superseded by IFRS 7 effective 2007
IAS 33	Earnings per share
IAS 34	Interim financial reporting
IAS 35	Operations being discontinued, superseded by IFRS 5 effective 2005
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
IAS 41	Agriculture

CHAPTER 2

Analysis of International Financial Reporting Standards

Audited financial statements provide crucial information that market participants, such as investors, creditors, and managers, use to analyze an enterprise's historical performance, evaluate its liquidity, and help project free cash flow for decision-making purposes.

Of all the documents an enterprise distributes to market participants, the most important is the annual report. This report has two main components. The verbal section contains a letter from the company's chairman, the past year's operating results, and a description of developments that will have an impact on the operation. Financial statements provide quantitative information on financial position (balance sheet), income (profit and loss), changes in equity (retained earnings), and cash flow. Financial statements show what actually happened to a company's assets, earnings, liabilities, and dividends over the past years; the verbal section explains why the numbers are at those levels.

An investigator, such as an analyst, examining an annual report with a critical eye must understand the significance of financial data. These data form the bedrock of financial ratios, firm valuation, and trend analysis.

To critically analyze an annual report

- Begin with the audit opinion.
- Read the footnotes.
- Scrutinize the financial statements and notes reflecting the details of the aggregate numbers.

The following International Financial Reporting Standards (IFRS) by the International Accounting Standards Board (IASB) are useful for analyzing annual reports.

Accounting Policies (IAS 8)

Accounting policies are the principles, foundations, conventions, rules, and practices that companies use to prepare and present their financial statements. A business operation's day-to-day transactions must be captured quantitatively in the financial statements. Each transaction has unique attributes that require special attention in the statements.

Accounting policies are guided by standards such as International Financial Reporting Standards (IFRS) or U.S. Generally Accepted Accounting Principles (U.S. GAAP). However, when business transactions are not covered or clear to the application of the standards, management must use sound judgment to develop and apply policies that ensure accounting information is both relevant and reliable.

KEY QUESTIONS

- Have I examined the "summary of significant accounting policies" located in the footnotes of the annual report?
- What method is used to depreciate property, plant, and equipment (PP&E)?
- What method is used for costing inventories?
- What is management's strategy for dealing with risk?

Analyst's Role

The analyst should:

- Examine the disclosures in the annual report; they provide important information about the company's accounting policies.
- Pay close attention to accounting policies that are based on management's judgment; there is a potential for discreet manipulation of earnings.
- Investigate the reasons for any inconsistency in accounting methods from one period to another. Note, for example, that the inventory cost-flow method of "last in, first out" (LIFO) produces different net income from the "first in, first out" (FIFO) method. During inflationary periods, LIFO produces lower net income than FIFO.
- Recognize that accounting estimates can change, and that such changes are permitted. Determine whether the change is relevant and reliable. For example, a change in the useful lives of PP&E affects the depreciation expense, which will ultimately affect net income. The settlement of litigation may increase or decrease liability.
- Be cognizant of nonrecurring events and transactions. Such events (for example, unusual government expropriation of a company's foreign business segment owing to political unrest) might not occur in the future and, therefore, should not be included in the analysis.

Financial instruments

The relevant standards for financial instruments are:

- IFRS 7 Financial Instruments: Disclosures (effective January 1, 2007)
- IAS 32 Financial Instruments: Disclosure and Presentation
- IAS 39 Financial Instruments: Recognition and Measurement.

What are financial instruments?

A contract is a financial instrument that results in a financial asset in one company and a financial liability in another company. Examples of financial instruments include cash; leases; derivatives (that is, options, swaps, and warrants); equity securities (that is, common stocks and preference shares); and debt securities (that is, purchasing of bonds of another company).

Table 2.1 shows how some financial instruments are recorded.

Classification of financial assets

Financial assets can be classified according to management's purpose in acquiring them:

- Financial assets at fair value through profit or loss (trading). Assets acquired principally for the purpose of generating short-term profits (within less than a year) by taking advantage of changes in price, as in the purchase of common stocks.
- Loans and receivables. Nonderivative financial assets arising through a transfer between a borrower and a lender and having fixed or determinable payments that are not quoted in an active market. An example is money that one company lends to another on contractual terms.
- Held-to-maturity investments. Assets with fixed or determinable payments and fixed maturity, which an entity intends to hold to maturity and has the ability to do so. An example is a bond subscription.
- Available-for-sale. Financial securities that do not meet the definition of the other financial assets. An example is a stock purchased with the intention of not selling it in the near future.

Table 2.1 Recording of Financial Instruments

Instrument	Valued at[a]	Unrealized gain/loss due to fair value changes	Realized gain/loss	Balance sheet classification
Financial assets at fair value through profit or loss (trading), including all derivatives	Fair value	Recognized directly in the income statement	Recognized directly in the income statement	Current
Loans and receivables	Amortized cost	None	Recognized directly in the income statement	Current or noncurrent
Held-to-maturity investments	Amortized cost	None	Recognized directly in the income statement	Current or noncurrent
Available-for-sale	Fair value	Unrealized gain is recognized directly in the equity account of the balance sheet; however, all impaired losses are included in the income statement.	When the instrument is sold, derecognized, or impaired, the cumulative effect of the gain or loss that was credited directly to equity now flows through the income statement. The effect is an actual gain or loss.	Current or noncurrent

a. Fair value is derived through quoted market prices in an active market; in the absence of an active market, it is derived from internal valuation models. Amortized cost is derived from the initial recognized amount with adjustments relating to principal payments and amortization of discounts and premiums.

What are compound financial instruments?

Compound financial instruments contain elements of both liability and equity (table 2.2). Each element must be classified accordingly at the time of issuance, and no subsequent change can be made in its classification.

KEY QUESTIONS

- After identifying the financial instruments, do I understand how each is valued in the balance sheet?
- Where are the effects of changes in the fair value of trading and derivative instruments recorded?
- What corroborative evidence is used to establish the fair value of the financial instruments?

Analyst's Role

The analyst should:

- Scrutinize the notes to the financial statements and determine how the valuation of the financial instruments is derived. As noted in table 2.1, gains and losses are recorded on income statements, which measure the performance of the portfolios. It may be necessary to provide estimates of the value of these portfolios using internal models. Estimates create the possibility for error and thus the manipulation of earnings.
- Make sure the financial assets have been recorded properly. At each balance sheet date, an entity should calculate the carrying amount of its financial instruments. If the decline in value is not temporary, the carrying amount is recorded in relation to

Table 2.2 Examples of Compound Financial Instruments

Convertible bond	Preferred shares	Put options
• The loan principle is the liability, and the holder's option to convert into common shares is equity. • The equity component is assigned the residual amount after deducting the liability component.	• When a corporation issues preference shares that have features of a fixed coupon rate per annum and are to be redeemed at a particular date, they are considered a liability because the issuer has entered a contract to deliver cash in the future. • If the preference shares do not have a fixed maturity and the issuer does not have to deliver cash in the future, then they are an equity.	• Put options are instruments that give the holder the right, not the obligation, to return the instrument to the issuer in exchange for cash. • At times stocks may be purchased with "put options" embedded as one of the features. • The "put option" is considered a liability and the residual amount an equity.

Note: See the International Finance Corporation's (IFC's) corporate valuation guidelines at its "Corporate Portfolio Management" website.

the fair value. The recognition of impairment loss affects any decrease in assets and, correspondingly, in earnings.

- Classify liability and equity properly for compound instruments such as convertible bonds. This is essential. The classification affects financial ratios such as debt ratio and debt-to-equity ratio.
- Include "put option" when calculating any debt ratios or conducting financial analysis. Put option is regarded as a liability from the standpoint of the issuer.

Inventory (IAS 2)

Inventories are company assets that are sold to customers to earn revenue for the company. Some examples are computers, agricultural equipment, agricultural products, and manufacturing products.

It is important to scrutinize a corporation's method of valuing inventory because it affects financial statements (see table 2.3 for U.S. GAAP and IFRS methods). The inventory method depends on the flow of inventory costs, which affects income stream. Each method produces different financial results. Ultimately, inventories are recorded as the lower of cost and net realizable value.

IFRS no longer allows LIFO, mainly because LIFO does not fully represent the inventory flow. The strategy for using LIFO is often tax driven; that is, during a period of inflation, the LIFO cost of inventory is higher, and therefore the cost of goods sold is higher (see table 2.4). Consequently, taxable income will be lower and cash savings will be higher. But advocates of LIFO argue that this method represents current cost levels, which should be reflected in financial statements.

Table 2.3 Common Methods of Valuing Inventory Used by U.S. GAAP and IFRS

Method	U.S. GAAP	IFRS
Weighted average	Yes	Yes
FIFO	Yes	Yes
LIFO	Yes	Not allowed

KEY QUESTIONS

- How are inventories recorded—as the lower of cost or net realizable value?
- What type of inventory costing is used? Each method has different effects in financial statements.
- Is LIFO used? Remember, this method is prohibited under IFRS.
- Are the inventories strongly connected to the valuation of the company?
- What is the market demand for the company's inventory?

Table 2.4 Effects of FIFO Versus LIFO During a Period of Rising Prices

Affected financial components	FIFO	LIFO
Working capital (balance sheet)	Higher	Lower
Liquidity ratio	Higher	Lower
Cost of goods sold (income statement)	Lower	Higher
Net income	Higher	Lower
Profitability ratios	Higher	Lower
Free cash flow	Lower	Higher

Analyst's Role

The analyst should:

- Examine the notes relating to inventory in the annual report. They contain vital information.
- Note the impact of varied inventory costing methods when comparing companies.
- Pay attention to the inventory turnover ratio, a key measurement of cost inventory. This ratio shows the average number of times the inventory was sold during a given period; it measures the liquidity of the inventory. This ratio allows the analyst to gauge how long it will take to sell the company's inventory in comparison with the industry average. Ultimately, the result will affect the cash flow stream.
- Watch for inventories that grow faster than sales from one year to the next. This is a warning signal. It could indicate that fewer consumers are buying the company's product and, therefore, revenue is decreasing and the profit margin is being squeezed.

Property, Plant, and Equipment (IAS 16)

PP&E represent a company's physical or fixed assets; for example, its land, buildings, and equipment. PP&E are used to generate future cash inflows. The valuation of these assets is based on historical cost.

Initial recording and depreciation

When physical assets are purchased, they are recorded initially at cost on the balance sheet (capitalized). Subsequently, as the asset is utilized, a portion of the original cost is transferred to the income statement as an "expense." The process of transferring this allocated cost over time or the loss of the asset's earning power is called depreciation.

Subsequent measurement

A company can use either of two methods to indicate the carrying value of a physical asset. The fair-value model integrates cost, changes in fair value, and impairment loss. The cost model integrates cost, accumulated depreciation, and impairment loss.

Depreciation methods

Countries use various methods of depreciation:

- Straight-line
- Sum-of-the-years-digits (accelerated method)
- Declining-balance (accelerated method)
- Units-of-production (productive output).

Whatever method is used, it must be consistent with the consumption pattern of the operation. Each depreciation method has a different impact on the operation's net income, balance sheet, and financial ratios (see table 2.5).

Capitalization versus expense

When physical assets are purchased, they are recorded in a designated PP&E account on the balance sheet. This process, called "capitalization" (see table 2.6), is required by U.S. GAAP. However, IFRS does not indicate whether to capitalize or to record a purchased item as an

Table 2.5 Effects of Depreciation Methods

Method	Expense	Effect on income statement	Effect on balance sheet (book value)
Accelerated (i.e., declining-balance)	Higher depreciation expense early in the asset's life; depreciation declines in the latter part of its life	During the initial period, when the depreciation expense is higher, net income will be lower. In the latter period, when the depreciation expense is lower, net income will be higher.	The book value of the asset would decline at a higher rate than under straight-line depreciation.
Straight-line	Equal amounts of depreciation expense throughout the useful life of the asset	Because the depreciation expense is equal throughout the asset's useful life, net income is affected only by what is treated as an expense for that period.	The book value of the asset would not decline at a higher rate than under accelerated depreciation.

Table 2.6 Effects of Capitalization Versus Expense, Initial Period of Purchase

Financial	Capitalization	Expense
Net income	Higher. The depreciation expense is lower; therefore net income is higher. The depreciation expense is allocated over time, spread across the asset's useful life.	Lower. The entire expenditure on the asset is deducted in the income statement; therefore, net income is lower. The expenditure is only deducted at the time of purchase.
Balance sheet	Higher. The cost of the item is initially recorded as an asset.	Lower. The cost of the item is not reflected on the balance sheet; rather, it appears in the income statement as an expense.
Equity	Higher. With a higher net income, this amount will flow into the equity section.	Lower. With a lower net income, this amount will flow into the equity section.
Total asset turnover	Lower. The purchased item increases the total asset account.	Higher. The purchased item has no effect on the asset account because it is expensed in the income statement.
Profit margin	Higher. The depreciation expense is lower; therefore, net income is higher, which results in a higher profit margin.	Lower. The entire expenditure on the asset is deducted in the income statement; therefore, net income is lower, which results in a lower profit margin.
Return on asset (ROA)	Higher. Because the percentage increase in net income is higher than the percentage increase in the asset, ROA is higher.	Lower. Because the percentage increase in net income is lower than the percentage increase in the asset, ROA is lower.
Return on common equity (ROE)	Higher. Because the percentage increase in net income is higher than the percentage increase in equity, ROE is higher.	Lower. Because the percentage increase in net income is lower than the percentage increase in equity, ROE is lower.

expense when initially recognizing an expenditure for a tangible item; the standard does not specify what constitutes an item of property, plant, and equipment. As a result, some countries may have the flexibility to expense the purchased item instead of recording it as an asset.

KEY QUESTIONS

- How valuable are the physical assets of the firm?
- How profitable are the assets in generating future cash flows? Are they maintainable?

- Will the expected return be greater than the cost of capital?
- How much risk is buried in these assets?
- Does the method used provide a strong suggestion that management is manipulating earnings? A fixed asset's value is influenced strongly by the method of depreciation.
- How much new PP&E is needed to support the forecasted sales?
- If excess capacity exists, how will that affect the additional funds needed for expansion?

Analyst's Role

The analyst should:

- Analyze the footnotes of the annual report. They indicate the types of physical assets that generate revenue for the organization.
- Make sure that an independent entity has revalued the assets if a revaluation model is used after the assets are initially recorded. This measure should be reflected in the footnotes. Note that increases in revaluation are credited directly to equity. Revaluation decreases are offset first against the surpluses in the equity; thereafter, any excesses are charged against profit and loss.
- Consider what PP&E mean for management's future expansion. PP&E is one of the vital forces of economic growth. Funds, through capital or reinvestment of earnings, are needed to implement the projects that affect the valuer's calculation of free cash flow.
- Understand the important role that depreciation plays in calculating income tax. A larger depreciation expense contributes to smaller taxable income; thus, a lower tax bill produces higher cash flow to the operation.
- Take into account the ramifications of management's choice to capitalize or expense an asset. This choice has a significant effect on a financial statement. For example, in the United States, WorldCom capitalized charges paid to local telephone networks to complete calls amounting to approximately $3.1 billion; the company planned to amortize these costs over a period of time. Because the entire cost was not booked in the income statement, WorldCom's net income in 2001 was calculated to be a positive $1.38 billion. However, U.S. GAAP considered the $3.1 billion an operating expense, which would have been a deduction in the income statement. Consequently, WorldCom's net income for 2001 should have been a "loss." After this discovery, WorldCom filed for bankruptcy.

Investments in Associates (IAS 28)

In today's dynamic capital markets, capital investments are mobilized across the globe in search of lucrative investments and growth prospects. These investments in associates are cross-transactional events that must be reported in financial statements.

An associate is an entity in which an investor has significant influence over the entity's financial and operating policy decisions. However, the investor's influence cannot amount

to control or joint control over the entity's financial and operating policy decisions. An investor that directly or indirectly holds 20 percent or more, but less than 50 percent, of an entity's voting shares is presumed to have significant influence. A shareholding of less than 20 percent does not represent significant influence, unless the influence can be demonstrated.

An investor might exert significant influence through any of the following channels:

- Representation on the entity's governing body
- Participation in policy-making processes such as strategic decisions
- Material transactions between the investor and the entity
- Interchange of managerial personnel
- Provision of essential technical information.

Equity method

The equity accounting method (see table 2.7) is used to recognize the initial cost of investment in associates and any adjustments due to subsequent transactions relating to the investor's share of the associate's (investee's) net profit or loss.

Effect of investee's profit or losses

At the end of an operating period, an investor must analyze its percentage share of the investee's profit or losses. This allocated share is adjusted to the investment account of the investor's balance sheet. For example, if there was a loss, this amount would be deducted (credited) to

Table 2.7 Example of Equity Method

Date	Action	Effect on financial statements (company A's perspective)
January 1, 2004	Company A purchased $50 million of Company X's common stock, which represents 35% of voting shares.	The investment account (asset) on the balance sheet is increased by $50 million. The payment of the purchase of common stocks decreases the cash account (asset) on the balance sheet.
December 31, 2004	Company X had a net income of $10 million.	The investment account (asset) on the balance sheet is increased by $3.5 million ($10 million × 35%) with a corresponding increase on "investee income" that is reflected in the income statement.
December 31, 2004	Company X paid its shareholders a dividend totaling $4 million	Company A would receive $1.4 million ($4 million × 35%) in cash. As a result, cash is increased by $1.4 million, with a corresponding decrease in the investment account.

the investment account (asset). If there was a profit, this amount would be treated as an increase (debit) in the investment account.

KEY QUESTIONS

- Are the associate's accounting policies the same as those of the investor? They must be the same.
- Is the equity method used? If so, how are the results affecting the financial statements?
- Has the valuer applied reasonable assumptions that will make it possible to measure the valuation of the company reliably? Limited market-based data are available for valuing unlisted companies.
- Is there an appropriate exit strategy for the investment?

Analyst's Role

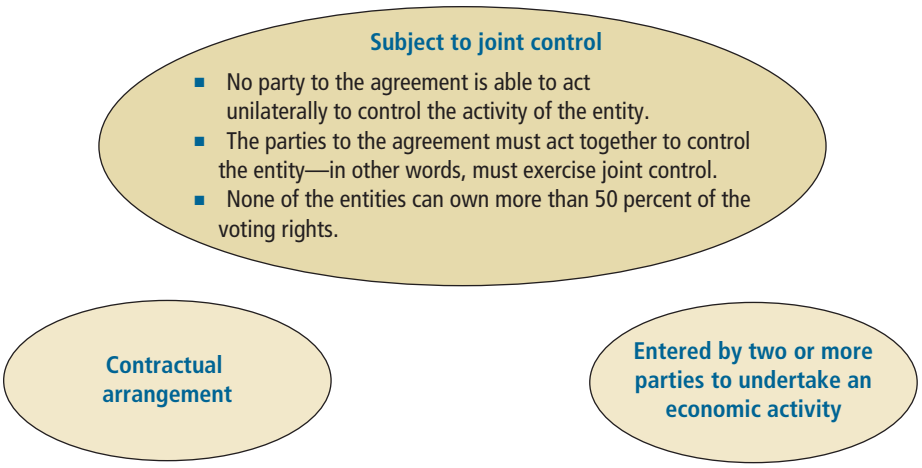
The analyst should:

- Ensure that the investee's net income or loss is included in the investor's financial statements.
- Make sure that an appropriate exit strategy, such as a Put Option, is in the contractual agreement.

Interests in Joint Ventures (IAS 31)

Companies can join forces through mergers or corporate alliances. A joint venture—one form of corporate alliance—is a way to create an entity from piecemeal byproducts of existing business operations. Examples include a marketing force joint venture or development joint venture. Once a joint venture reaches its objective, it can be dissolved (see figure 2.1).

Figure 2.1 Features of Joint Ventures



Equity method

The accounting method used for these transactions is the equity method, the same method used for "Investments in Associates."

KEY QUESTIONS

- What is the objective of the joint venture?
- Are the assets, liabilities, income, and expenses appropriately captured in the venturer's separate and consolidated financial statements?

Analyst's Role

Joint ventures may take various forms, such as jointly controlled operations and jointly controlled assets. The transactions of the joint venture can be perceived as a dumping of transactions away from the venturer. For example, if the joint venture acquires debt to finance the building of a warehouse, this transfers the debt portion out of the venturer's financial statements. As a result, the venturer's debt ratio would be lower, debt-to-equity would be lower, and times-interest-earned (TIE) would be higher. Ultimately, the venturer's set of financial statements would appear to be operating efficiently in terms of debt management.

The analyst should:

- Make sure the financial statements of each party to the venture specify the asset that the party controls, its incurred liabilities, its earned income as a result of the joint venture, and its incurred expenses.
- For holding companies, make sure to include the net debt in the analysis if it is not captured elsewhere.

Investment Property (IAS 40)

Investment properties are tangible assets that are held for the purpose of earning rental income or taking advantage of price appreciation. Examples include:

- Land held for the purpose of selling it when the price is high
- Leased buildings that are under operating lease
- Vacant buildings held to be leased under operating lease
- Land held for undecided future use.

Accounting methods

Two methods are used to account for subsequent changes in an investment property. A company may choose either one. In the cost model, the asset is carried at cost less accumulated depreciation and impairment. In the revaluation model, the asset is carried at a revalued amount—its fair value at the date of revaluation less subsequent depreciation—provided that

fair value can be measured reliably. Note that each method affects financial statements differently (see table 2.8).

KEY QUESTIONS

- Is the valuation of the company tied to the investment properties?
- Which model is used to value the investment property in the balance sheet?
- What is the impact of the model chosen?

Table 2.8 Effects of Revaluation Model versus Cost Model

Date	Transaction	Effect on revaluation model	Effect on balance sheet cost model
1/1/Year 1	Company A purchased a facility to be used for operating lease in the amount of $1 million for land and $2 million for the building.	• The "Investment Property" asset account on the balance sheet would increase by $3 million ($1 million + $2 million). • The total asset account on the balance sheet is increased.	• The "Investment Property" asset account on the balance sheet would increase by $3 million ($1 million + $2 million). • The total asset account on the balance sheet is increased. • Depreciation elements: useful life of building (20 years); depreciation method (straight-line); annual depreciation of building ($100,000).
12/31/Year 1	An independent valuer determined that the value of the facility is now $3.5 million.	• The "Investment Property" is increased by $0.5 million. The balance sheet is increased by $0.5 million and a gain is recorded on the income statement. • Earnings increase by $0.5 million.	• The $0.5 million gain does not affect the cost method. • Depreciation expense of $100,000 is recorded on the income statements. • Earnings decrease by $100,000.
12/31/Year 2	An independent valuer determined that the value of the facility is now $3.1 million.	• The "Investment Property" is decreased by $0.4 million and a loss is recorded on the income statement. • Earnings decrease by $0.4 million.	• The $0.4 million loss does not affect the cost method. • Depreciation expense of $100,000 is recorded on the income statements. • Earnings decrease by $100,000.

Analyst's Role

The analyst should:

- Recognize that when investment properties are purchased, they are initially recorded in the balance sheet at cost. As a result, the total assets are increased. The analyst must recognize that this treatment affects the financial ratios, the future earning power of the company (owing to the rental income that will be received from the operating lease), and the future financial requirements of the company.
- Make adjustments to the original cost after any subsequent changes to the investment property, such as appreciation of value or improvement to the building. As illustrated in table 2.8, the "fair value method" and the "cost model" produce different results, which in turn affect the financial statements and financial analysis.
- Examine the notes to the annual report because they contain information that is valuable in assessing the company. Pay particular attention to items such as discontinuation of operation, reconciliation between the carrying amounts of investment property at the beginning and end of the period, and any inconsistencies in the using of the various methods.
- Apply the elected subsequent measurement model to all investment properties.

Provisions, Contingent Liabilities, and Contingent Assets (IAS 37)

Provisions

Provisions indicate liabilities arising from uncertain timing or amount. The following conditions must be present to record a provision:

There is a present obligation arising from past events.	Example: A legal case is mounted when one of the company's product lines malfunctions.
Payment is probable ("more likely than not").	Example: Lawyers believe there is a 90 percent probability that the case will be settled in the defendant's favor.
The amount can be estimated reliably.	Example: The probable loss will be in the range of $5 million to $8 million.

Because the three conditions are present in the example, a provision should be made for a charge to liability and a corresponding charge to income on the balance sheet. However, management must determine the best estimate of loss.

Provisions must be recognized in a financial report, assuming that the transactions meet the three conditions. The uncertainties they cover arise from sources such as

- Environmental damages from waste or pollutants
- Product warranty
- Restructuring of an operation given a formal plan
- Threat of asset expropriation
- Threatened litigation
- Sale of business segment, given a binding sale agreement.

Contingent liabilities and contingent assets

Contingent liabilities are either a possible obligation of a company in case of an uncertain future event or a current obligation of a company in which payment is not measured reliably or is not probable. A contingent asset is a possible asset of a company that arises from past events and is made manifest by the occurrence or nonoccurrence of uncertain future events.

Financial statements do not recognize contingent assets and liabilities, although their disclosure is required unless the possibility of an outflow of resources is remote.

KEY QUESTIONS

- Are the provisions reflected in the valuation of the company? Examine the disclosures.
- In recognizing provisions, is the amount valid and reliably estimated?

Analyst's Role

The analyst should:

- Maintain a critical frame of mind when assessing management's data on provisions. Remember that provisions reflect one's "best estimate."
- Ignore any possible gains on the sale of assets.
- Identify contingent liabilities by examining the required disclosure in the notes of the annual report. Contingent liabilities are not recognized in income statements and they could have an impact on the operation's cash flow.
- Assess the validity of adjustments. IFRS require that, when studying the historical trend of the provisions, these amounts be reviewed at the time each balance sheet is due and adjusted to reflect current best estimates.

Employee Benefits (IAS 19)

IAS 19 prescribes the scope of "Employee Benefits"; IAS 26 provides information on "Accounting and Reporting by Defined-Benefit Plans."

Companies provide their employees benefits in various forms, such as wages, profit-sharing plans, and pension plans (see box 2.1). These benefits are available to employees and, often, to their dependents and may be issued as payments (or goods or services) made directly to employees, their spouses, children, or other dependents, or to others, such as insurance companies.

KEY QUESTIONS

- When calculating enterprise value (EV) or earnings before interest taxes depreciation and amortization (EBITDA), does the entity add the present value of pension liabilities to EV?
- Are the nonoperating gains and losses pertaining to pension plan assets omitted from the valuation calculation?

Box 2.1 Types of Pension Plans

Defined-Contribution Plan

- This is a post-employment benefit plan in which the employer pays fixed contributions into a separate fund.
- When the employer contributes to the fund for a specific period, the company is no longer obliged to add more to the fund.
- This fund is invested to earn money on behalf of the employees' retirement benefit.

Defined-Benefit Plan

- This plan provides employees retirement benefits based on a formula that is usually linked to employee earnings.
- The current value of the employer's obligation is calculated at defined periods on the basis of some actuarial assumptions.
- Once the amount is determined, it is credited as a liability on the balance sheet and as a pension expense on the income statements.

Analyst's Role

The analyst should examine the components of actuarial assumptions used to calculate the current value of the pension obligation. Any erroneous estimates could distort the financial statements (see table 2.9). The following are the actuarial elements:

- Rate used to discount estimated cash flows—should be determined by reference to market yields at the balance sheet date on high-quality corporate bonds
- Assumption regarding wage growth—increase or decrease in the number of employees or increases in salaries of employees
- Assumed service life of the employees
- Assumed expected long-term rate of return on the plan assets
- Age distribution of the employees.

Table 2.9 Effects of Changes in Actuarial Components

Component	Increase	Decrease
Discount rate	The valuation of the pension obligation would decrease; therefore, an actuarial gain is recognized.	The valuation of pension obligation would increase; therefore, an actuarial loss is recognized.
Wage growth rate	Wage growth affects the service cost component of the pension expense. Therefore, an increased service cost increases pension expense.	The decreased service cost would decrease the pension expense.
Expected long-term rate of return	High expected return affects the low pension cost. Therefore, income is higher.	Low expected return affects high pension cost. Therefore, income is lower.

Construction Contracts (IAS 11)

A construction contract is an agreement to construct an asset or a group of interrelated assets. A key issue is when to recognize revenue. A company need not wait until construction is

complete to recognize revenue, because it can take years to complete a project. U.S. GAAP uses the "completed-contract" method, which recognizes revenue when construction is completed (or substantially completed). IFRS uses the "percentage-of-completion" approach when the outcome of a construction contract can be estimated reliably and recognition of revenue and costs is in proportion to the stage of completion of the contract activity.

To estimate the outcome of a contract reliably, the enterprise must be able to make a reliable estimate of total contract revenue, stage of completion, and costs to complete the contract. See figure 2.2 for an illustration.

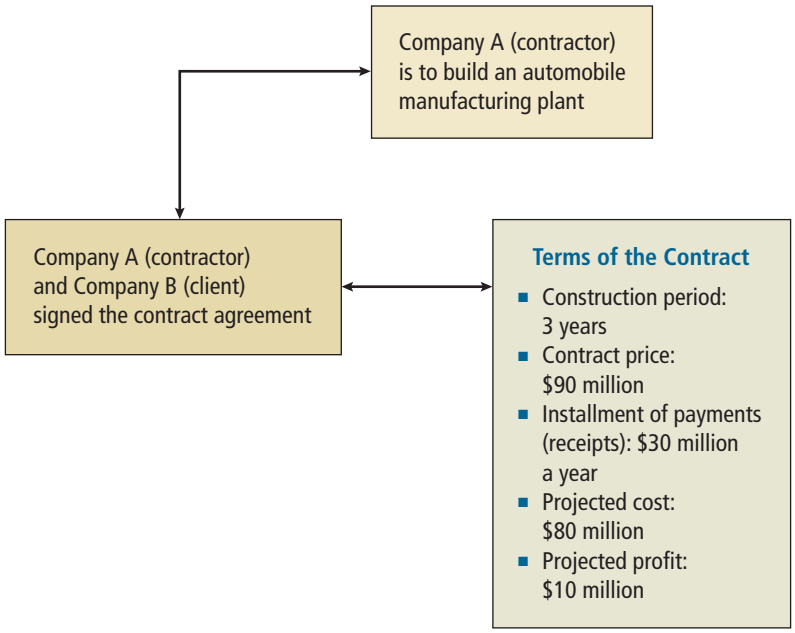
An advantage of the percentage-of-completion method is the periodic recognition of income, which is in keeping with the matching principle. A disadvantage is that amounts are based on estimates rather than actual results. See table 2.10 for a comparison of methods.

Based on the given information in figure 2.2 coupled with the actual costs incurred each year, construction revenue is recognized as follows for Company A.

Calculation of annual revenue

$$= \frac{\text{Actual costs for each period}}{\text{Total project cost}} \times \text{Total estimated project price}$$

Figure 2.2 Estimating the Outcome of a Construction Contract—Company A (Contractor) Agrees to Construct an Automobile Manufacturing Plant for Company B (Client)



KEY QUESTION

- How will the company record receipts from the project? When the outcome of the construction contract is not reliably estimated, no revenue should be recognized.

Table 2.10 Effects of Percentage-of-Completion versus Completed-Contract Methods

Financial statement	Percentage-of-completion	Completed-contract
Income	• Revenue is recorded on the basis of the stage of completion. • Revenue is based on an estimate, rather than actual amount. • Any estimated loss is recorded immediately.	• Revenue is recorded when the contract is completed or substantially completed. • In the initial period of the contract, no income is recorded; therefore, net income is lower. • In the latter period of the contract, income will be higher. • Any estimated loss is recorded immediately.
Equity	Higher. During the initial period, revenue is included in the net income, and this amount is carried forward into equity.	Lower. Because revenue is not included in the initial period, net income is lower.
Total asset turnover	Higher. Sales are reported from the initial period of the project.	Lower. Sales are not reported from the initial period.
Profit Margin	Higher. During the initial period, the pro rata character of revenue is recognized; therefore, net income is higher.	Lower. During the initial period, revenue might not even be recognized; therefore, net income is lower.
Operating cash flows	Operating cash receipt is recorded the same under either method.	Operating cash receipt is recorded the same under either method.

Analyst's Role

The analyst should:

- Be mindful that if construction costs "probably" will exceed the total revenue, the expected loss should be expensed immediately.

Intangible Assets (IAS 38)

Intangible assets do not have physical substance. Some examples are:

- Computer software
- Licenses
- Patents
- Copyrights

- Franchises
- Marketing rights
- Mortgage servicing rights.

IAS 38 requires an entity to recognize an intangible asset only when the intangible is purchased or created by the corporation itself. The intangible asset can be derived through mergers and acquisitions, or through the creation or reconfiguration of innovative products and services (such as computer software). Effective merger and acquisition strategies can position a company for economic growth.

KEY QUESTIONS

- Is the enterprise truly earning the economic benefits derived from the intangible?
- Are there other intangible elements that are not reflected in the balance sheet but that add value to the corporation?
- Are the research costs charged to expense?
- Are the development costs capitalized accordingly?

Analyst's Role

The analyst should:

- Evaluate the validity of the intangible assets. Appraisals of a company's market potential may be overoptimistic, its synergies overestimated, or its post-acquisition integration poor. Substantial doubt about such factors will affect the analysis. If the analyst decides to eliminate the intangible amount from the analysis report, for example, this will affect the financial ratios, such as total assets turnover, debt ratio, and return on assets.
- Integrate unrecognized elements (intangible assets such as management skills, brand name, and synergy) into the cash flow projection or valuation of the company. Unrecognized elements might contribute to the company's forward-looking posture or economic growth.
- Pay attention to the notes of the financial statements because they contain essential details, such as the different types of intangible assets, impairment, and amortization amount.

Borrowing Costs (IAS 23)

Borrowing costs consist of the interest and other costs associated with borrowing money relating to a "qualified asset" (see box 2.2). Interest is not necessarily capitalized for every asset purchased on credit. Capitalization relates only to qualified assets that require substantial time to bring them to their intended use or saleable condition (see table 2.11). Examples of qualified assets include construction of a manufacturing plant; purchase of equipment, such as trucks and bulldozers, for farming; and building of investment property.

Not all the interest paid for the period is capitalized (see figure 2.3).

Box 2.2 Methods Used to Account for Borrowing Cost

Benchmark Treatment

All borrowing costs are expensed in the period they are incurred.

Allowed Alternative Treatment

Borrowing costs are capitalized. The designated interest cost is added to the carrying amount of the asset. This method increases the total assets.

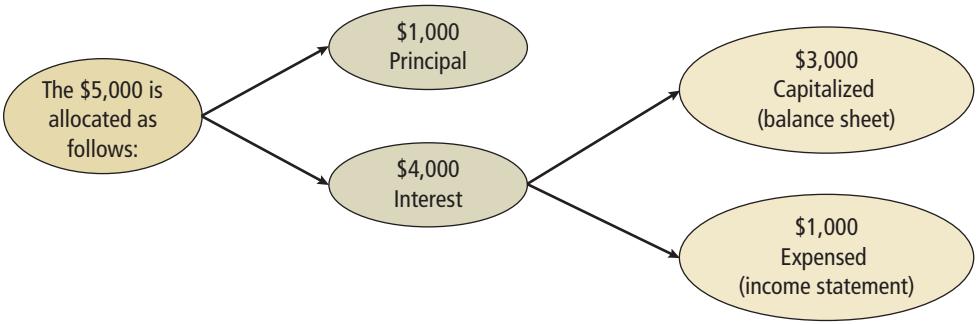
Capitalization of the borrowing costs starts when:
- Qualifying assets are purchased.
- Interest costs are incurred.
- Actions necessary to bring the asset for its intended purposes are in progress.

Capitalization of the borrowing costs ends when
- The qualifying asset is ready to be used for its intended purpose.
- Active development is suspended for an extended period.
- Construction is completed in part and the completed part can be used by the entity.

Table 2.11 Effects of Interest: Expense versus Capitalization

Financial statement	Expense	Capitalization
Net income	Lower. The entire interest payment will cause a higher reduction of income; therefore, net income will be lower.	Higher. A portion, if not all, of the interest paid is capitalized; therefore, the amount is added to the carrying amount of the asset. The remainder of the interest payment that is "not" capitalized will be expensed; thus, net income will be higher.
Balance sheet	Lower. The entire interest payment flows directly to the income statement.	Higher. The interest payment that is capitalized is added to the carrying amount of the asset. Therefore, this will increase total asset.
Total asset turnover	Higher. There is no effect on sales or total assets because the entire interest payment flows directly to the income statement (expense).	Lower. The capitalized interest increases the total assets.
Debt ratio	Higher. Total assets are not affected by the paid interest.	Lower. The capitalized interest increases the total assets.
Times-interest-earned (TIE)	Lower. The interest charge is greater.	Higher. The interest charge is lower.
Profit margin	Lower. Interest deduction is higher; as a result, net income is lower.	Higher. Net income is higher because interest paid is capitalized.

Figure 2.3 Allocation of a Loan Payment—Company A Paid Its Loan Payment for the Month in the Amount of $5,000



KEY QUESTION

- Are the borrowing costs that are capitalized directly related to a qualified asset? Otherwise, the costs should be expensed.

Analyst's Role

The analyst should:

- Be aware of the ramifications of the treatment of interest capitalization versus expense. Each component has a different effect in the analysis.

Impairment (IAS 36)

Impairment occurs when the carrying amount of an asset (net book value = cost of item less accumulated depreciation) is more than the recoverable amount. This recoverable amount is the higher of the following:

- Net selling price: fair value less costs to sell the item
- Value in use: discounted present value of estimated future cash flows from using the asset until its disposal point.

An impaired asset incurs an impairment loss. Impairment could be due to a market decline, negative changes in technology and obsolescence, or physical damage to the asset. Where impairment is identified, a write-down of the carrying value to the recoverable amount should be charged as an immediate expense in the income statement (see table 2.12).

Derecognition (retirement and disposals)

When an asset is disposed of or withdrawn from use, the item should be removed from the balance sheet.

Table 2.12 Effects of Impairment

Financial statement	With impairment loss	Without impairment loss
Balance sheet	Lower. The carrying amount (net book value) of the asset is reduced as a result of the write-down or impairment loss.	Higher. No asset adjustment is made on the financial statement.
Equity	Lower. Impairment loss causes a reduction in net income; this amount flows through the equity account as a reduction.	Higher. There is no reduction of net income.
Income	Lower. The impairment loss is an immediate expense.	Higher. No impairment loss is recorded.
Total assets turnover	Higher. Total asset is reduced.	Lower. There is no reduction in asset.
Debt ratio	Higher. Because of asset reduction, total assets are decreased.	Lower. There is no reduction in asset.
Profit margin	Lower. The impairment loss would decrease the net income.	Higher. There is no effect on the net income.
Debt-to-equity	Higher. Because net income is reduced, this effect would flow through the reduction of equity.	Lower. There is no effect on the net income; hence, there is no effect on equity.

KEY QUESTION

- In the dynamic marketplace, the fair value of an asset changes over time because of technological advances, obsolescence, and ferocious competition, all of which affect pricing. As a result, are the assets reasonably tested for impairment?

Analyst's Role

The analyst should:

- Recognize impairment loss. Impairment significantly influences financial statements. If impairment loss is not recognized, the value of the company is overstated.
- Make sure that goodwill and other intangible assets with indefinite useful lives are tested for impairment at least annually, even though they are not subject to amortization.

- Be cognizant of indicators that cause impairment loss, such as a significant change in the usage of the asset; a significant adverse change in the legal environment or in the business climate that affects the fair value of the asset; and a projection that indicates a constant loss with an asset.

Revenue (IAS 18)

Revenue is the gross inflow of cash or accounts receivable to a company as a result of performing a service or selling a product. Such services might consist of technical assistance to a client in the Philippines in the area of corporate governance; computer maintenance; or auditing.

The product sold might be agricultural equipment sold to a client in Peru; computers; or a power supply unit.

Key components of the accounting standards

Approach every financial statement with a degree of professional skepticism. Recognize that just because a revenue number appears on the income statement does not mean that it is correct. A company cannot record a revenue transaction unless IAS 18 criteria are met.

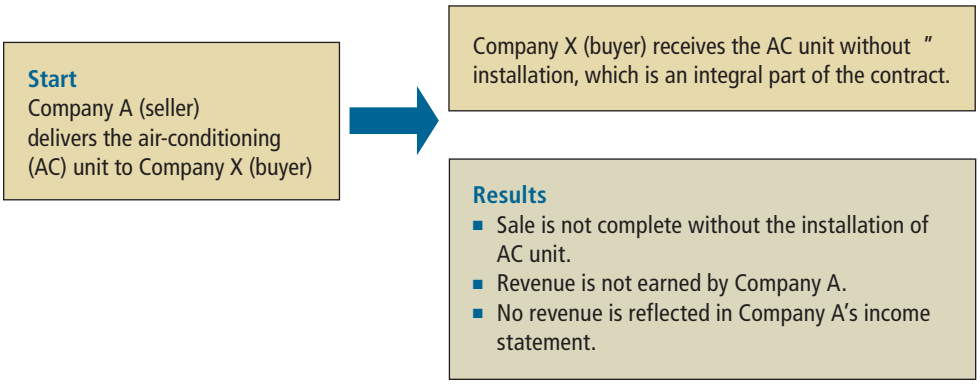
Suppose a contract has been drawn up to sell an air-conditioning unit, as shown below. An integral component is to install the item from Company A (seller) in the building of Company X (buyer). Company X (buyer) receives the unit without the installation. Until the unit is completely installed by Company A (seller), the transaction will not be complete. Because revenue is not earned, it is not reflected in the income statement of Company A (see figure 2.4).

Sale of goods

All of the following elements must be met to recognize revenue from the sale of goods:

- The significant risks and rewards of ownership are transferred to the customer.
- The seller does not have continuing managerial involvement with or control over the goods.

Figure 2.4 A Revenue-Earning Process



- The amount of the goods can be measured reliably.
- It is probable that the economic benefits will flow to the seller.
- The costs incurred, or to be incurred, in the transaction can be measured reliably.

Sale of services

Revenue is recognized by reference to the state of completion of the transaction at the balance sheet date (for example, December 31 of a given year). The following criteria must be satisfied:

- The amount of revenue can be measured reliably.
- The economic benefits probably will flow to the seller.
- The stage of completion at the balance sheet date can be measured reliably.
- The costs incurred, or to be incurred, in the transaction can be measured reliably.

It is essential to look for and investigate any clues to actual revenue because a company has the ability to manipulate the number. With revenue inflated, net profit would increase, financial ratios would be affected, and the company would appear to have growth potential. On the other hand, a company might understate its revenue with the intention of shifting the income at a later period.

KEY QUESTIONS

- Have the services reflected in the contract been performed?
- Are any investment gains erroneously recorded in revenue?
- Because of an acquisition, are any revenues being withheld instead of recorded in the current period? The company might be intending to release the revenues at a later period to show an improvement in its operations as a result of the acquisition.
- Are economies of scale and excess capacity considered in the financial forecast?
- Are the company's revenues attached to one key client?
- What are the key drivers or competitive advantage attributed to favorable sales growth?
- Is the sales growth sustainable, given the competitive environment?
- Is the company able to generate a realistic cash flow stream, given the surrounding business conditions coupled with macroeconomic variables? The discounted cash flow (DCF) relies heavily on forecasts of future performance, including revenue stream, to determine the present value of an investment.

Analyst's Role

The analyst should:

- Make further investigations when these questions do not have encouraging answers.
- Remember that the revenue trend is a key to the valuation of a firm. The result of the valuation method, such as DCF or Relative (multiple-based) Valuation through listed industry comparables strongly depends on the analyst's forecast.

- Be aware that the higher the company's sales growth rate, the greater the positive correlation in the financing requirements.
- Remain guarded at each level of the valuation stage. After all, management has a vested interest in massaging the numbers to impress the public market with a company that is doing well.
- Consider such risks as management misstating revenues to meet an earnings-per-share (EPS) target; or management misstating sales or receivables to improve the balance sheet or liquidity ratios.

Income Taxes (IAS 12)

During the ordinary course of business, taxes are paid to tax authorities such as the federal government, state agencies, and local institutions. An analyst must recognize that "income tax expense" in the income statement is different from "income tax payable" on the tax return. In addition, "financial income" on the income statement differs from "taxable income" on the tax returns. These differences arise mainly because the method used for recording certain transactions (such as method of depreciation and treatment of prepaid rents) depends on the time frame considered, which is dictated by IFRS for financial statements and by tax regulators (that is, the federal or state government) for the tax returns.

Because of the timing differences (see table 2.13), future tax liability (deferred tax liabilities) and future tax benefit (deferred tax assets) are incurred and must be accounted for appropriately in the financial statements. The recording of these calculations affects the analysis of the financial statements.

KEY QUESTIONS

- Are the appropriate tax rates used? The "effective tax rate" is used in the income statement and the "statutory tax rate" is used in the tax returns. It is located in the footnotes of the financial statements.
- When forecasting, are the appropriate effective income tax rates used?
- Are comparisons made between "actual income tax paid" to tax authorities and the "income tax expense" reflected on the financial statements for the purpose of assessing operating cash outflow?
- Are there any indications of an aggressive use of tax shelters?

Analyst's Role

The analyst should:

- Remember that discounting of deferred tax assets and liabilities is prohibited.
- Be aware that deferred taxes are classified as noncurrent taxes in the balance sheet. Do not include the item in calculating current ratios.

Table 2.13 Examples of Timing Differences and the Effect of Deferred Tax Asset/Liability

Example	Income statement	Tax return	Net effect
Choice of depreciation method: example of deferred tax liability	Straight-line method, $100 per month of depreciation expense	Double-declining method (accelerated method), $150 per month of depreciation expense	Current taxable income would be $50 lower. In the future, however, tax liability would be incurred. Because accelerated depreciation method leads to deferral of taxes, the taxes on the income reported in financial statements will generally be much greater than the actual tax paid. Deferred tax liability is recorded.
Prepaid rent for $100 (example of deferred tax asset)	No entry in the income statement; balance sheet entry as a prepaid asset	$100 is included in the taxable income.	Because of $100 taxable income, current income tax would be higher this period. In the future, however, tax benefit (asset) would be incurred. The corporation's earnings in the future will be greater; the firm is given credit for the deferred taxes. Deferred tax asset is recorded.
Installment sales of $100 (example of deferred tax liability)	$100 is recognized as income.	$100 is not included in the taxable income.	Because financial income is $100 higher, income tax expense is higher. However, future tax liability would be incurred. Deferred tax liability is recorded.

Leases (IAS 17)

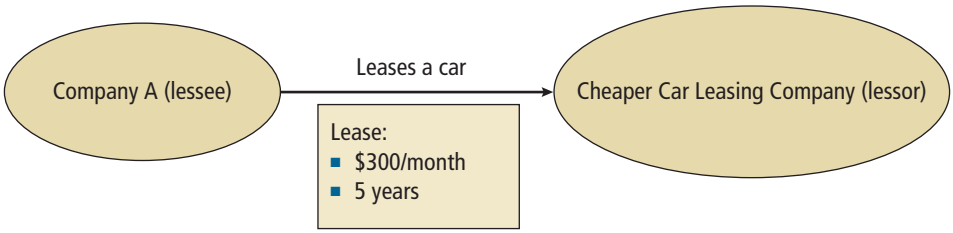
A lease is a contract between the owner of a leased asset (lessor) and an entity (lessee) that agrees to pay rent for using the leased asset on a periodic basis for a specific period of time.

Types of leases

In an operating lease, the lessee pays a periodic rental payment directly to the lessor. In a finance lease, the lessee has to obtain debt financing to use the leased asset. The leased equipment is treated as fixed asset.

As an illustration of operating lease, Company A (lessee) agrees to lease a car from Cheaper Car Leasing Company (lessor) for five years (see figure 2.5). During that period,

Figure 2.5 An Operating Lease



Company A (lessee) pays Cheaper Car Leasing Company (lessor) $300 a month. At the end of the lease, Company A can purchase the car for $4,000, which is the expected fair value. Effects of the lease on Company A's financial statements are shown in table 2.14.

As an illustration of finance lease, Company A (lessee) agrees to lease the heating, ventilating, and air-conditioning (HVAC) unit from AC Mechanical (see figure 2.6). To consummate the agreement, Company A (lessee) must obtain loan financing through Money Capital to pay AC Mechanical once the HVAC unit is installed. Once the installation is completed, the payment process of the loan is generated by Company A to pay Money Capital in the amount of $5,000 a month for a period of eight years at an interest rate of 10 percent. The effect of the finance lease on Company A's financial statements is shown in table 2.15, and the effect of both the finance and operating lease is shown in table 2.16.

Table 2.14 Effects of the Operating Lease on Company A's Financial Statements

Circumstance	Balance sheet	Income statement
No valuation of the future periodic payments is needed (present value process)	• The fixed asset account on the balance sheet is not affected in regard to any rental payments. • The equity account on the balance sheet will be affected indirectly when net income is carried forward into the equity.	
Monthly rental payments of $300 for 5 years	• The cash account decreases.	• Rental expense of $300 • Decreases net income
Lease expiration: If Company A decides to purchase the car at the end of the lease term for $4,000 cash	• Increase the equipment (asset) account by $4,000 • Cash decrease	• Monthly depreciation expense of the capitalized asset ($4,000) over its useful life

Figure 2.6 A Finance Lease

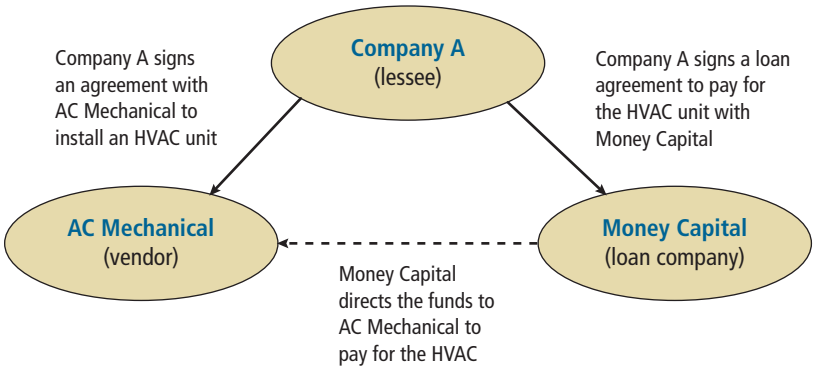


Table 2.15 Effect of the Finance Lease

Item	Balance sheet	Income statement
Value of the HVAC unit. The present value (PV) of $329,507 (PV of $5,000 per month for eight years @ 10 percent)	• The asset account (equipment) increases by $329,507. • The liability account increases by $329,507.	Not affected during the initial stage of the transaction
Monthly $5,000 payment	• The $5,000 will decrease the cash account. • Based on the amortization schedule, the initial payments will be allocated to interest expense (income statement). • Eventually, the monthly payments will be allocated to the principal, thereby decreasing the liability account.	The amortization schedule allocates the payments to interest expense in the early stage of the loan. Interest expense would be higher and payment to the loan principal would be lower. Eventually, it will be the reverse.
Monthly depreciation expense: because the leased equipment was recorded as a fixed asset, the cost will be depreciated over the period of the lease. The monthly depreciation expense is $3,432.	• The monthly depreciation expense will decrease the fixed asset account. • An account called "accumulated depreciation" will keep track of this monthly recording until the asset is fully depreciated (8 years or 96 months).	• The depreciation expense of $3,432 will be recorded. • This amount will decrease net income.

Table 2.16 Impact of Finance Lease and Operating Lease

Financial statement	Finance lease	Operating lease
Income	Interest on loan and depreciation expense is deducted. During the early period of the lease, expenses are higher because of the interest. However, expenses will eventually decline over the life of the lease.	The periodic lease payment is treated as a rental expense over the lease term.
Balance sheet (asset)	The equipment is recorded as an asset. Over the life of the lease, the carrying amount will decrease with depreciation of the asset.	No asset account is recorded.
Balance sheet (liability)	The loan that was used to acquire the asset is booked as a liability.	No liability account is recorded.
Statement of cash flow	The interest payment is operating cash outflow; the principal repayment is a financing outflow. Note: The depreciation expense is a non-cash item; therefore, it is not a cash outflow.	The rental expense is treated as an operating cash outflow.
Allocation of monthly lease payment	One portion is to pay for the principal of the loan (balance sheet); the other is to pay for the interest (income statement).	The entire payment is rental expense (income statement).
Depreciation	Depreciation is treated as an expense.	No depreciation
Current ratio	Lower. The current portion of the loan triggers an increase in the current liabilities.	Higher. No debt is incurred.
Fixed assets turnover and total assets turnover	Lower. The leased equipment is recorded as an addition to the asset of the balance sheet.	Higher. No asset is recorded.
Debt ratio	Higher	Lower
Times-interest-earned (TIE) ratio	Lower. Because of the recognition of loan for the leased asset; interest expense is incurred.	Higher. No interest expense is recorded.
Profit margin	Lower. The interest expense and depreciation lower net income; however, the principal repayment does not affect net income. On the other hand, during the latter period of the lease, net income would be higher because interest expense would be lower.	Higher. The entire rental payment reduces net income, but it is lower than the financing method. However, in the latter period of the lease, net income would be lower.

Why does a company choose to lease?

Tax purposes

Under an operating lease, the entire rental payment is deducted on the income statement. The ramification is, if a company is in the higher tax bracket, the deduction would lower taxable income. Hence, cash savings are derived.

Debt-ratio effect

Under an operating lease, there is no debt obligation; therefore, debt ratio would not be affected. The debt ratio is important because it affects the company's credit rating, which eventually affects the cost of capital.

Cash flow effect

Under finance leasing, the "Operating Activities" have a higher cash flow.

KEY QUESTION

- EV/EBITDA valuation methodology: With operating leases, is the leased-asset debt added to the calculation of enterprise value?

Analyst's Role

The analyst should:

- Note that with operating leases, as opposed to finance leases, the leased asset is not capitalized; therefore the attributable debt is ignored in the balance sheet. Not including this off-balance-sheet item in the valuation analysis would not provide a best-estimate valuation of the company. This would affect the enterprise value in the EV/EBITDA relative valuation.
- Be aware that, if a company signs an operating lease agreement, this is an obligation of future cash outflow. Therefore, include the amount in calculating the true debt ratio, but note that this will change the appropriate capital structure (leverage) of the company.

Earnings per Share (IAS 33)

Earnings per share is a standard measure used to assess an entity's performance over time. It is a consistent measure that helps the analyst compare the entity with other companies.

IAS 33 applies to entities whose stocks are traded publicly or are in the process of being issued to the public. Other companies that choose to present EPS information must follow IAS 33 guidelines.

Financial statements

EPS is located on the income statement. The following two values relate to EPS:

- Basic EPS. Shareholders' net profit or loss earned for the period. This is the amount available to each outstanding share of common stock.

$$\text{Formula} = \frac{\text{Net profit or loss attributable to ordinary shareholders less preference dividends}}{\text{The weighted average number of ordinary shares outstanding during the period}}$$

Example of basic EPS

Net income = $100,000
Common shares outstanding = 150,000
Preference shares outstanding = 10,000; dividend rate = $1/share

$$\text{Calculation: } \frac{\$100{,}000 - \$10{,}000}{150{,}000} = \$0.60 \text{ per share}$$

- Diluted EPS. "Reduction" of the basic EPS. This occurs because of the assumption that the convertible debts, option rights, and warrants are exercised by the holders, then converted into common stocks.

$$\text{Formula} = \frac{\text{Net profit or loss attributable to ordinary shareholders less preference dividends plus dividends on converted securities}}{\text{The weighted average number of ordinary shares outstanding during the period (assuming all dilutive securities are converted into common stock)}}$$

Example of diluted EPS

Net income = $100,000
Common shares that are outstanding = 150,000
Convertible preference shares outstanding = 10,000; dividend rate = $1/share; each share is convertible into 2 shares of common stock

$$\text{Calculation: } \frac{(\$100{,}000 - \$10{,}000 + \$10{,}000)}{150{,}000 + (10{,}000 \times 2)} = \$0.59 \text{ per share}$$

KEY QUESTIONS

- In using price/earnings (P/E) multiples to value a company, does the analyst understand that both operating and nonoperating activities are commingled in EPS?
- Why are P/E multiples across comparable companies different?
- What key drivers of earnings increase or decrease affected EPS?

Analyst's Role

The analyst should:

- Note that, when using EPS or P/E ratios to gauge the performance of a company over time, both the operating and nonoperating activities are embedded in the net income. This affects the EPS calculation. Examples of nonoperating activities include discontinued operation of a business segment, write-offs, changes in accounting policy, and restructuring costs.
- Eliminate one-time or nonrecurring events while valuing companies. Otherwise, the results will be misleading.
- Exercise the utmost caution when scrutinizing the P/E ratios of comparable companies, because each company will be subject to problems.

Effects of Changes in Foreign Exchange Rates (IAS 21)

In the dynamic global market, foreign enterprises conduct their transactions using foreign currencies for their expenditures, hedging strategies, and investing and financing activities. These business activities must be reflected on the financial statements in the corporation's reporting currency.

Types of accounting currency

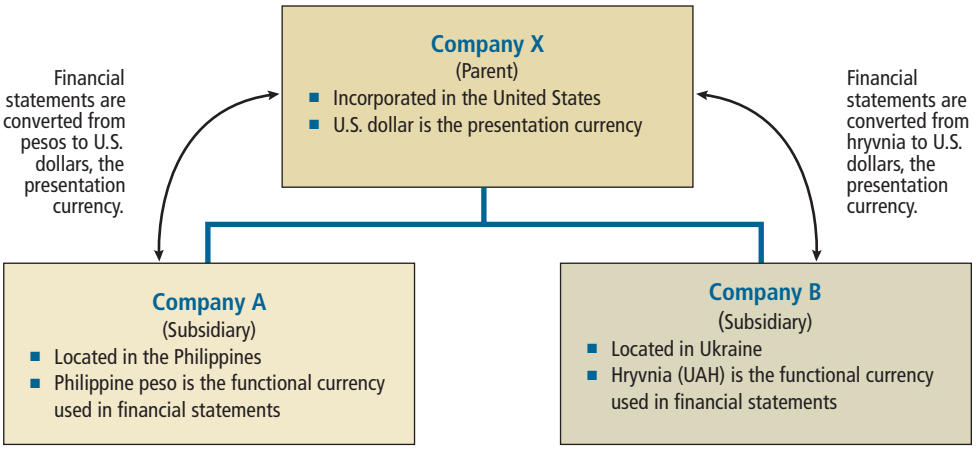
Presentation currency is the currency used to report financial statements. Note that a foreign subsidiary's presentation currency may not be the same as its functional currency. Functional currency is the currency of the economic environment in which the entity operates primarily, usually the local currency.

As an illustration, Company A, located in the Philippines, and Company B, located in Ukraine, are foreign subsidiaries of Company X (parent) (see figure 2.7). Company A uses peso currency for its local operations and Company B uses hryvnia as its local currency. However, the parent Company X, which is based in the United States, must report to the Securities and Exchange Commission (SEC); therefore, the presentation currency is the U.S. dollar. Company A and B's financial statements must be translated into U.S. dollars to consolidate Company X's financial statement.

Converting functional currency to presentation currency

The financial statements of an entity that uses functional currency other than the presentation currency must be converted into the presentation currency. Assets and liabilities are

Figure 2.7 Currency Conversion



converted at the spot exchange rate at the balance sheet date. Income and expenses are converted at exchange rates at the transactions. All resulting exchange differences should be classified as a separate component of equity of the reporting entity until disposal of the net investment in a foreign entity.

Effect of currency conversion on the balance sheet

Because the gains or losses from currency translation are recorded directly into equity, conversion affects the volatility of the balance sheet, not the income statement.

Transactions denominated in a foreign currency

Currency gains or losses may be incurred through the buying or selling of goods and services on different dates. The gains or losses are incorporated into the income statement.

As an illustration, on October 1, 2004, Company A (a U.S.-based company) purchased microchips on credit for 100,000 pesos. Company A paid the invoice on March 31, 2005. Table 2.17 shows the exchange rates and various effects.

KEY QUESTIONS

- What is the functional currency of the subsidiary?
- What is the presentation currency of the parent company?
- When translating the financial statements to the presentation currency, are the appropriate exchange rates applied to assets and liabilities and to income and expenses?

Table 2.17 Effect of Exchange Rates on Financial Statements

Date	Rate ($ per peso)	Effect
10/1/2004	$.10	The recording of the purchases would include $10,000 ($.10 × 100,000). This would increase the inventory (asset) and the liability (accounts payable).
12/31/2004	$.06	12/31/2004 is the balance sheet date of Company A. Appreciation of the U.S. dollar translates into a $4,000 (100,000 × $.10 – $.06) gain. This brings a $4,000 decrease to the liability account (accounts payable-balance sheet) and a corresponding $4,000 increase to the foreign exchange transaction gain on the income statement.
3/31/2005	$.09	On 3/31/2005 the vendor was paid a cash amount of $9,000 ($.09 × 100,000 pesos), with the following impact on the financial statements: • The liability account (accounts payable) on the balance sheet is reduced by $6,000 ($10,000 – $4,000). • The foreign exchange transaction produces a loss on the income statement in the amount of $3,000 ([$.06 – $.09] × 100,000 pesos).

Analyst's Role

Foreign exchange gains and losses arise in a variety of transactions. The analyst should:

- Identify the sources of these variables and take their effects into account when analyzing historical financial data.
- Gains and losses affect net income, and this trickles down to financial ratios such as profit margin, return on assets, and return on equity.

Hyperinflationary Economies (IAS 29)

Hyperinflationary environments can also affect financial analysis, cash flow projection, and comparisons of financial data across companies in the same industry. In some countries, financial statements are not adjusted to take into account the effect of inflation.

For example, because PP&E assets are recorded at cost on the balance sheet, the amount is not adjusted to reflect their estimated value as a result of inflation. Yet it is quite clear that when a firm maintains a building or equipment for a period of time, the historical cost reflected on the balance sheet is not the same as the market value. The value of the fixed assets bought in the past is seriously understated. Consequently, inflation distorts the financial statements. To address this matter, IFRS require all financial statements, including cash flow statements, to be restated into current purchasing power at the balance sheet date.

Restatement of financial statements

Financial statements may be restated by the following procedure:

- Select a general price index.
- Segregate monetary and nonmonetary items.
- Restate nonmonetary items, including deferred tax.
- Restate the income statement.
- Calculate and prove the monetary gain or loss.
- Preparate the cash flow statement recognizing inflationary effects.
- Restate corresponding figures.

KEY QUESTIONS

- Is the appropriate inflation index injected in the cash flow projections?
- What is the impact of the inflation rate on the valuation discount rate?

Analyst's Role

The analyst should:

- Use both nominal and real terms in the financial statements when valuing companies (see below).

Terms	Advantage	Disadvantage
Nominal	• Taxes on the financial statements can be calculated. • Changes in working capital are captured.	• Meaningful ratios are not captured to reflect the current position or performance of a firm. • Estimating future capital expenditures from the book value of fixed assets is an inefficient approach for cash flow projection.
Real	• Meaningful ratios are captured, such as return on invested capital (ROIC). • Valuable capital expenditure budget is formulated.	• Changes in working capital would not be captured for cash flow projections. • Taxes would not be calculated on the financial statements based on the designated accounting standards.

Insurance Contracts (IAS 4)

An insurance contract is an agreement between two parties concerning risk compensation. The insurer agrees to accept significant insurance risk incurred by the policyholder. The insurer agrees to compensate the policyholder when a specified and uncertain future event adversely affects the policyholder.

KEY QUESTIONS

- Did the analyst examine the insurer's liability account to make sure that it does not include any provisions of possible future claims not in existence in the balance sheet data?

Analyst's Role

The analyst should:

- Note that the insurer's financial statements cannot recognize liabilities on any provisions of possible future claims that are not in existence at the reporting date, and that the insurer cannot remove the insurance liability on the balance sheet unless the obligation is discharged.
- Consider fair value. At each reporting date, the insurer measures the adequacy of the insurance liabilities. The analyst should consider the validity of current liability estimates because it affects future cash outflows along with debt-related financial ratios. Any deficiencies should be reflected on the income statement.
- Be on the lookout for companies that might use the historical record of insurance liabilities at subsequent periods. This would distort the financial statements.
- Pay attention to the notes of the financial statements because they reflect relevant information on the amount, timing, and uncertainty of future cash flows from insurance contracts.

Segment Reporting (IAS 14)

Segment reporting captures the risks and returns relating to an entity's line of business and geographical scope. It can be divided into two types: business segment and geographical segment reporting. IAS 14 is used for companies in which securities are traded publicly and for those that are in the process of issuing their securities publicly.

What is a business segment?

A business segment is a distinct component of an entity that provides a single product or service or a group of related products and services (such as financial services for a consulting company), and is subject to risks and returns different from those of other business segments (such as demand for the product or services).

What is a geographical segment?

A geographic segment is a distinct component of an entity that provides products and services within a particular economic environment (i.e. the operational results of the Asian division of a global enterprise), and is subject to risks and returns different from those of components operating in other economic environments (i.e. interest rate risk, currency risk, and country risk).

KEY QUESTIONS

- Is the company deriving its revenue from a few key customers?
- Is the company relying on a single supplier?
- Is the company's revenue tied to one product source?
- Is the main focus of the company's operation overseas?

Analyst's Role

The analyst should:

- Be cognizant of market conditions that have an impact on value drivers, such as changes in macroeconomics elements, ferocious competitors, and elasticity of demand and prices. These variables affect financial analysis. Segment reporting highlights factors that generate value in a company's operation, such as its key products, customers, and suppliers.

Business Combinations (IFRS 3)

Business combination refers to the integration of different business entities into one reporting entity. Business combination is consummated through mergers, acquisitions, and tender offers.

Goodwill

Inherent in business combination is the recognition of goodwill if the cost paid for the acquisition is higher than the fair value of the acquired entity. The derived goodwill amount is reflected on the balance sheet and is tested periodically for impairment. However, if the fair market value of the acquired entity is higher than the cost, a "gain" is recognized in the income statement. Example of a goodwill transaction:

Description	Amount
Cost price of acquired entity	500,000
Fair market value of the acquired entity	(400,000)
Difference	
$100,000 is recorded on the balance sheet as "Goodwill"	**100,000**
Cost price of acquired entity	500,000
Fair market value of the acquired entity	(525,000)
Difference	
$25,000 is recorded on the income statement as a "Gain"	**(25,000)**

KEY QUESTIONS

- In the midst of business combination, is the goodwill account screened properly?
- Is the goodwill amount valid for inclusion in the valuation of the company?

Analyst's Role

The analyst should:

- Beware of comparing historical trends in periods of business combinations, when the normal estate of an entity becomes injected with variables from other periods that

cannot be compared reliably. In those circumstances, current financial ratios will not be meaningful.

- Be cognizant that valuation of goodwill is a subjective exercise because it is based on a valuer's assumptions. Nevertheless, high goodwill amounts would increase the total assets on the balance sheet and thus have an impact on the ratio analysis.
- Note that the effect of periodic impairment is reflected on the income statement. It's a non-cash expense that affects the reduction of net income and is carried forward to affect the equity account.
- Scrutinize the disclosures on business combinations in the annual report. They will provide key information on the nature of the combining entities, the elements that contributed to the recognition of goodwill, and how fair value is determined on the acquired entity.

Consolidated and Separate Financial Statements (IAS 27)

What are consolidated financial statements?

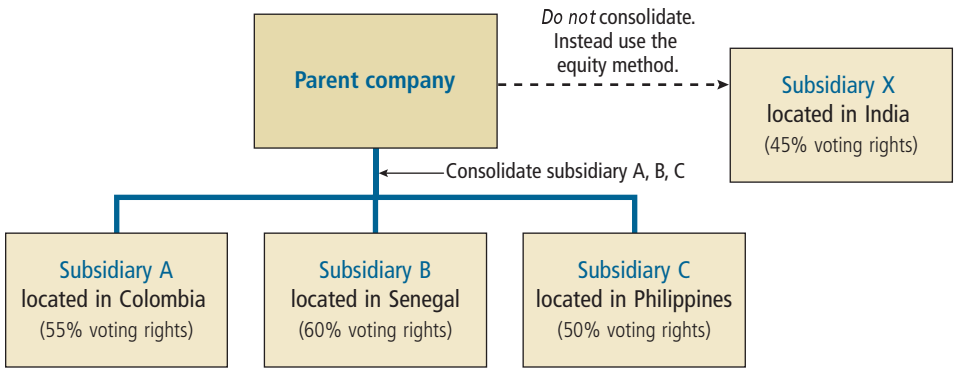
Consolidated statements integrate a parent company's financial statements with those of its respected subsidiaries, both domestic and foreign, as long as the parent's voting rights are greater than 50 percent. As a caveat, make sure that any transactions between the parent and its subsidiaries, such as the sale of goods from the subsidiary company to the parent company, are eliminated from the consolidated statements.

As an illustration, suppose a parent company must consolidate Subsidiary A, Subsidiary B, and Subsidiary C (see figure 2.8). On the other hand, it does not consolidate Subsidiary X because the control over the investee is less than 50 percent of the voting rights. The equity method is used to account for Subsidiary X.

KEY QUESTIONS

- Are all the subsidiaries, foreign and domestic, included in the consolidated financial statements?
- Which subsidiaries are the drivers of revenue and cost?

Figure 2.8 Consolidating Subsidiaries



- Which subsidiaries have maintainable and positive earnings? Which subsidiaries have negative earnings?
- If synergies are important to the valuation process, was this element included in the pro forma financial statements?
- What is the effect of any antitrust regulations on the value of the company?

Analyst's Role

The analyst should:

- Remember that one entity's weakness can be masked by another's strength. Because consolidated statements hide the uniqueness of a stand-alone entity, a thorough analysis must be conducted to determine its character. For example, if a stand-alone subsidiary is having debt-management and liquidity problems, these negative components will be concealed in the consolidated statements.
- Note that in the ratio analysis, rational depiction of the estate of a subsidiary will not be represented accurately. For example, intercompany transactions will be eliminated, but these are important components of the ratio analysis.
- Value each subsidiary separately, if feasible. The sum of the result is the enterprise value.
- Check to see whether a foreign subsidiary's operation has a different presentation and functional currency. In the earlier example of Subsidiaries A, B, and C, their financial statements must be translated into U.S. dollars, which is the presentation currency.
- Be aware that when antitrust regulations concerning mergers apply, certain assets will be disposed of. This element must be included in the projected financial statements.
- Remember that mergers and acquisitions affect the discount rate; therefore, apply the appropriate discount rate.

Cash Flow Statements (IAS 7)

Cash flow statements are integral components of the annual report that focus on the sources of cash (receipts or proceeds) and the use (expenditure or consumption) of cash. Because cash is at the heart of a company's survival, it is the key element critically scrutinized by market participants.

Cash flow statements consist of three components.

Operating activities

Cash inflow items include cash received from customers, sale of trading securities, interest income on loans, and dividends on equity securities.

Cash outflow items include cash paid to suppliers and employees, interest paid, income taxes paid, and cash paid for trading securities.

Investing activities

Cash inflow items include sale of assets, sale of securities (available-for-sale), and collection of notes receivable.

Cash outflow items include cash expenditures (divestiture and acquisition of real assets), loans made to other entities, and purchase of equity securities (other than trading).

Financing activities

Cash inflow items include proceeds from sale of a company's common stock and proceeds from issuance of mortgage bonds.

Cash outflow items include principal payment for bond indenture, purchase of treasury stocks, principal payment under finance lease obligation, and dividend payment.

KEY QUESTIONS

Regarding operating activities

- Is the company generating sufficient cash from its existing resources and capabilities?
- Did the company produce enough cash to pay its debt obligations?
- Are there any cash cushions to invest in new projects for future growth?
- Is there extra cash to pay dividends to shareholders?
- Is the "net cash provided by operating activities" experiencing a shortfall? This is a negative signal to both management and market participants.
- Did management tighten or loosen its credit policy affecting the collectivity of its accounts receivable?
- Do you find a continuous decline in operating cash? If so, what strategic plans is management developing to address this critical issue?

Regarding investing activities

- Is the investment in the construction of a manufacturing plant enhancing the capacity level for future demand of the company's product line?
- Are loans granted to related parties valid?
- Is the company selling any assets? What indicates the sale of its business segment?
- When operating cash is insufficient, how does the company cover the capital and investment expenditures?

Regarding financing activities

- Is the company going to issue bonds or stocks to finance its new developments?
- Is the company going to issue stocks to finance its new projects?
- Is the company able to pay dividends to its shareholders? Is the dividend payment low or high this year in comparison with other periods?

Analyst's Role

The analyst should:

- Recognize that the income statement contains recorded revenues that are not actually received and recorded expenses that are not actually paid. This is due mainly to

the fact that transactions are recorded on an accrual rather than cash basis. Furthermore, the use of accounting methods such as depreciation produces varied results in net income. Professional skepticism argues that management has the capability to manipulate earnings and has a vested interest in producing favorable bottom-line results. With the apparent transparency of cash in the cash flow statements, this is the most striking information about a company's actual performance.

- Know how a company that is expanding its operation—for example, by building a facility to expand production capacity—is financing the project. Will the company use its existing free cash flow and issue debt (which affects debt ratio) or issue stocks (which affect equity ratios)? The cash flow statement is an important tool for assessing the company's prospective growth, as well as the needed capital structure to finance the project.
- Examine the cash flow statement; it is a useful objective measure of the free cash flow used to value the firm. The valuation models use the results in their "operating activities."
- Scrutinize the answers to the questions above; they provide evidence of the company's lifeline. Close scrutiny is crucial in areas of suspicious activities.

Events after the Balance Sheet Date (IAS 10)

Financial statements must also capture critical events after the balance sheet date (year-end), such as the settlement of an ongoing legal case or acquisition of an entity. They must be taken into account to provide transparency about whether the operation is a going concern.

What are events after the balance sheet date?

These are events occurring between the end of the accounting year (for example, December 31, for a calendar-year operation) and the date of the auditor's report.

For example: If Company A's operating period runs from January 1 to December 31, its financial statements must show the events and adjustments outlined in table 2.18.

Adjusting events

Financial statements should be adjusted to reflect important events after the balance sheet date. Adjust the appropriate accounts in the balance sheet and income statements. Adjusting entries include:

- A discovery of fraud or error making the financial statements incorrect at year-end before the adjustments
- The verification after the balance sheet date of the cost of assets purchased, or verification of the proceeds from assets disposed before the balance sheet date
- Resolution after the balance sheet date of a court case that validates a current obligation requiring either an adjustment to an existing provision or recognition of a provision instead of disclosure of a contingent liability.

Table 2.18 Events after the Balance Sheet Date and Adjustments to the Financial Statements

Date	Event	Required?	Adjustments explanation
December 31	Company A's books are closed.	—	—
February 15	Start of audit fieldwork	—	—
February 18	Ongoing legal case with a former client was settled. A settlement of $1 million is to be paid for the entire legal cost.	Yes	Because the settlement amount is known before the issuance of the audit report, the December 31 financial statement is adjusted to reflect the $1 million as a liability.
February 22	Declaration date of dividend: 50 cents per share payable to holders of record on December 31	No	The transaction would be recorded on February 22, not December 31.
February 25	Sale of mortgage bonds	No	No adjustments are required, but disclosure is required in the notes of the financial statements.
February 28	Last day of audit fieldwork	—	The auditor is not required to perform any audit services for the client after February 28. However, if the auditor is aware of any subsequent events after this date, the auditor should consider any needed adjustments or disclosures. **Note: This is the report date of the audited financial statement.**
March 10	Annual report is submitted to the client.	—	—
March 31	Submission date to stock exchange agency (in the United States, it is the Securities and Exchange Commission) for public companies.	—	—

Nonadjusting events

Financial statements should not be adjusted to reflect nonadjusting events after the balance sheet date. Nonadjusting entries include:

- Decline in the market value of investments between the balance sheet date and the date when financial statements are issued
- Announcement of a plan to discontinue an operation
- Entity's declaration of a dividend after the balance sheet date.

KEY QUESTIONS

- Have the disclosures subsequent to the balance sheet date been examined? Pockets of value might be hidden behind these events.
- Does the annual report fail to disclose any significant events that have an impact on the operation, such as the loss of a vital customer, change in the management team, or new legislation?

Analyst's Role

The analyst should:

- Examine disclosures not included in the financial statements. The events to which they refer affect future cash flows, which in turn affect the estimate of the business's fair value.
- Look for events that were not disclosed on the financial statements but which could affect the valuation of the company, such as changes in the company's management team, termination of a key client's contract, or dwindling market demand for the client's product.

Extractive Industries (IFRS 6)

Extractive industries include minerals, oil, and natural gas resources.

Costs

The costs associated with extractive industries arise from rights to explore; topographical, geological, geochemical, and geophysical studies; drilling; activities related to evaluating technical feasibility; tunnels; and trenching.

Accounting methods

According to IFRS 6, companies may continue to use their existing accounting policies for exploration costs and evaluation of assets. Companies can defer these costs on the balance

sheet or recognize all the expenditures on the income statement. They must recognize actual cost for initial transactions but may use the cost model or revaluation model (table 2.19) to account for the cost of subsequent transactions.

Importance of impairment

Entities must conduct an impairment test on assets when facts and circumstances indicate that the carrying amount on the balance sheet is greater than the recoverable value (that is, the net selling price).

Circumstances that call for an impairment test of an entity's assets include:

- When an entity's right to explore has expired during the period or will expire in the near future, and renewal is not expected.
- When an entity has conducted further substantial exploration and evaluation of mineral resources that are neither budgeted for nor planned.
- When the exploration and evaluation of mineral resources have not uncovered adequate quantities of mineral resources, and the entity decides to discontinue the project.
- When there are sufficient data to suggest the carrying amount is unlikely to be recovered.

KEY QUESTIONS

- How reliable is the valuation of the size of the company's natural resource deposits?
- Are commodity prices and extraction costs included in the valuation process?
- What impact will the volatility of commodity prices have on the projected income statement?
- To what extent is the reported result based on management's assumption? Is it reliable, relevant, and measurable?

Table 2.19 Consequences of Different Accounting Methods

Description	Cost model	Revaluation model
Nature of accounting method	The asset is carried at cost less depletion expense and impairment loss.	The asset is carried at a revalued amount. The revaluation process is carried out regularly.
When revaluation increases	Added to the asset's carrying amount and depleted accordingly	The equity of the balance sheet is increased. The heading "Revaluation Surplus" is used on the equity section.
When revaluation decreases	The asset's carrying amount is decreased and accumulated depletion adjusted accordingly.	Recognized as an expense on the income statement.

Analyst's Role

The analyst should:

- Determine how asset impairment is being measured. If assets are not revalued accordingly, this distorts the financial statements. For example, if loss due to asset impairment is not recognized, the asset account will be overstated and will fail to depict the financial position of the company.
- Note that IFRS 6 does not require or prohibit any specific accounting policies for the recognition and measurement of exploration and evaluation assets. Therefore, companies are more flexible to choose methods that would ultimately portray a better financial performance.
- Look at the disclosures to the notes of the financial statements because they will reveal the company's accounting policies and indicate whether exploration and evaluation expenditures have been recognized. Make sure that the methodology used across the period of operation is consistent.
- Be cognizant that the amount of proven and probable deposits of natural resources is a key driver of value, coupled with commodity prices and extraction costs.

Agriculture (IAS 41)

Agriculture consists of the management of biological transformation of plants and animals into an end product that may be consumed or processed further. Some examples are livestock farming, forestry, annual and perennial cropping, the cultivation of orchards, plantation, and aquaculture.

Value of agricultural assets

Agricultural assets are valued at fair market value less point-of-sale costs (that is, commissions to brokers and dealers and transfer taxes) on the balance sheet. For example, a purchase of livestock would increase the asset account. The value of agricultural assets may change in relation to a market index and must be adjusted accordingly. These changes in value are reported in the income statements.

How is the fair value of agricultural produce measured?

One measure is the quoted market price in an active market. If market prices are not available, fair value is estimated using the present value of expected net cash flows derived from the use of the asset. See table 2.20 for an example.

KEY QUESTIONS

- What is the market demand for the agricultural product?
- If market-determined prices are not preset in the active market, what method of valuation has been used? Is it a reliable measure?
- If the company receives an unconditional government grant related to the biological asset, how will it affect the valuation process?

Table 2.20 Measuring the Fair Value of Livestock

Date	Value	Effect on financial statements
January 1	Purchase of livestock at market price, $500,000 (200 head × $2,500 per cow) plus commission cost of $10,000	The asset account (Dairy Livestock) increases by $490,000 ($500,000 – $10,000) on the balance sheet.
March 31	Fair value increases to $3,000 per head in accordance with a quoted market price.	For the same quantity of livestock, a gain of $100,000 (200 × [$3,000 – $2,500]) is recorded in the income statement.

Analyst's Role

The analyst should:

- Note how fair value is measured. If reliable market-based prices are not available, evaluate the method used. For example, in calculating the present value of expected net cash flows, consider the validity of the discount rate that is used.
- Scrutinize the notes to the financial statements, especially the financial risk management strategies. Agricultural product prices are volatile; ultimately, this affects the company's operation.
- When market-determined prices or values are not available, derive the value by discounting the expected net cash flows to present value.

Disclosures in the Financial Statements of Banks and Similar Financial Institutions (IAS 30)

IAS 30 covers the standards of disclosures in the financial statements of banks and similar financial institutions. However, effective in 2007, IAS 30 will be superseded by IFRS 7. IAS 30 provides comprehensive disclosures to help users better understand the financial position and performance of banks.

The following are some of the required presentation and disclosures (see chapter 3, part 2 for an example).

Balance sheet

- Group assets and liabilities by nature
- Accounts in terms of liquidity sequence
- Loan reserves
- Fair value of financial securities.

Income statements

- Group income and expenses by nature (for examples, see chapter 3, part 2).

Notes

- Banking risks
- Contingencies and commitments
- Maturity groupings of assets and liabilities
- Related party transactions.

KEY QUESTIONS

- What degree of uncertainty is associated with valuing these assets?
- Have the disclosures of contingencies and commitments, including off balance sheet items, been fully scrutinized? These items have an adverse effect on an entity's valuation.

Analyst's Role

The analyst should:

- Consider transparency. Because banks and other financial institutions play a key role in the financial cycle of the global market, their operational transparency is vital to the market participant's trust. The analyst is relied on to relate concrete information about current performance, risks, and growth potential of the banking institutions.
- Study annual reports. They disclose off-balance-sheet transactions such as commitments and contingencies, which should be scrutinized because they affect the future cash flow of the bank, and the valuation of the firm.
- Question the valuation of the financial assets and financial liabilities. Its figures are based not only on market factors but also on management's judgments or best estimates. Ultimately, management has the power to overestimate the value of assets and thereby deceive innocent investors.
- Assess the financial risk associated with the bank's operation. Quantitative scrutiny is important and should cover details such as financial ratios, capital adequacy, and loan portfolio quality, coupled with the qualitative factors. Disclosures are among the qualitative factors that shed light on how management's corporate governance, internal control, and information system run the operation.

Related Party Disclosures (IAS 24)

A related party is one of two entities conducting business transactions together. The primary features of this relationship are:

- Ability to control the other party
- Capacity to exercise significant influence in financial and operating decisions
- Joint control over the other

- A key role in management of the other entity
- Role as a close family member of key management individuals.

Figure 2.9 illustrates Company A's function as a related party.

Types of related party transactions include selling or purchasing goods and services, selling or purchasing property and other assets, leasing arrangements, and financing.

KEY QUESTIONS

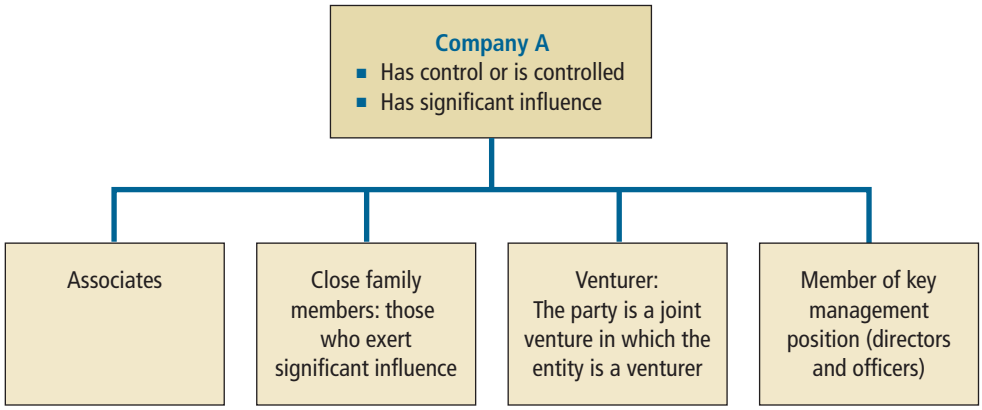
- Are any significant related-party transactions materially relevant to the valuation of the firm?
- Will the enterprise remain viable if the related party decides to terminate the service?

Analyst's Role

The analyst should:

- Analyze notes to the annual report to identify the types of related transactions embedded in the financial statements. Pay close attention to the transactions near the reporting periods (such as December 31). These unusual transactions could bolster earnings greatly but also could send a negative signal to the valuation.
- Do not assume that related-party transactions are conducted at arm's length. Some examples are borrowing money at an unusual interest rate or purchasing or selling goods at an abnormally low or high price.

Figure 2.9 A Related Party



Interim Financial Reporting (IAS 34)

During the interim period, corporations are required to report their financial statements to regulatory agencies (in the U.S., for example, quarterly statements must be submitted to the Securities and Exchange Commission). International Financial Reporting Standards (IFRS) do not mandate the following:

- Which companies should publish interim financial reports
- Frequency of reporting
- Deadline of submission.

However, IFRS encourages publicly traded companies to make the interim financial reports available at least 60 days after the end of the interim period.

Contents of an interim financial report

Contents of an interim financial report include a condensed balance sheet, condensed income statement, condensed statement of changes in equity, condensed cash flow statement, and explanatory notes.

KEY QUESTIONS

- Are accounting policies and methods consistent with those that will be used for the next full financial year?
- Are revenues recognized when earned and costs recognized when incurred?
- Is the tax charge calculated using the effective tax rate expected for the full year?

Analyst's Role

The analyst should:

- When using interim financial statements to assess an enterprise in accordance with relative valuation methodology, make sure the basis of the amount is relevant to the calculation. For example, if the interim financial statements are dated September 30 (covering three quarters) and you want to extract the EBITDA amount using the latest financials, you must annualize the amount to cover four quarters.
- Use accounting policies and methods for the interim statements that were used in preparing the annual reports.
- Note that, in general, interim statements are not audited. Some countries (for example, the U.S.) require them to be reviewed by independent auditors.
- Make sure the income tax expense is calculated using the estimated annual effective tax rate applicable for the entire year.

Small and Medium-Sized Entities

Currently, there are no specific IFRS pronouncements for small and medium-sized entities (SMEs). However, IASB is keenly aware that SMEs are in dire need of their own customized accounting standards.

With IAS 8 (Accounting Policies) as a guide, an entity is expected to develop and apply accounting policies that are both relevant and reliable. It would not be prudent to apply IFRS in full to SMEs' financial reporting because of the smaller scale of their operations and, hence, simpler accounting needs. Forcing SMEs to use comprehensive and complex IFRS would neither be relevant nor ensure reliability.

On a global level, however, IFRS could be used to meet the varied needs of market participants, for reliable financial information, to assist in cross-border lending, and to streamline the preparation of financial statements. Indeed, IASB's customized standards for SMEs would reassure global stakeholders.

For the time being, SMEs could fall back on IFRS concepts and apply them accordingly, given that the financial statements would not be extensive. Obviously, the account categories (chart of accounts) and disclosures would be more limited than for larger corporations.

CHAPTER 3

Illustrative Set of Financial Statements

In this chapter, the following industries will be highlighted through the presentation of illustrative financial statements:

- General manufacturing
- Banking
- Small and medium-sized entities (SMEs)

Part I. General Manufacturing and Commercial Enterprises

This section provides a full set of illustrative financial statements of general manufacturing and commercial enterprises, prepared in accordance with the International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (GAAP). They are also presumed to have been audited in compliance with the International Standards on Auditing (ISA) and the Generally Accepted Auditing Standards (GAAS).

IFC requires that all financial statements submitted to the corporation from client companies to be prepared and audited in accordance with IFRS and ISA. However, IFC may accept the client's financial statements prepared on the basis of other national GAAPs (e.g. US GAAP) only if agreed upon in the legal contract audited by a reputable local accounting firm and international firm.

The formats of the illustrative financial statements are tailored to the needs of IFC in order to facilitate the financial data transfer into our financial analyses applications (e.g. Moodys Financial Analyst) but they do not deviate from the requirements of the major accounting standards. All IFC clients are to use this formats as applicable in providing their interim and year-end financial statements to IFC.

The illustrative statements have been designed to create a realistic set of the financial statements for a corporate entity. Not all possible transactions have been included on the statements, as some items may be particular to each *entity depending on the nature of the business and the industry sector.* A company and its auditors may include additional information deemed important to the potential readers of the financial statements. Additional disclosures may also be required by IFC as part of the contractual agreement.

Exhibit 1. Consolidated Balance Sheet (IFRS)

IBI International Holding Company
For Fiscal Ending December 31, XXXX
($-in thousands)

Description	Note	As of 31 December 2005	2004
ASSETS			
Non-current assets			
Construction in Progress		—	—
Land and Buildings	3	95,129	39,330
Leasehold Improvements		—	—
Plant & Equipment (including machinery)	3	58,268	66,903
Furniture & Fixtures	3	26,927	20,026
Vehicles & Transport Equipment		—	—
Other Fixed Assets		—	—
Gross fixed assets	**3**	**180,324**	**126,259**
Accumulated Depreciation & Impairment (–)		(24,983)	(27,589)
Net fixed assets		**155,341**	**98,670**
Goodwill	4	15,992	12,000
Accumulated Goodwill Impairment (–)		—	—
Trademarks and Licenses	4	14,480	7,710
Other Intangible Assets	4	1,800	1,300
Accumulated Amortization & Impairment (–)	4	(6,850)	(1,410)
Net intangibles		**25,422**	**19,600**
Investment Property (Net)		—	—
Investments in Associates	5	13,373	13,244
Investments in JVs & Partnerships		—	—
Available-for-Sale Financial Assets	6	17,420	14,910
Due from Related Parties (Net)		—	—
Loans to Related Parties (LTP)		—	—
Due from Officer/Shareholder—LTP		—	—
Securities & Other Fincl Assets		—	—
Derivatives & Hedging Instruments	7	395	245
Retirement Plan Actuarial Surplus		—	—
Other Non-Current Assets		—	—
Deferred Income Tax Assets	16	3,319	3,110
Trade and Other Receivables (Net)—LTP	8	2,322	1,352
Prepayments and Other Accrued Assets—LTP		—	—
Restricted Cash		—	—
Total Investment and other non-current assets		**36,829**	**32,861**
Total non-current assets		**217,592**	**151,131**

Exhibit 1. Consolidated Balance Sheet (IFRS) *(Continued)*

Description	Note	As of 31 December 2005	2004
Current assets			
Operating Lease Receivables		—	—
Inventories	9	24,700	17,740
Due from Associates		—	—
Due from JVs & Partnerships		—	—
Due from Related Parties (Net)—CP	8	400	82
Due from Officer/Shareholder—CP		—	—
Securities & Other Financial Assets		—	—
Available-for-Sale Financial Assets	6	1,950	—
Derivatives & Hedging Instruments—CP	7	1,069	951
Other Financial Assets at Fair Value Thru P&L	10	11,820	7,972
Current Tax Receivables		—	—
Prepayments and Accrued Assets	8	1,300	1,146
Other Current Assets		—	—
Trade Receivables (Gross)	8	18,174	16,944
Allowance for Doubtful Accounts (-)	8	(109)	(70)
Other Receivables (Net)—CP		—	—
Cash and Cash Equivalents	11	22,228	36,212
Total current assets		**81,532**	**80,977**
Total assets		**299,124**	**232,108**
Equity & reserves			
Share Capital—Common	12	25,300	21,000
Share Capital—Preferred			
Share Premium	12	18,656	11,316
Reserves—Capital/Restricted			
Permanent equity		**43,956**	**32,316**
Reserves—Revaluation	13	1,689	1,774
Reserves—Hedging	13	126	62
Other Reserves	13	1,794	1,402
Retained Earnings		77,297	57,271
Treasury Shares (-)	12	(2,564)	—
Foreign Currency Translation—Equity	13	5,707	3,787
Subordinated Debt—Equity	13	5,433	—
Other Equity		—	—
Accumulated Other Equity Reserve Income		—	—
Equity & reserves		**89,482**	**64,296**
Minority Interests—Equity		7,188	1,766
Total equity & reserves		**140,626**	**98,378**

Exhibit 1. Consolidated Balance Sheet (IFRS) *(Continued)*

Description	Note	As of 31 December 2005	2004
Non-current liabilities			
Long term Debt—Bank	15	32,193	40,244
Long term Debt—Other		—	—
Long Term Debt—Convertible	15	42,822	
Long Term Debt—Subordinated	15	3,300	18,092
Redeemable Preference Shares	15	30,000	30,000
Due to Related Parties & Associates—LTP		—	—
Due to Officer/Shareholder—LTP		—	—
Finance Leases—LTP		—	—
Other Non-Current Liabilities		—	—
Advances & Deferred Income—LTP		—	—
Derivatives & Hedging Instruments—LTP	7	135	129
Social Security & Other Taxes—LTP		—	—
Decommissioning & Envirnmntl Costs—LTP	18	320	274
Share Options & Associated Costs—LTP		—	—
Retirement & Associated Benefits—LTP	17	4,540	2,130
Deferred Income Tax Liability	16	12,370	9,053
Restructuring Provision—LTP		—	—
Other Provisions—LTP		—	—
Total non-current liabilities		**125,680**	**99,922**
Current liabilities			
Long Term Debt CP—Bank	15	3,368	4,598
Long Term Debt CP—Other		—	—
Long Term Debt CP—Convertible		—	—
Long Term Debt—Subordinated	15	2,492	4,608
Short Term Loans Payable—Bank		—	—
Short Term Loans Payable—Other	15	1,014	—
Overdrafts	15	2,650	6,464
Due to Related Parties & Associates—CP	14	2,202	1,195
Due to Officer/Shareholder—CP		—	—
Finance Leases—CP		—	—
Other Accrued Current Liabilities	14	1,483	828
Advances & Deferred Income—CP		—	—
Billings in Excess of Costs		—	—
Derivatives & Hedging Instruments—CP	7	460	618
Current Income Tax Payable		2,942	2,846
Interest Payable		—	—
Social Security & Other Taxes—CP	14	2,002	960
Dividends Payable		—	—
Trade Payables—CP	14	11,983	9,391
Decommissioning & Environmntl Costs—CP	18	531	472
Retirement Benefit Obligations		—	—
Restructuring Provision—CP	18	1,100	—
Other Provisions for Other Liabilities and Charges		591	1,828
Total current liabilities		**32,818**	**33,808**
Total liabilities		**158,498**	**133,730**
Total equity and liabilities		**299,124**	**232,108**

Exhibit 2. Consolidated Income Statement (IFRS)

($-in thousands)

Description	Note	As of 31 December 2005	2004
Sales/Revenues		211,034	112,360
Cost of Sales		(71,538)	(48,982)
Changes in Inventories & Work-In-Process		(5,828)	2,300
Expenses/Own Work Capitalized		—	—
Total cost of sales		**(77,366)**	**(46,682)**
Gross profit		**133,668**	**65,678**
Rents, Royalties and Other	19	1,873	2,442
Grants & Subsidies		—	—
Selling & Marketing Costs		(46,690)	(20,648)
General & Administrative Expenses		(28,786)	(10,434)
Personnel & Benefit Expenses		—	—
Provision for Retirement/Benefit Costs		—	—
Share Options & Associated Costs		—	—
Officers' Compensation		—	—
Operating Lease Expenses		—	—
Research and Development		—	—
Restructuring Costs & Provisions		—	—
Bad Debt Expense		—	—
Other Operating Expenses		—	—
Other Non-Cash Oper Expense/Provisions		—	—
Total operating expenses (excl.deprec. and amort.)		**(73,603)**	**(28,640)**
Earning before interest, tax and depreciation (EBITDA)		**60,065**	**37,038**
Depreciation & Impairment—Tangibles		—	—
Amortization & Impairment—Intangibles		(800)	(565)
Impairment—Goodwill		(4,650)	—
Capitalized Costs (Excl. Interest)		—	—
Earning before interest and tax (EBIT)		**54,615**	**36,473**
Interest Expense (–)	20	(7,803)	(7,234)
Capitalized Interest Expense		—	—
Interest Income		—	—
Net Foreign Exchange Transactions Gains/(Losses)	20	2,594	(1,995)
Fair Value Gains/(Losses) on Financial Assets	20	86	119
Dividend/Other Income from Financial Assets	20	(1,950)	(1,950)
Other Gains(Losses) on Financial Assets		—	—
Adjustments on Securitization Programs		—	—
Net interest and other financial costs (income) expenses		**(7,073)**	**(11,060)**
Income(Loss) from Associated Entities	5	(174)	145
Income(Loss) from JVs & Partnerships		—	—
Income(Loss) from Other Related Parties		—	—
Gain(Loss) on Disposal of Fixed Assets		—	—
Gain(Loss) on Investment Properties		—	—

Exhibit 2. Consolidated Income Statement (IFRS) *(Continued)*

Description	Note	As of 31 December 2005	2004
Net interest and other financial costs (income) expenses (*continued*)			
Gain(Loss) on Disp of Discontinued Operations		—	—
Exchange Gain(Loss)—Sale of Business		—	—
Other Non-Operating Income(Expense)		—	—
Other Non-Cash Non-Oper Income(Expense)		—	—
Other income(expense)		**(174)**	**145**
Profit(loss) before tax		**47,368**	**25,558**
Current Income Taxes	21	14,413	6,230
Deferred Income Taxes	21	379	2,635
Tax Adjustment—Prior Year			
Total income tax		**14,792**	**8,865**
Profit before extraordinary income		**32,576**	**16,693**
Extraordinary Gain(Loss)—After Tax		—	—
Other After Tax Income(Expense)		—	—
Other After Tax Non-Cash Income(Expense)		—	—
Net profit(loss)		**32,576**	**16,693**
Attributable to:			
Equity Holders of the Company		31,376	37,635
Minority Interests		1,200	1,201
Total profit		**32,576**	**38,836**
Earnings per share for profit attributable to the equity holders of the Company during the year (expressed in $ per share)			
— basic	Note 26	**1.28**	**0.77**
— diluted	Note 26	**1.16**	**0.73**

Exhibit 3. Consolidated Statement of Changes in Equity (IFRS)

($-in thousands)

Description	Note	Attributable to equity holders of the company			Minority interest	Total equity
		Share capital	Other reserves	Retained earnings		
Balance at 1 January 2004		30,424	6,364	57,083	1,500	95,371
Fair value gains and (losses), net of tax:						
• land and buildings		—	759	—	—	759
• available-for-sale financial assets		—	68	—	—	68
Depreciation transfer, land and buildings		—	(87)	87	—	—
Cash flow hedges, net of tax		—	(3)	—	—	(3)
Net investment hedge		—	40	—	—	40
Currency translation differences		—	(116)	—	(40)	(156)
Net income/(expense) recognised directly in equity		—	661	87	(40)	708
Profit for the year		—	—	15,837	856	16,693
Total recognised income for 2004		**—**	**661**	**15,924**	**816**	**17,401**
Employees share option scheme:						
• value of employee services		822	—	—	—	822
• proceeds from shares issued		1,070	—	—	—	1,070
Dividend relating to 2003		—	—	(15,736)	(550)	(16,286)
Sub-total		1,892	—	(15,736)	(550)	(14,394)
Balance at 31 December 2004		32,316	7,025	57,271	1,766	98,378
Balance at 1 January 2005		32,316	7,025	57,271	1,766	98,378
Fair value gains and (losses), net of tax:						
• available-for-sale financial assets	13	—	406	—	—	406
Depreciation transfer, land and buildings	13	—	(100)	100	—	—
Cash flow hedges, net of tax	13	—	64	—	—	64
Net investment hedge	13	—	(45)	—	—	(45)
Currency translation differences	13	—	1,966	—	252	2,218
Net income recognised directly in equity		—	2,291	100	252	2,643
Profit for the year		—	—	30,028	2,548	32,576
Total recognised income for 2005		**—**	**2,291**	**30,128**	**2,800**	**35,219**
Employee share option scheme:						
• value of employee services	12	690	—	—	—	690
• proceeds from shares issued	12	950	—	—	—	950
Issue of share capital—business combination	12	10,000	—	—	—	10,000
Purchase of treasury shares	12	(2,564)	—	—	—	(2,564)
Convertible bond—equity component	13	—	5,433	—	—	5,433
Dividend relating to 2004		—	—	(10,102)	(1,920)	(12,022)
Minority interest arising on business combinations		—	—	—	4,542	4,542
		9,076	5,433	(10,102)	2,622	7,029
Balance at 31 December 2005		**41,392**	**14,749**	**77,297**	**7,188**	**140,626**

Exhibit 4. Cash Flow Statements (IFRS-Indirect)

($-in thousands)

Description	Note	As of 31 December 2005	2004
OPERATING ACTIVITIES			
Net profit		32,576	16,693
Depreciation and Impairment Charge		17,754	9,662
Amortization Expense		800	565
Goodwill Impairment Charge		4,650	—
Income Tax Paid		14,792	8,865
(Profit)/Loss on Disposal of Fixed Assets		(17)	8
(Profit)/Loss on Disposal of Financial Assets		—	—
Net Movements in Provisions for Liabilities and Charges		43	—
Fair Value (FV) Gains on Derivative Financial Instruments		172	207
FV (Gains)/Losses on other Financial Assets at FV thru P&L		506	232
Foreign Exchange (Gains)/Losses (non-cash)		(2,594)	1,955
Investment Income		—	—
Associates—(Gains)/Losses Share (Net of Dividends)		174	(145)
Interest Income Received (Operating)		(1,180)	(1,120)
Interest Expense Paid (Operating)		9,753	9,184
Dividend Income		(2,230)	(1,400)
(Gains)/Losses from Extraordinary Items		—	—
Minority Interests		—	—
Changes in working capital		—	—
Chg in Provisions		—	—
Chg in Post Employ Benefit Obligtns		—	—
Chg in Trade Receivables		(1,518)	(2,966)
Chg in Other Receivables		—	—
Chg in Inventories		(6,489)	(962)
Chg in Prepayments		—	—
Chg in Other Current Assets		—	—
Chg in Trade Payables and Other Payables		(9,416)	565
Chg in Other Current Liabilities			
Chg in Other Financial Instruments Thru P&L		(4,354)	(858)
Chg in Other Working Capital Items		—	—
Chg in Income Taxes Payable		(14,517)	(10,974)
Chg in Deferred Taxes		—	—
Chg in Interest Payable		(9,170)	(9,184)
Dividends Received (Operating)		—	—
Dividends Paid (Operating)		—	—
Other Non-Cash Adjustments (Oper)		—	—
Cash flows from operating activities		**29,735**	**20,327**

Exhibit 4. Cash Flow Statements (IFRS-Indirect) *(Continued)*

Description	Note	As of 31 December 2005	2004
INVESTING ACTIVITIES			
Purchase of Intangible Assets	4	(3,050)	(700)
Proceeds from Sale of Intangible Assets		—	—
Purchase of Property, Plant and Equipments	3	(9,755)	(6,042)
Proceeds from Sale of Property, Plant and Equipments	22	6,354	2,979
Purchase of Investment Property		—	—
Proceeds from Sale of Investment Property		—	—
Purchase of Financial Assets	6	(2,781)	(1,126)
Proceeds from Sale of Financial Assets		—	—
Purchase of Other Assets		—	—
Proceeds from Sale of Other Assets		—	—
Investment in Associates & Affiliates		—	—
Sale of Associates & Affiliates		—	—
Acquisition of Subsidiaries(Net of Cash Acquired)	23	(3,900)	—
Proceeds from Sale of Subsidiary		—	—
Payment of Finance Lease Liabilities		—	—
Interest Received (Investing)		1,180	359
Dividends Received (Investing)		2,230	1,396
Loans Granted to Related Parties	24	(1,343)	(112)
Loan Repayments Received from Related Parties	24	63	98
Cash Flow from Extraordinary Items (Invest)		—	—
Cash Flow from Hedging on Investment Securities		—	—
Cash Flow Other Investing Activities		—	—
Net cash flows from investing activities		**(11,002)**	**(3,148)**
FINANCING ACTIVITIES			
Net Proceeds-Issuance of Share Capital	12	950	1,070
Purchase/Sale of Treasury Stock	12	(2,564)	
Proceeds from Issuance of Convertible Bonds	25	50,000	
Proceeds from Issuance of Redeemable Preferred Shares		—	30,000
Proceeds from Borrowings		8,500	18,000
Repayments of Borrowings		(74,302)	(37,738)
Change in other Current Liabilities		—	—
Interest Paid (Financing)		—	—
Translation Adjustment Relating to Cash		—	—
Cash Flows from Extraordinary Items (Fin)		—	—
Cash Flows from Hedging (Fin)		—	—
Dividends Paid to the Company's Shareholders		(10,102)	(15,736)
Dividends Paid (Minority Shareholders)		(1,920)	(550)
Other Cash Flows from Financing		—	—
Cash flows from financing activities		**(29,438)**	**(4,954)**
Net (decrease)/increase in cash and bank overdrafts		(10,705)	12,225
Cash and bank overdrafts at the beginning of the year		29,748	17,587
Net Foreign Exchange Difference		535	(64)
Cash and bank overdrafts at end of the year	11	**19,578**	**29,748**

Notes to Financial Statements

Purpose of notes to the financial statements

The purpose of the notes is to provide information about:

- the basis of preparation of the financial statements and the specific accounting policies
- the information required by accounting standards (IFRS) that is not presented on the face of the balance sheet, income statement, statement of changes in equity and cash flow statement
- additional information that is not presented on the face of the balance sheet, income statement, statement of changes in equity and cash flow statement, but is relevant to an understanding of any of them

We suggest to disclose significant accounting policies as a separate note before the remainder of the notes. This way accounting policies are given more prominence and are not lost within the individual notes to the financial statements.

Disclosure of significant accounting policies

An entity should disclose in the summary of its significant accounting policies:

- the measurement basis (or bases) used in preparing the financial statements
- the other accounting policies used that are relevant to an understanding of the financial statements
- the judgments used in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognized in the financial statements
- information about the key assumptions concerning the future, and other key sources of estimation at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year

IFRS compliance

An entity whose financial statements comply with IFRS must make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRS unless they comply with all the requirements of IFRS.

Basis of preparation used in preparing the financial statements

It is important for users to be informed of the measurement basis or bases used in the financial statements (for example, historical cost, current cost, net realizable value, fair value or recoverable amount) because the basis on which the financial statements are prepared significantly affects their analysis. When more than one measurement basis is used in the financial statements, for example when particular classes of assets are revalued, it is sufficient to provide an indication of the categories of assets and liabilities to which each measurement basis is applied.

Other significant accounting policies

In deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in the reported financial performance and financial position. Disclosure of particular accounting policies is especially useful to users when those policies are selected from alternatives that are allowed in Standards and Interpretations. Some Standards specifically require disclosure of particular accounting policies, including choices made by management between different policies they allow (e.g. IAS 16 requires disclosure of the measurement bases used for classes of property, plant and equipment).

Each entity considers the nature of its operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity. The accounting policies that an entity might consider presenting include, but are not limited to, the following:

- Revenue recognition
- Consolidation principles
- Business combinations
- Joint ventures
- Recognition and depreciation/amortization of tangible and intangible assets
- Capitalization of borrowing costs and other expenditure
- Employee benefit costs
- Foreign currency translation
- Hedging
- Inflation accounting
- Government grants
- Impairments for tangible, intangible and financial assets
- Taxes, including deferred taxes
- Provisions
- Definition of cash and cash equivalents
- Definition of business and geographical segments and the basis for allocation of costs between segments
- Construction contracts
- Investment properties
- Financial instruments and investments
- Financial and operating leases
- Research and development costs
- Inventories

Illustrative examples of accounting policies

IBI International Holding Co. is a holding company incorporated in Eastern Europe.

Note 1. Summary of Significant Accounting Policies

Basis of preparation

During the ordinary course of business, events occur that leads to accounting for these transactions. Such events maybe in the form of sale of goods or services, purchasing of equipments,

paying employees, acquiring debt financing, and issuing stocks. These events are captured quantitatively in the financial statements. The accounting standards of capturing these transactions are embodied in IFRS. As a component of IFRS, each entity is required to account for these transactions on a cost basis; subsequently, other accounts, such as derivatives, are revalued to reflect the fair value at each reporting/balance sheet date (i.e. December 31, XXXX).

Financial asset

The following are the relevant standards to use:

- IFRS 7 Financial Instruments: Disclosures (effective January 1, 2007)
- IAS 32 Financial Instruments: Disclosure and Presentation
- IAS 39 Financial Instruments: Recognition and Measurement

Financial assets are items such as common stocks, preferred shares, and debt securities. Financial assets are classified as one of the categories:

- Financial assets at fair value through profit or loss
- Available-for-sale
- Loans and receivables
- Held-to-maturity investments

Based on management's intention, classification of the financial asset is determined. Subsequent to the initial recognition of most financial instruments, they are revalued using the fair value at the balance sheet date (i.e. December 31, XXXX). The gains and losses derived from adjustments are reflected in the income statements.

Derivative financial instruments and hedging activities

The following are the relevant standards to use:

- IFRS 7 Financial Instruments: Disclosures (effective January 1, 2007)
- IAS 32 Financial Instruments: Disclosure and Presentation
- IAS 39 Financial Instruments: Recognition and Measurement

Financial derivatives are initially recognized in the balance sheet at cost and subsequently measured at their fair value. The method of recognizing the resulting gain or loss depends whether or not the derivative is designated as a hedging instrument, and the nature of the item being hedged.

The corporation designates certain derivatives as either:

- *Fair value hedge.* hedges of the fair value of recognized assets or liabilities or a firm commitment
- *Cash flow hedge.* hedges of a particular risk associated with a recognized asset or liability or a highly probable forecast transaction
- *Net investment hedge.* hedges of a net investment in a foreign operation

Certain derivative transactions, while providing effective economic hedges under the corporation's risk management policies, do not qualify for hedge accounting under the specific rules in IAS 39 and therefore changes in the fair value of such non-qualifying hedge instruments are immediately recognized in the income statement under financial items.

Property, plant and equipment

IAS 16 covers the standards for property, plant and equipment.
IAS 36 covers the standards for impairment of assets.

Land and buildings comprise mainly factories, retail outlets and offices. Land and buildings are shown at fair value, based on periodic valuations by external independent valuers, less subsequent depreciation for buildings. All other property, plant and equipment is stated at historical cost less depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred.

Land is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate their cost or revalued amounts to their residual values over their estimated useful lives, as follows:

- Buildings 25–40 years
- Machinery 10–15 years
- Vehicles 3–5 years
- Furniture, fittings and equipment 3–8 years

The assets' residual values and useful lives are reviewed and adjusted if appropriate at each balance sheet date. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in the income statement. When revalued assets are sold, the amounts included in other reserves are transferred to retained earnings.

Intangible assets

IAS 38 covers the standards for intangible assets.

Intangible assets are items such as goodwill, computer software, and patents.

Computer software. Acquired computer software licenses are capitalized on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortized over their estimated useful lives (three to five years).

Costs associated with developing or maintaining computer software programs are recognized as an expense incurred. Costs that are directly associated with the production of identifiable and unique software products controlled by the Group and that will probably generate economic benefits exceeding costs beyond one year, are recognized as intangible assets.

Goodwill. Represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary/associate at the date of acquisition.

Inventories

IAS 2 covers the standards for inventories.

Inventories are stated at the lower of cost and net realizable value. Cost is determined using the first-in, first-out (FIFO) method. The cost of finished goods and work in progress comprises design costs, raw materials, direct labor, other direct costs and related production overheads. Net realizable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses.

Borrowings

The following are the relevant standards to use:

- IFRS 7 Financial Instruments: Disclosures (effective January 1, 2007)
- IAS 32 Financial Instruments: Disclosure and Presentation
- IAS 39 Financial Instruments: Recognition and Measurement
- IAS 23 Borrowing Costs

Borrowings are recognized initially at fair value, net of transaction costs. Borrowings are subsequently stated at amortized cost; any difference between the proceeds (net of transaction) and the redemption value is recognized in the income statement over the period of the borrowings using the effective interest method.

Employee benefits

IAS 19 covers the standards for employee benefits.
IAS 26 covers the standards for accounting and reporting by retirement benefit plans.

Pension obligations. The company has both defined benefit and defined contribution plans. A defined contribution plan is a pension plan under which the Group pays fixed contributions into a separate entity. A defined benefit plan is a pension plan that is not a defined contribution plan. Typically, defined benefit plans define an amount of pension benefit that an employee will receive on retirement, usually dependent on one or more factors such as age, years of service and compensation.

Other post-employment obligations. The company provides post-retirement healthcare benefits to their retirees.

Provisions

IAS 37 covers the standards for provisions.

Provisions for environmental restoration, restructuring costs and legal claims are recognized when the company has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation. The increase in the provision due to passage of time is recognized as interest expense.

Revenue recognition

IAS 18 covers the standards for revenue.

Revenue is recognized as follows:

- Sales of goods
- Sales of services
- Interest income
- Dividend income

Note 2. Financial Risk Management

Financial risk factors

IAS 32 prescribes the disclosure and presentation of financial instruments.

The company's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the company's financial performance. The company uses derivative financial instruments to hedge certain risk exposures. The company's activities are exposed to a variety of financial risks: market risk (including currency risk, fair value interest rate risk and price risk), credit risk, liquidity risk and cash flow interest rate risk.

Fair value estimation

IAS 39 provides a hierarchy to be used in determining the fair value for a financial instrument.

The fair value of financial instruments traded in active markets (such as trading and available-for-sale securities) is based on quoted market prices at the balance sheet date. The fair value of financial instruments that are not traded in an active market (for example, over-the-counter derivatives) is determined by using valuation techniques. The company uses a variety of methods and makes assumptions that are based on market conditions existing at each balance sheet date.

Note 3. Property, Plant and Equipment

($-in thousands)

Description	Land & buildings	Vehicles & machinery	Furniture & fixtures	Total
Year ended 31 December 2005				
Opening net book amount	38,694	47,800	12,176	98,670
Exchange differences	1,601	1,280	342	3,223
Acquisition of subsidiary	49,072	5,513	13,199	67,784
Additions	7,126	427	2,202	9,755
Disposals	(2,000)	(3,729)	(608)	(6,337)
Depreciation charge	(3,545)	(4,768)	(9,441)	(17,754)
Closing net book amount	90,948	46,523	17,870	155,341
Revaluation	95,129	58,268	26,927	180,324
Accumulated depreciation	(4,181)	(11,745)	(9,057)	(24,983)
Net book amount	90,948	46,523	17,870	155,341

If land and buildings were stated on the historical cost basis, the amounts would be as follows:

Cost	81,541
Accumulated depreciation	(15,512)
Net book amount	66,029

Note: The land and buildings were last revalued on 1 January 2004 by independent valuers. Valuations were made on the basis of market value.

Note 4. Intangible Assets

($-in thousands)

Description	Goodwill	Trademarks & licences	Other[a]	Total
Year ended 31 December 2005				
Opening net book amount	12,000	7,000	600	19,600
Exchange differences	341	96	134	571
Additions	—	2,684	366	3,050
Acquisition of subsidiary	3,651	4,000	—	7,651
Impairment charge	(4,650)	—	—	(4,650)
Amortisation charge	—	(680)	(120)	(800)
Closing net book amount	11,342	13,100	980	25,422
Cost	15,992	14,480	1,800	32,272
Accumulated amortisation and impairment	(4,650)	(1,380)	(820)	(6,850)
Net book amount	11,342	13,100	980	25,422

a. Other intangibles include internally generated capitalised software development costs and other costs.

NOTE 5. INVESTMENTS IN ASSOCIATES

($-in thousands)

Description	2005
Beginning of the year	13,244
Acquisition of subsidiary	389
Share of (loss)/profit[a]	(174)
Exchange differences	(74)
Other equity movements	(12)
End of the year	13,373

a. The company's share of the results of its principal associates, all of which are unlisted, and its share of the assets (including goodwill and liabilities) are as follows:

Name	Country of incorporation	Assets	Liabilities	Revenues	Profit/ (Loss)	% held
Alfa Limited	Cyprus	32,381	25,174	31,123	200	25
Beta SA	Greece	12,115	5,949	9,001	15	30
Delta Limited	UK	15,278	15,278	25,741	(389)	42
		59,774	46,401	65,865	(174)	

NOTE 6. AVAILABLE-FOR-SALE FINANCIAL ASSETS

($-in thousands)

Description	2005
Beginning of the year	14,910
Exchange differences	646
Acquisition of subsidiary	473
Additions	2,781
Revaluation surplus transfer to equity	560
End of the year	19,370
Less: non-current portion	(17,420)
Current portion	1,950
Available-for-sale financial assets include the following:	
Listed securities:	
• Equity securities—eurozone countries	8,335
• Equity securities—US	5,850
• Equity securities—UK	4,550
• Debentures with fixed interest of 6.5% and maturity date of 27 August 2010	210
• Non-cumulative 9.0% non-redeemable preference shares	78
Unlisted securities:	
• Debt securities traded on inactive markets with fixed interest ranging from 6.3% to 6.5% and maturity dates between July 2008 and May 2010	347
	19,370

Note 7. Derivative Financial Instruments

($-in thousands)

Description	2005 Assets	2005 Liabilities
Interest rate swaps—cash flow hedges	351	110
Interest rate swaps—fair value hedges	57	37
Forward foreign exchange contracts—cash flow hedges	695	180
Forward foreign exchange contracts—held-for-trading	361	268
Total	1,464	595
Less non-current portion:		
Interest rate swaps—cash flow hedges	345	100
Interest rate swaps—fair value hedges	50	35
	395	135
Current portion	1,069	460

Trading derivatives are classified as a current asset or liability. The full fair value of a hedging derivative is classified as a non-current asset or liability if the remaining maturity of the hedged item is more than 12 months and, as a current asset or liability, if the maturity of the hedged them is less than 12 months.

Note 8. Trade and Other Receivables

($-in thousands)

Description	2005
Trade receivables	18,174
Less: provision for impairment of receivables	(109)
Trade receivables—net	18,065
Prepayments	1,300
Receivables from related parties	54
Loans to related parties	2,668
	22,087
Less non-current portion: loans to related parties	(2,322)
Current portion	19,765
The fair values of trade and other receivables are as follows:	
• Trade receivables	18,065
• Prepayments	1,300
• Receivables from related parties	54
• Loans to related parties	2,722
	22,141

Note 9. Inventories

($-in thousands)

Description	2005
Raw materials	7,622
Work in progress	1,810
Finished goods	15,268
	24,700

Note 10. Other Financial Assets at Fair Value through Profit or Loss

($-in thousands)

Description	2005
Listed securities:	
• Equity securities—eurozone	5,850
• Equity securities—US	4,250
• Equity securities—UK	1,720
	11,820
The carrying amounts of the above financial assets are classified as follows:	
• Held for trading	9,847
• Designated as at fair value through profit or loss on initial recognition	1,973
	11,820

Note 11. Cash and Cash Equivalents

($-in thousands)

Description	2005
Cash at bank and in hand	12,698
Short-term bank deposits	9,530
	22,228
Cash, cash equivalents and bank overdrafts include the following for the purposes of the cash flow statement:	
• Cash and cash equivalents	22,228
• Bank overdrafts	(2,650)
	19,578

NOTE 12. SHARE CAPITAL

($-in thousands)

Description	Number of shares	Ordinary shares	Share premium	Treasury shares	Total
At 31 December 2004	21,000	21,000	11,316	—	32,316
Employee share option scheme:					
• Value of services provided	—	—	690	—	690
• Proceeds from shares issued	750	750	200	—	950
Acquisition of subsidiary	3,550	3,550	6,450	—	10,000
Treasury shares purchased	(875)	—	—	(2,564)	(2,564)
At 31 December 2005	24,425	25,300	18,656	(2,564)	41,392

NOTE 13. OTHER RESERVES

($-in thousands)

Description	Conv. bond	Land and buildings revaluation	Hedging reserve	Available for sale inv.	Currency trans. adj.	Total
Balance at 31 December 2004	—	1,774	62	1,388	3,801	7,025
Revaluation—gross	—	—	—	560	—	560
Revaluation—tax	—	—	—	(142)	—	(142)
Revaluation—associates	—	—	—	(12)	—	(12)
Depreciation transfer—gross	—	(149)	—	—	—	(149)
Depreciation transfer—tax	—	49	—	—	—	49
Cash flow hedges:						
• Fair value gains in year	—	—	368	—	—	368
• Tax on fair value gains	—	—	(123)	—	—	(123)
• Transfers to net profit	—	—	(120)	—	—	(120)
• Tax on transfers to net profit	—	—	40	—	—	40
• Transfers to inventory	—	—	(151)	—	—	(151)
• Tax on transfers to inventory	—	—	50	—	—	50
Net investment hedge	—	—	—	—	(45)	(45)
Currency translation differences:						
• Group	—	15	—	—	(2,025)	2,040
• Associates	—	—	—	—	(74)	(74)
Convertible bond–equity	7,761	—	—	—	—	7,761
Tax on equity component	(2,328)	—	—	—	—	(2,328)
Balance at 31 December 2005	5,433	1,689	126	1,794	5,707	14,749

Note 14. Trade and Other Payables

($-in thousands)

Description	2005
Trade payables	11,983
Amounts due to related parties	2,202
Social security and other taxes	2,002
Accrued expenses	1,483
	17,670

Note 15. Borrowings

($-in thousands)

Description	2005
Non-current	
Bank borrowings	32,193
Convertible bond	42,822
Debentures and other loans	3,300
Redeemable preference shares	30,000
	108,315
Current	
Bank overdrafts	2,650
Collateralised borrowings	1,014
Bank borrowings	3,368
Debentures and other loans	2,492
	9,524
Total borrowings	117,839
The maturity of non-current borrowings is as follows:	
• Between 1 and 2 years	5,870
• Between 2 and 5 years	74,967
• Over 5 years	27,478
	108,315

	2005	
	Carrying amounts	Fair values
The carrying amounts and fair value of the non-current borrowings are as follows:		
• Bank borrowings	32,193	32,590
• Redeemable preference shares	30,000	28,450
• Debentures and other loans	3,300	3,240
• Convertible bond	42,822	42,752
	108,315	107,032

Note 16. Deferred Income Tax

($-in thousands)

Description	2005
Deferred tax assets:	
• Deferred tax asset to be recovered after more than 12 months	(2,672)
• Deferred tax asset to be recovered within 12 months	(647)
	(3,319)
Deferred tax liabilities:	
• Deferred tax liability to be recovered after more than 12 months	10,743
• Deferred tax liability to be recovered within 12 months	1,627
	12,370
	9,051

Note 17. Retirement Benefit Obligations

($-in thousands)

Description	2005
Balance sheet obligations for:	
Pension benefits	3,138
Post-employment medical benefits	1,402
	4,540

Note 18. Provisions for Other Liabilities and Charges

($-in thousands)

Description	Environ. restoration	Restruc-turing	Legal claims	Profit-sharing & bonuses	Total
At 1 January 2005	746	—	828	1,000	2,574
Charged to consolidated income statement:					—
• Additional provisions	316	2,087	2,405	500	5,308
• Unused amounts reversed	(12)	(101)	(15)	(10)	(138)
Exchange differences	(7)	—	(68)	—	(75)
Increase in provision–discount unwinding	41	—	—	—	41
Used during year	(233)	(886)	(3,059)	(990)	(5,168)
At 31 December 2005	851	1,100	91	500	2,542

Analysis of total provisions:	2005
Non-current (environmental restoration)	320
Current (environmental restoration)	531
Current	1,691
	2,542

Note 19. Other

($-in thousands)

Description	2005
Other financial assets at fair value through profit or loss:	
• Fair value losses	(839)
• Dividend income	330
• Dividend income	610
Derivative instruments:	
• Forward contracts: transactions not qualifying as hedges	86
Net foreign exchange gains/(losses)	(277)
	(90)
Other income:	
Interest income on available-for-sale securities	1,180
Dividend income on available-for-sale securities	1,900
Investment income	3,080
Other expenses:	
Expropriation Costs	(1,117)
	1,873

Note 20. Finance Costs

($-in thousands)

Description	2005
Interest expense:	
• Bank borrowings	(4,679)
• Dividend on redeemable preference shares	(1,950)
• Convertible bond	(3,083)
• Provisions: discount unwinding	(41)
	(9,753)
Net foreign exchange transaction gains/(losses)	2,594
Fair value gains on financial instruments:	
• Interest rate swaps: cash flow hedges, transfer from equity	102
• Interest rate swaps: fair value hedges	(16)
	(7,073)

Note 21. Income Tax Expense

($-in thousands)

Description	2005
Current tax	14,413
Deferred tax	379
	14,792

Note 22. Proceeds from Sale of Property, Plant and Equipment

($-in thousands)

Description	2005
Net book amount (Note 3)	6,337
Profit/(loss) on sale of property, plant and equipment	17
	6,354

Note 23. Business Combinations

($-in thousands)

Description	2005
Purchase consideration settled in cash	4,200
Cash and cash equivalents in subsidiary acquired	(300)
Cash outflow on acquisition	3,900

Note 24. Loans to Related Parties:

($-in thousands)

Description	2005
Beginning of the year	1,388
Loans advanced during year	1,343
Loan repayments received	(63)
Interest charged	217
Interest received	(217)
End of the year	2,668

Note 25. Convertible Bond

($-in thousands)

Description	2005
Face value of convertible bond issued on 2 January 2005	50,000
Equity component (Note 13)	(7,761)
Liability component on initial recognition at 2 January 2005	42,239
Interest expense (Note 20)	3,083
Interest paid	(2,500)
Liability component at 31 December 2005 (Note 15)	42,822

NOTE 26. EARNINGS PER SHARE

($-in thousands)

Description	2005	2004
Basic		
Profit attributable to equity holders of the Company	30,028	15,837
Weighted average number of ordinary shares in issue (thousands)	23,454	20,500
Basic earnings per share	**1.28**	**0.77**
Diluted		
Profit attributable to equity holders of the Company	30,028	15,837
Interest expense on convertible debt (net of tax)	2,158	—
Profit used to determine diluted earnings per share	32,186	15,837
Weighted average number of ordinary shares in issue (thousands)	23,454	20,500
Adjustments for—assumed conversion of convertible debt (thousands)	3,030	—
• share options (thousands)	1,213	1,329
Weighted average number of ordinary shares for diluted earnings per share (thousands)	27,697	21,829
Diluted earnings per share	**1.16**	**0.73**

Part II. Banking Industry

The following illustrations relates to the banking industry. They are used as guidelines to relevant users.

Exhibit 1. Consolidated Income Statement

Description	Note	As of 31 December 2005	2004
Interest, commissions and Fees on Loans Income	6	7,243	6,483
Interest expense and Other Loan Processing charges	6	(4,656)	(4,079)
Net interest income		**2,587**	**2,404**
Fee and commission income—Non-Loan Related	7	1,095	1,044
Fee and commission expense—Non-Loan Related	7	(48)	(52)
Other Bank Servicing Charges		—	—
Net fee and commission income		**1,047**	**992**
Dividend income	8	87	33
Net trading income (Including FX Trading)	9	268	251
Gains/(losses) from investment securities	21	46	112
Gain/(Losses) on Investment Management		—	—
Gain (Losses) on Other FX Transactions		—	—
Income from Sales of Real Estate Holdings		—	—
Other operating income (Non-Interest)		130	98
Impairment losses on loans and advances	12	(120)	(136)
Operating expenses (Admin, Deprec. and Amort.)	10	(2,797)	(2,558)
Other Non-Interest Operating Expenses (Net)		—	—
Provisions on Earning Assets & Commitment and Contingencies		—	—
Operating profit		**1,248**	**1,196**
Share of profit of associates	22	7	7
Gain on Sale of Premises and Equipment		—	—
Gain on Sale of Foreclosed Properties		—	—
Provisions For Decline in Value of Foreclosed Properties		—	—
Profit before income tax		**1,255**	**1,203**
Income tax expense	13	(377)	(375)
Profit for the year		**878**	**828**
Attributable to:			
Equity holders of the Company		871	820
Minority interest		7	8
Profit for the year		**878**	**828**
Earnings per share for profit attributable to the equity holders of the Company during the year (expressed in $ per share):			
• basic	Note 14	**0.76**	**0.74**
• diluted	Note 14	**0.73**	**0.71**

Exhibit 2. Consolidated Balance Sheet

($-in thousands)

Description	Note	As of 31 December 2005	2004
ASSETS			
Cash and balances with central banks	15	6,080	4,315
Demand Deposits with Other Banks		—	—
Treasury bills and other eligible bills	16	1,485	771
Loans, Placements, and advances to banks	17	8,576	5,502
Trading securities	18	5,231	8,204
Investments in Shares of Stock		—	—
Derivative financial instruments	19	5,325	5,442
Other financial instruments at fair value through profit or loss	18	2,520	1,102
Loans and advances to customers (incl. Overdrafts) (Net)	20	59,203	53,208
Lease Financing Receivable		—	—
Accrued Interest Receivable		—	—
Investment securities:			
• available-for-sale	21	3,972	1,182
• held-to-maturity	21	3,999	1,009
Pledged assets	37	1,004	1,083
Investments in associated undertakings	22	112	108
Other Investments		—	—
Intangible assets (Net of Impairment)	23	237	312
Property, plant and equipment (Net)	24	1,519	1,555
Foreclosed Properties		—	—
Deferred income tax assets	35	273	255
Other assets	25	2,003	2,111
Total assets		**101,539**	**86,159**
LIABILITIES			
Deposits from Other banks	26	15,039	13,633
Acceptances, Placements, and Other Deposits	27	16,249	12,031
Derivative financial instruments and other trading liabilities	19	4,039	6,277
Customers Deposits	28	51,775	42,698
Debt securities in issue	29	1,766	1,232
Estimated Losses on Commitment & Contingencies	—	—	—
Other borrowed funds (Including Subordinated Notes)	30	2,808	2,512
Capital Lease Obligations	—	—	—
Other Accrued/Deferred liabilities	33	2,871	2,224
Current income tax liabilities		101	173
Deferred income tax liabilities	35	1,109	693
Retirement benefit obligations	36	237	221
Total liabilities		**95,994**	**81,694**

Exhibit 2. Consolidated Balance Sheet *(Continued)*

Description	Note	As of 31 December 2005	2004
EQUITY			
Capital and reserves attributable to the Company's equity holders			
Share capital—Common (Net of Treasury Shares)	38	2,010	1,916
Share Capital—Preferred		—	—
Retained earnings	39	2,359	1,920
Reserves (Revaluation, Capital, Other)	39	1,132	592
Total Equity		5,501	4,428
Minority interest		44	37
Total equity		**5,545**	**4,465**
Total equity and liabilities		**101,539**	**86,159**

Exhibit 3. Consolidated Statement of Changes in Equity

($-in thousands)

Description	Note	Attributable to equity holders of the company: Share capital	Other reserves	Retained earnings	Minority interest	Total equity
At 31 December 2004/1 January 2005		1,916	592	1,920	37	4,465
Net change in available-for-sale investments, net of tax	39	—	128	—	—	128
Net change in cash flow hedges, net of tax	39	—	360	—	—	360
Currency translation differences	39	—	(20)	—	—	(20)
Net gains not recognized in the income statement		—	—	—	—	—
Net profit		—	—	871	7	878
Total recognized income for 2005		**—**	**468**	**871**	**7**	**1,346**
Dividend for 2004		—	—	(360)	—	(360)
Transfer to general banking reserves		—	58	(58)	—	—
Transfer to statutory reserve		—	14	(14)	—	—
Purchases/sales of treasury shares		14	—	—	—	14
Employee share option scheme:						
• value of employee services		30	—	—	—	30
• proceeds from shares issued		50	—	—	—	50
At 31 December 2005		**2,010**	**1,132**	**2,359**	**44**	**5,545**

Exhibit 4. Consolidated Cash Flow Statements

($-in thousands)

Description	Note	As of 31 December 2005	2004
Cash flows from operating activities			
Interest and commission received		7,003	6,497
Interest received		(4,889)	(4,156)
Dividends received		89	37
Fee and commission received		1,008	1,099
Net trading and other income		305	331
Recoveries on loans previously written off		29	37
Cash payments to employees and suppliers		(2,506)	(2,264)
Income taxes paid		(390)	(307)
Cash flows from operating profits before changes in operating assets and liabilities		649	1,274
Changes in operating assets and liabilities:			
• net increase in trading securities		(160)	(552)
• net increase in bought and sold options		(181)	(101)
• net decrease/(increase) in loans and advances to banks		81	(119)
• net increase in loans and advances to customers		(5,765)	(4,527)
• net (increase)/decrease in other assets		(341)	127
• net increase in deposits from other banks		1,339	1,273
• net increase in other deposits		4,235	1,819
• net increase in trading liabilities		258	—
• net increase in amounts due to customers		9,019	1,175
• net increase in other liabilities		268	133
Net cash from operating activities		**9,402**	**502**
Cash flows from investing activities			
Acquisition of subsidiaries, net of cash acquired		(293)	—
Disposal of subsidiaries, net of cash disposed		46	—
Purchase of property and equipment	24	(431)	(382)
Proceeds from sale of property and equipment		67	79
Purchase of securities	21	(5,852)	(249)
Proceeds from sale and redemption of securities		469	498
Net cash used in investing activities		**(5,994)**	**(54)**
Cash flows from financing activities			
Proceeds from borrowed funds and debt securities		1,455	1,269
Repayments of borrowed funds and debt securities		(577)	(518)
Issue of ordinary shares	38	50	30
Purchase of treasury shares	38	(96)	(112)
Sale of treasury shares	38	110	121
Dividends paid	40	(360)	(322)
Net cash from financing activities		**582**	**468**
Net increase in cash and cash equivalents		3,990	916
Cash and cash equivalents at beginning of year	41	10,840	9,998
Effect of exchange rate changes on cash and cash equivalents		(180)	(74)
Cash and cash equivalents at end of year		**14,650**	**10,840**

Notes to Financial Statements

Note 1. General Information

Universal Banking Group (the Group) provides retail, corporate banking and investment banking services in various parts of the world. The Group has operations in over 20 countries and employs over 22,000 people.

Note 2. Summary of Significant Accounting Policies

Note: each entity considers the nature of its operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity. The accounting policies that an entity might consider presenting include, but are not limited to, the following:

- Basis of presentation
- Consolidation
- Segment reporting
- Foreign currency translation
- Derivative financial instruments and hedge accounting
- Interest income and expense
- Fee and commission income
- Financial assets
- Sale and repurchase agreements
- Intangible assets
- Property, plant and equipment
- Leases
- Cash and cash equivalents
- Provisions
- Employee benefits
- Deferred income tax
- Borrowings
- Share capital

Note 3. Financial Risk Management

This section covers the following components:

- Strategy in using financial instruments
- Credit risk
- Geographical concentrations of assets, liabilities and off-balance sheet items
- Market risk
- Currency risk
- Interest sensitivity of assets, liabilities and off balance sheet items
- Liquidity risk
- Fair values of financial assets and liabilities
- Fiduciary activities

Note 4. Critical Accounting Estimates and Judgments in Applying Accounting Policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year, such as impairment losses on loans and advances.

Note 5. Business Segments

The Group is organized on a worldwide basis into three main business segments: Retail banking, Corporate banking, and Investment banking. (Client provides table with a reconciliation of all business segments).

Note 6. Net Interest Income

($-in thousands)

Description	2005	2004
Interest income		
Cash and short term funds	617	550
Investment securities	259	227
Securities borrowed and reverse repos.	104	147
Loans and advances	5,935	5,242
Other	328	317
	7,243	6,483
Interest expense		
Banks and customers	3,751	3,238
Debt securities in issue	105	89
Securities lent and repos.	98	84
Other borrowed funds	191	199
Other	511	469
	4,656	4,079

Note 7. Net Fee and Commission Income

($-in thousands)

Description	2005	2004
Fee and commission income		
Credit related fees and commissions	675	631
Corporate finance fees	201	176
Portfolio and other management fees	74	98
Asset management and related fees	140	135
Other fees	5	4
	1,095	1,044
Fee and commission expense		
Brokerage fees paid	42	48
Other fees paid	6	4
	48	52

Note 8. Dividend Income

($-in thousands)

Description	2005	2004
Trading securities	64	22
Available-for-sale securities	23	11
	87	33

Note 9. Net Trading Income

($-in thousands)

Description	2005	2004
Foreign exchange:		
• translation gains less losses	100	100
• transaction gains less losses	80	76
Interest rate instruments	55	59
Equities	33	16
	268	251

Note 10. Other Operating Expenses

($-in thousands)

Description	2005	2004
Staff costs (Note 11)	1,467	1,374
Administrative expenses	397	466
Depreciation (Note 24)	323	298
(Profit)/loss on sale of property and equipment	15	(5)
Impairment charges:		
• property and equipment (Note 24)	2	—
Software costs	14	11
Operating lease rentals	198	194
Restructuring costs (Note 34)	283	—
Other	98	220
	2,797	2,558

Note 11. Staff Costs

($-in thousands)

Description	2005	2004
Wages and salaries	995	943
Social security costs	264	250
Pension costs:		
• defined contribution plans	132	114
• defined benefit plans (Note 36)	66	58
Other post retirement benefits (Note 36)	10	9
	1,467	1,374

Note 12. Impairment Losses on Loans and Advances

($-in thousands)

Description	2005	2004
Amounts due from other banks (Note 17)	7	—
Loans and advances to customers (Note 20)	113	136
	120	136

Note 13. Income Tax Expense

($-in thousands)

Description	2005	2004
Current tax	312	321
Deferred tax (Note 35)	65	54
	377	375

Note 14. Earnings per Share

($-in thousands)

Description	2005	2004
Basic		
Profit attributable to equity holders of the Company	871	820
Weighted average number of ordinary shares in issue (millions)	1,149	1,108
Basic earnings per share (expressed in $ per share)	**0.76**	**0.74**
Diluted		
Profit attributable to equity holders of the Company	871	820
Interest expense on convertible debt (net of tax)	8	8
Net profit used to determine diluted earnings per share	879	828
Weighted average number of ordinary shares in issue	1,149	1,108
Adjustments for:		
• bonus element on conversion of convertible debt	25	25
• share options (millions)	23	27
Weighted average number of ordinary shares for diluted earnings per share (millions)	1,197	1,160
Diluted earnings per share (expressed in $ per share)	**0.73**	**0.71**

Note 15. Cash and Balances with Central Banks

($-in thousands)

Description	2005	2004
Cash in hand	1,778	791
Other money-market placements	3,395	2,608
Balances with central banks other than mandatory reserve deposits	892	903
Included in cash and cash equivalents	6,065	4,302
Mandatory reserve deposits with central banks	15	13
	6,080	4,315

Note 16. Treasury Bills and Other Eligible Bills

($-in thousands)

Description	2005	2004
Treasury bills	579	228
Other eligible bills	906	543
	1,485	771

Note 17. Loans and Advances to Banks

($-in thousands)

Description	2005	2004
Items in course of collection from other banks	163	109
Placements with other banks	4,988	2,982
Included in cash equivalents (Note 41)	5,151	3,091
Loans and advances to other banks	3,432	2,411
Less: allowance for losses on amounts due from other banks (Note 12)	(7)	—
	8,576	5,502

Note 18. Financial Assets at Fair Value Through Profit or Loss (Including Trading)

($-in thousands)

Description	2005	2004
Trading		
Government bonds included in cash equivalents	1,949	2,676
Other government bonds	1,180	945
Other debt securities	885	3,402
Equity securities:		
• listed	1,083	1,080
• unlisted	134	101
Total trading	5,231	8,204
Financial assets at fair value through profit or loss (designated at initial recognition)	2,520	1,102
	7,751	9,306

NOTE 19. DERIVATIVE FINANCIAL INSTRUMENTS AND TRADING LIABILITIES

($-in thousands)

Description	Contract/notional amount	At 31 December 2005 Fair values	
		Assets	Liabilities
1) Derivatives held for trading			
a) Foreign exchange derivatives			
Currency forwards	74,210	1,162	(1,314)
Currency swaps	4,580	99	(268)
OTC currency options bought and sold	8,597	37	(57)
Total OTC derivatives		1,298	(1,639)
Currency futures	5,531	53	(67)
Exchange-traded currency options—bought and sold	470	3	(26)
		1,354	(1,732)
b) Interest rate derivatives			
Interest rate swaps	57,217	634	(611)
Cross-currency interest rate swaps	28,609	314	(590)
Forward rate agreements	54,875	51	(55)
OTC interest rate options	5,954	6	—
Other interest rate contracts	193	2	—
Total OTC derivatives		1,007	(1,256)
Exchange-traded interest rate futures	38,534	25	(20)
Exchange-traded interest rate options	37,918	74	(31)
		99	(51)
Total derivative assets/(liabilities) held for trading		2,460	(3,039)
2) Derivatives held for hedging			
a) Derivatives designated as fair value hedges			
Currency futures	4,300	110	(26)
Interest rate swaps	25,262	1,286	(311)
Cross currency interest rate swaps	11,315	554	(88)
		1,950	(425)
b) Derivatives designated as cash flow hedges			
Currency swaps	4,018	803	(313)
Exchange traded currency options bought	5,020	112	—
Total derivative assets/(liabilities) held for hedging		2,865	(738)
Total recognized derivative assets/(liabilities)		5,325	(3,777)
3) Other trading liabilities			
Treasury bills sold not yet re-purchased (Note 37)			(262)
Total recognized derivative and other trading liabilities			(4,039)

Note 20. Loans and Advances to Customers

($-in thousands)

Description	2005	2004
Loans to individuals:		
• overdrafts	2,198	2,432
• credit cards	2,817	2,876
• term loans	2,827	2,633
• mortgages	30,942	30,625
Loans to corporate entities:		
• direct commercial loans	15,695	12,201
• sub-participation loans	4,236	2,348
• other	1,431	1,144
Gross loans and advances	60,146	54,259
Less: allowance for losses on loans and advances	(943)	(1,051)
	59,203	53,208

Note 21. Investment Securities

($-in thousands)

Description	2005	2004
Securities available-for-sale		
Debt securities—at fair value	2,474	933
Equity securities—at fair value	1,498	249
Total securities available-for-sale	3,972	1,182
Total securities held-to-maturity	3,999	1,009
Total investment securities	7,971	2,191
Gains and losses from investment securities comprise:		
Derecognition of available-for-sale financial assets	51	117
Impairment of available-for-sale equity securities	(5)	(5)
	46	112

Note 22. Investment in Associates

($-in thousands)

Name	Country of incorporation	Assets	Liabilities	Revenues	Profit/(loss) held	% interest
[Associate X]	[country]	1,326	1,272	165	7	30
[Associate Y]	[county]	1,459	1,401	183	5	33
		2,785	2,673	348	12	

Note 23. Intangible Assets

($-in thousands)

Description	2005	2004
Goodwill		
Opening net book amount	204	327
Exchange differences	(5)	(15)
Acquisition of a subsidiary	38	—
Closing net book amount	237	312

Note 24. Property, Plant and Equipment

($-in thousands)

Description	Land & Building	Leasehold improvements	Equipment	Total
Year ended December 2005				
Opening net book amount	776	50	729	1,555
Additions	71	10	350	431
Disposal	(43)	—	(37)	(80)
Impairment charge	—	(2)	—	(2)
Depreciation charge	(34)	(7)	(282)	(323)
Exchange rate adjustments	(30)	(3)	(29)	(62)
Closing net book amount	740	48	731	1,519

Note 25. Other Assets

($-in thousands)

Description	2005	2004
Accounts receivable and pre-payments	1,048	1,029
Accrued income	615	737
Other	340	345
	2,003	2,111

Note 26. Deposits from Banks

($-in thousands)

Description	2005	2004
Items in course of collection	103	197
Deposits from other banks	14,936	13,436
	15,039	13,633

Note 27. Other Deposits

($-in thousands)

Description	2005	2004
Other money-market deposits	12,074	8,369
Certificates of deposits	4,175	3,662
	16,249	12,031

Note 28. Due to Customers

($-in thousands)

Description	2005	2004
Large corporate customers:		
• current/settlement accounts	26,975	5,471
• term deposits	3,938	2,625
Small and medium sized enterprises:		
• current/settlement accounts	4,569	3,656
• term deposits	3,938	3,308
Retail customers:		
• current/demand accounts	6,520	4,583
• term deposits	5,835	23,055
	51,775	42,698

Note 29. Debt Securities in Issue

($-in thousands)

Description	2005	2004	2005	2004
	Average interest rate (%)			
€medium-term notes	5.6	5.5	842	161
US$ medium-term notes	5.9	5.8	69	66
£ medium-term notes	6.3	5.5	183	183
£95m floating-rate notes due 2004	—	5.6	—	129
US$256m floating-rate notes due 2005	6.0	5.8	120	435
€260m floating-rate notes due 2006	5.8	5.5	552	258
			1,766	1,232

Note 30. Other Borrowed Funds

($-in thousands)

Description	Interest rate %	2005	2004
Collateralized borrowing		2,056	1,310
Subordinated notes			
40m fixed rate notes due 2004	6.13	—	35
25m fixed rate notes due 2005	4.89	38	38
100m fixed rate notes due 2004	5.12	—	105
460m floating-rate notes due 2004	LIBOR + 0.09	—	311
		38	489
Redeemable preference shares (Note 32)	6.50	552	552
Convertible bond (Note 31)			
200m due 2012	6.00	162	161
		2,808	2,512

Note 31. Convertible Bonds

($-in thousands)

On 4 January 2004, the Company issued 200 million 6% convertible bonds at a nominal value of $1 per bond. The bonds mature 25 years from the issue date at the nominal value unless converted into the Company's ordinary shares at the holder's option at the rate of 25 shares per $200.

The convertible bond is presented in the consolidated balance sheet as follows:

Description	2005	2004
Initial recognition:		
• face value of convertible bond issued	—	200
• equity conversion component net of deferred tax liability	—	–24
• deferred tax liability	—	–16
Liability component at 1 January	161	160
Interest expense	13	13
Interest paid	(12)	–12
Liability component at 31 December	162	161

Interest on the bond is calculated on the effective yield basis by applying the effective interest rate (7.9%) for an equivalent non-convertible bond to the liability component of the convertible bond and for the year ended 31 December 2005 amounted to $12.7 (2004: $12.6).

Note 32. Redeemable Preference Shares

($-in thousands)

On 4 January 2003, the Company issued 552 million cumulative redeemable preference shares with a par value of $1 per share, which are redeemable at the option of the holder at par on 1 January 2013 or by the Company at any time before that date.

Note 33. Other Liabilities

($-in thousands)

Description	2005	2004
Creditors	1,367	1,311
Dividends payable	57	44
Accruals	796	534
Other provisions (Note 34)	467	229
Other	184	106
	2,871	2,224

Note 34. Other Provisions

($-in thousands)

Description	2005	2004
A+ 1 January	229	—
Exchange differences	3	—
Additional provisions charged to income statement	283	249
Utilized during year	(48)	(20)
At 31 December	467	229

Note 35. Deferred Income Taxes

($-in thousands)

Description	2005	2004
Deferred income tax liabilities		
Accelerated tax depreciation	342	223
Convertible bond	15	16
Available-for-sale securities	84	86
Cash flow hedges	235	272
Other temporary differences	433	96
	1,109	693
Deferred income tax assets		
Pensions and other post retirement benefits	62	51
Provision for loan impairment	7	34
Other provisions	184	92
Cash flow hedges	—	32
Hedged deposits from customers	—	4
Tax losses carried forward	20	42
	273	255

Note 36. Retirement Benefit Obligations

($-in thousands)

Description	2005	2004
Pension schemes	182	170
Other post retirement benefits	55	51
	237	221

Note 37. Contingent Liabilities and Commitments

($-in thousands)

Description	2005	2004
a) Legal proceedings		
There were a number of legal proceedings outstanding against the Group at 31 December 2004. No provision has been made as professional advice indicates that it is unlikely that any significant loss will arise.		
b) Capital commitments		
The contractual amounts of the Group's off-balance sheet financial instruments that commit it to extend credit to customers are as follows:		
Bankers acceptances	1,777	898
Guarantees and standby letters of credit	2,660	1,789
Documentary and commercial letters of credit	415	391
Commitments to extend credit:		
• Original term to maturity of one year or less	16,965	13,209
• Original term to maturity of more than one year	4,836	4,030
	26,653	20,317
c) Assets pledged		
Assets are pledged as collateral under repurchase agreements with other banks and for security deposits relating to local futures, options and stock exchange memberships. Mandatory reserve deposits are also held with local central banks in accordance with statutory requirements. These deposits are not available to finance the Group's day to day operations.		

Note 38. Share Capital

($-in thousands)

Description
The total authorized number of ordinary shares at year end was 1,400 million (2004: 1,400 million) with a par value of $1 per share (2004: $1 per share). All issued shares are fully paid. The total number of treasury shares at the end of 2005 was 24 million (2004: 28 million).

Note 39. Reserves and Retained Earnings

($-in thousands)

Description	2005	2004
General banking risks	175	125
Statutory reserve	112	102
Convertible bond—equity component	24	24
Translation reserves	(155)	(147)
Revaluation reserve—available-for-sale investments	256	128
Hedging reserve—cash flow hedges	720	360
Total reserves at 31 December	1,132	592
Movements in retained earnings were as follows:		
At 1 January	1,920	1,512
Net profit for year	871	820
Dividend for prior year	(360)	(322)
Transfer to general banking reserve	(58)	(49)
Transfer to statutory reserve	(14)	(41)
At 31 December	2,359	1,920

Note 40. Dividends per Share

($-in thousands)

Final dividends are not accounted for until they have been ratified at the Annual General Meeting. At the meeting on [date] 2005, a dividend in respect of 2005 of $0.33 per share (2004: actual dividend $0.313 per share) amounting to a total of $396 (2004: actual $360) is to be proposed. The financial statements for the year ended 31 December 2005 do not reflect this resolution, which will be accounted for in shareholders' equity as an appropriation of retained profits in the year ending 31 December 2006.

Note 41. Cash and Cash Equivalents

($-in thousands)

Description	2005	2004
Cash and balances with central banks (Note 15)	6,065	4302
Treasury bills and other eligible bills (Note 16)	1,485	771
Loans and advances to banks (Note 17)	5,151	3091
Trading securities (Note 18)	1,949	2676
	14,650	10,840

Note 42. Related-party Transactions

($-in thousands)

The Group is controlled by Parent Ltd. (incorporated in [name of country]) which owns 60% of the ordinary shares. The remaining 40% of the shares are widely held. The ultimate parent of the Group is Ultimate Parent Ltd. (incorporated in [name of country]). A number of banking transactions are entered into with related parties in the normal course of business.

These include loans, deposits and foreign currency transactions. The volumes of related-party transactions, outstanding balances at the year end, and relating expense and income for the year are as follows:

	Directors and key management personnel		Associated companies	
Loans	**2005**	**2004**	**2005**	**2004**
Loans outstanding at 1 January	135	117	450	381
Loans issued during the year	14	33	25	116
Loan repayments during the year	(18)	(15)	(58)	(47)
Loans outstanding at 31 December	131	135	417	450
Interest income earned	11	10	35	33

No provisions have been recognized in respect of loans given to related parties (2004: nil).

Part III. Small and Medium-sized Entities (SMEs)

The financial statements of small and medium-sized entities (SMEs) are not as exhaustive compare to larger corporations. Due to the smaller-scale nature of SME's operation, the chart of accounts and disclosures are very limited. Currently, there is no specific International Financial Reporting Standards (IFRS) for SMEs; however, SMEs could fall back on the concepts of IFRS.

Exhibit 1. Balance Sheet

De Mayo Company
For Fiscal Ending December 31, XXXX

Description	Note	As of 31 December 2005	2004
ASSETS			
Non-current assets			
Property, plant & equipment	5	26,751,394	26,719,672
Accumulated depreciation	5	(10,876,114)	(10,188,488)
Net fixed assets		15,875,280	16,531,184
Other non-current assets	6	1,394,646	1,677,588
Total non-current assets		**17,269,926**	**18,208,772**
Current assets			
Inventories	11	18,471	9,385
Accounts receivable (Net)	7	198,575	292,342
Cash and cash equivalents		463,599	2,824
Total current assets		**680,645**	**304,551**
Total assets		**17,950,571**	**18,513,323**
LIABILITIES			
Non-current liabilities			
Long-term debt—bank		125,450	135,613
Long-term leases		652,640	656,222
Long-term debt—other	8	13,000,000	14,699,007
Total non-current liabilities		**13,778,090**	**15,490,842**
Current liabilities			
Bank Borrowings—short-term		450,613	580,360
Unearned revenue		245,046	299,707
Accounts payable—other		125,830	136,249
Trade payable and accrued expenses	12	642,327	807,208
Total current liabilities		**1,463,816**	**1,823,524**
Retained earnings		2,708,665	1,198,957
Total liabilities and net worth		**17,950,571**	**18,513,323**

Exhibit 2. Income Statement

Description	Note	As of 31 December 2005	2004
REVENUES			
Sales	9	7,738,815	8,638,648
Cost of Sales		(4,193,075)	(4,800,178)
Gross profit		3,545,740	3,838,470
Interest income		6,899	432
Other revenues		284,302	308,425
Gain on early extinguishment of bonds		2,469,716	—
Total revenues		**6,306,657**	**4,147,327**
EXPENSES			
Selling & Marketing Costs		(193,075)	(208,521)
General & Administrative Expenses		(1,466,030)	(1,348,812)
Telephone and utility		(517,613)	(596,656)
Earning Before Interest, Tax and Depreciation (EBITDA)		4,129,939	1,993,338
Interest expense		(1,081,750)	(603,862)
Depreciation & amortization		(725,561)	(679,467)
Profit(loss) before tax		**2,322,628**	**710,009**
Taxes		(812,920)	(248,503)
Net profit(loss)		**1,509,708**	**461,506**

Exhibit 3. Statement of Changes in Equity

Description	Note	Total equity
Balance at January 1, 2004		737,451
Net profit—December 31, 2004		461,506
Retained earnings at December 31, 2004		1,198,957
Net profit—December 31, 2005		1,509,708
Retained earnings at December 31, 2005		**2,708,665**

Exhibit 4. Cash Flow Statements

Description	Note	As of 31 December 2005	2004
OPERATING ACTIVITIES			
Net profit		1,509,708	461,506
Adjustments to reconcile net profit:			
Depreciation & amortization		725,561	677,467
Amortization of bond discount		—	(303,649)
Gain on early extinguishment of bonds		(2,469,716)	—
Loss on sale of assets		—	516
(Increase) Decrease in accounts receivable		93,767	(194,280)
(Increase) Decrease in inventory		(9,086)	41,252
(Increase) Decrease Other assets	6	20,050	(15,598)
Increase (Decrease) in accounts payable and accrued expenses		(305,047)	216,030
Increase (Decrease) in deferred revenue		(54,661)	(147,345)
Cash flows from operating activities		**(489,424)**	**735,899**
INVESTING ACTIVITIES			
Purchase of property and equipment		(31,722)	(369,632)
Proceeds from sale of property		—	1,500
Net cash flows from investing activities		**(31,722)**	**(368,132)**
FINANCING ACTIVITIES			
Proceeds from issuance of bond obligations	10	268,948	—
Principal payments on bonds		(1,387,291)	(2,558,832)
Reduction of bond sinking fund	6	1,063,009	(43,369)
Reduction of bond reserve fund	6	300,000	1,781,556
Repayment of bank borrowings—short-term		751,000	306,940
Long-term leases		(3,582)	(3,940)
Repayment of long-term debt—bank		(10,163)	(15,035)
Cash flows from financing activities		**981,921**	**(532,680)**
Net Increase (Decrease) in cash		460,775	(164,913)
Cash, beginning of year		2,824	167,737
Cash at the end of year (December 31, 2005)		**463,599**	**2,824**

Notes to Financial Statements

Note 1. General Information

De Mayo Company is incorporated in Mexico. The company manufactures semiconductors and sells their products to local corporations.

Note 2. Summary of Significant Accounting Policies

Note: each entity considers the nature of its operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity. The accounting policies that an entity might consider presenting include, but are not limited to, the following:

- Basis of presentation
- Consolidation
- Segment reporting
- Foreign currency translation
- Derivative financial instruments and hedge accounting
- Interest income and expense
- Fee and commission income
- Financial assets
- Sale and repurchase agreements
- Intangible assets
- Property, plant and equipment
- Leases
- Cash and cash equivalents
- Provisions
- Employee benefits
- Deferred income tax
- Borrowings
- Share capital

Note 3. Financial Risk Management

This section covers the following components:

- Strategy in using financial instruments
- Credit risk
- Geographical concentrations of assets, liabilities and off-balance sheet items
- Market risk
- Currency risk
- Interest sensitivity of assets, liabilities and off balance sheet items
- Liquidity risk
- Fair values of financial assets and liabilities
- Fiduciary activities

Note 4. Critical Accounting Estimates and Judgments in Applying Accounting Policies

De Mayo Company makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year.

Note 5. Property, Plant & Equipment

Description	2005	2004
Land and improvements	1,522,165	1,522,165
Buildings and improvements	23,190,860	23,190,860
Furniture, fixtures, and equipment	2,038,369	2,006,647
	26,751,394	26,719,672
Less accumulated depreciation	(10,876,114)	(10,188,488)
Net plant and equipment	**15,875,280**	**16,531,184**

Note 6. Other Non-current Assets

Description	2005	2004
Bond issue costs, net	1,100,117	—
Bond sinking fund	86,796	1,149,805
Bond reserve	200,000	500,000
Other	7,733	27,783
Total	**1,394,646**	**1,677,588**

Note 7. Accounts Receivable

Description	2005	2004
Gross accounts receivable	403,107	602,225
Less: Allowance for doubtful account	(204,532)	(309,883)
Accounts receivable (net)	**198,575**	**292,342**

Note 8. Long-term Debt—Other

Effective March 1, 2005, the Company entered into an agreement with a trust company and issued new bonds as described in the Trust Indenture in the maximum principal amount of $13,000,000. The bonds were used to refinance the previous bonds payable.

Future annual payments to the sinking fund are approximately as follows for the year ending December 31:

2006	1,165,000
2007	1,206,000
2008	1,206,000
2009	1,206,000
2010	1,207,000
2011 and thereafter	20,545,000

Note 9. Sales

Description	2005	2004
Gross sales	7,893,591	8,725,034
Less: Sales discounts	(154,776)	(86,386)
Net sales	**7,738,815**	**8,638,648**

Note 10. Net Proceeds

Description	2005
New bonds issued	13,000,000
Paid bank borrowings	(751,000)
Payments on old bond issue	(10,842,000)
Bond issue costs	(1,138,052)
Net bond proceeds	**268,948**

Note 11. Inventories

Description	2005	2004
Raw materials	5,549	5,046
Work in progress	6,579	2,168
Finished goods	6,343	2,171
	18,471	**9,385**

Note 12. Trade Payable and Accrued Expenses

Description	2005	2004
Trade payables	386,377	325,415
Taxes	10,344	18,706
Accrued expenses	245,606	463,087
	642,327	**807,208**

CHAPTER 4

Audit and the Financial Reporting

In the wake of scandals such as those involving Enron and WorldCom, the financial world has focused much of its attention on restoring public trust in financial reporting. This focus has triggered many changes in the way companies and audit committees approach reporting, as well as in the recruitment and management of external auditors. Auditors, lawyers, investment bankers, standards-setters, and regulators are also urging the boards of directors and audit committees to play a more active role in overseeing financial reporting activities in their companies.

Close involvement will enable these boards and audit committees to monitor ethical conduct, evaluate management performance, set appropriate compensation levels for managers, and keep a close watch on and communicate directly with internal and external auditors. Whether a company is reporting under the U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS), its boards and audit committees would have greater responsibility for financial reporting and audits.

The Sarbanes-Oxley Act of 2002, which established new and enhanced standards for the boards and management of all U.S. public companies and for public accounting firms, has made the audit committee directly responsible for selecting, compensating, retaining, overseeing, and evaluating the work of external auditors. The committee is also responsible for resolving disagreements between management and external auditors on financial reporting. Auditors, therefore, must report to the audit committee. Before selecting an auditor, International Finance Corporation (IFC) client companies are required to assess candidates' skills and ability to perform the audits; in addition, IFC must approve and feel comfortable with the selections. The Controller's Department (CCB) of IFC can assist the investment and portfolio staff with the selection process. An auditor evaluator questionnaire and checklist can be obtained from CCBFR's website.

Assessing External Auditors

Various criteria can be used to assess an external financial auditor, the audit firm, and the engagement partners (see box 4.1).

Because IFC operates in many countries, the auditor for a client company must be licensed to practice in the country in which the project company resides or is incorporated,

Box 4.1 Criteria for Assessing External Auditors

- The accounting firm's knowledge of and experience in the company's industry.
- The engagement team's overall business insight and knowledge of and experience in the company's industry.
- The lead partner's business acumen, knowledge of and experience in the company's industry, and the lead partner's personal credentials.
- The auditor's ability to communicate issues and concerns to the committee clearly and effectively.
- The committee's ability to develop a trusting relationship and its level of comfort with the lead partner.
- The auditor's ability to work cooperatively with the company's management team while maintaining objectivity, and the team's ability to stand up to management on difficult issues.
- The auditor's ability to meet deadlines and respond to issues in a timely fashion.
- The accounting firm's quality control procedures.
- Significant findings from recent firm inspections, peer reviews, or other governmental oversight reviews (if publicly available).
- The audit firm's overall reputation with previous audit clients.
- The scope of the accounting firm's international network and affiliations, if the company has international operations.
- The auditors' independence and the systems employed to ensure independence (auditors have no connection to the company, their family members have no direct or indirect financial interest, and they and their family members are not serving as directors, officers, or employees).

Under "The Code of Ethics," the fundamental principles that apply to all professional accountants are:

- Integrity
- Objectivity
- Professional competence
- Due care
- Confidentiality
- Professional behavior
- Technical standards.

In addition, auditors in public practice should be, and should be seen to be, free from any interest that might be considered incompatible with their objectivity and independence.

The code states that an auditor should be independent in fact and in appearance. It provides detailed guidelines on situations that impair independence, such as financial involvement with the client, appointments to managerial positions within the client, the provision of other services (such as consulting or bookkeeping), and personal relationships.

and must be a member in good standing of the national institute that governs auditors' professional conduct.

The appointment of external auditors by IFC's project client companies is subject to IFC's concurring review. The list of audit firm candidates must be sent to IFC to assess their qualifications. A checklist of auditors' qualifications is available in IFC's Controller's Department.

Prohibited Non-Audit Services

Once an auditor has been hired, it is prohibited from rendering certain non-audit services, including:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Design and implementation of financial information systems
- Appraisal or valuation services, fairness opinion, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources services
- Broker-dealer, investment adviser, or investment banking services
- Legal and expert services unrelated to the audit.

Objective of an Audit

The objective of an audit of financial statements is to enable the auditor to express an opinion on whether those statements give a true and fair view (or are presented fairly, in all material respects), in accordance with an identified accounting framework.

The auditor performs certain tests of the transactions and balances underlying the financial statements, and evaluates their overall presentation. Just as accounts are prepared in accordance with a specified framework (such as IFRS), they are audited in accordance with certain standards. The auditing standards most commonly associated with IFRS financial statements are the International Standards on Auditing (ISA).

The external auditor's report is normally is included with the published financial statements. The statutory requirements regarding which entities should be subject to audit, and the precise matters on which the auditor should report, are determined by each national governments. The rules regarding the training and education of auditors and regulation of the profession also vary from country to country. As indicated earlier in this chapter I, it is important for IFC staff to be involved in the recruitment of audit services to ensure that the audit firm has qualified staff. This chapter does not cover national requirements.

Audit Reports and Opinions

Audit reports (see figure 4.1) and opinions (see figure 4.2) are presented in specific ways and must include required elements.

FIGURE 4.1 Structure of an Audit Report

Title ("Independent" must be in title)

Addressee (Addressed to the board and shareholders of the company)

Introductory Paragraph—Financial Statements and Mutual Responsibilities

The introductory paragraph contains the following remarks:

- The accounting firm specifies which financial statements have been audited.
- It states clearly that the financial statements are the responsibility of the management.
- The accounting firm's responsibility is to express an opinion on the financial statements based on the audit.

Scope Paragraph

The scope paragraph states the following:

- The audit has been conducted in accordance with GAAS or ISA.
- The audit tests and procedures named therein have been applied and provide *reasonable assurance* that the financial statements are *free of material misstatement*.

Opinion/Disclaimer Paragraph—Audit Results

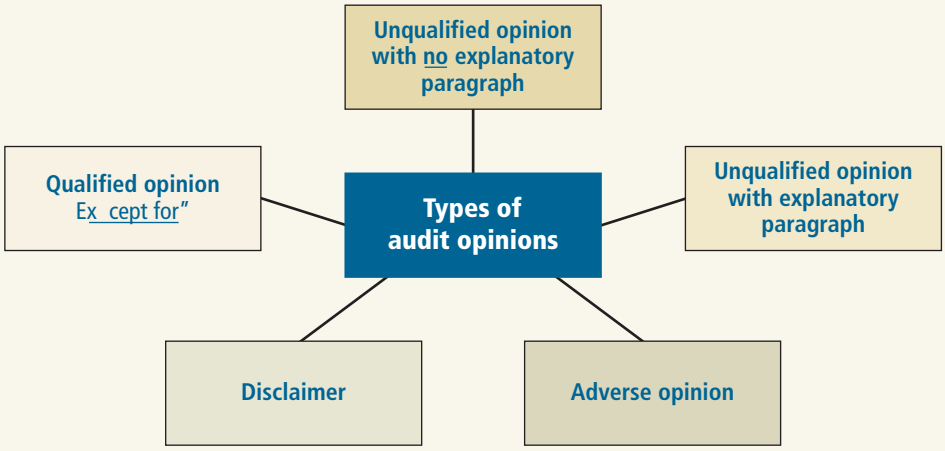
The opinion paragraph indicates:

- The financial statements *fairly present* their disclosures in conformity with GAAP.
- The financial statements *give a true and fair view* in conformity with IFRS.
- Supplementary information is provided.

Auditor's Signature

Audit Firm's Name

FIGURE 4.2 Types of Audit Opinions



Unqualified opinion with no explanatory paragraph

The financial statements present fairly, in all material respects, the company's financial position, results of operations, and cash flows in conformity with Accounting Standards

Unqualified opinion with explanatory paragraph

Does not affect the auditor's unqualified opinion, but draws reader's attention to a very important condition, transaction or policy which may have a material effect on the Company's operations or financial viability which is very different from prior years. Explanatory paragraph is required in auditor's report. Examples of explanatory paragraphs are:

- Auditor's opinion is based on the report of another auditor
- **Going concern issue**: there is substantial doubt about the entity's ability to continue as a going concern.
- Transactions with related parties
- Unusually important significant subsequent events
- Accounting matters

Adverse opinion

Financial statements do not present fairly, in all material respects, the company's financial position, results of operations, and cash flows in conformity with Accounting Standards. Examples of major Accounting Standards departures may be the following:

- Consolidations
- Revenue Recognition
- Foreign Currency Transactions

Disclaimer

Auditor does not express opinion of the financial statements. Major scope limitation and/or omitted procedures significantly impair the auditor's ability to form an opinion on the financial statements. Explanatory paragraph is required in the auditor's report.

Qualified opinion

"Except for" the effects of the matters for which the qualification relates, the financial statements present fairly, in all material respects, the company's financial position, results of operations, and cash flows in conformity with Accounting Standards.

Table 4.1 provides a summary of audit opinions and their outcomes.

Exhibits 4.1 through 4.5 provide examples of audit opinions issued under varying circumstances.

TABLE 4.1 Summary of Audit Opinions

Audit Opinion	What does it mean?	How to use	Comments
Unqualified ("clean")	Financial statements fairly present results of operations and financial position.	Accept	May have explanatory paragraphs; if so, read them carefully and note information in them.
Adverse	Financial statements *do not* fairly present results of operations and financial position.	Reject!	Client has failed to comply with IFC financial reporting requirements.
Disclaimer	Auditor has not rendered an opinion on the financial statements.	Reject!	Client has failed to comply with IFC financial reporting requirements.
Qualified ("except for")	*Except for the effects of items noted, financial statements fairly present results of operations and financial position.*	Accept, but more analysis is required	If auditors quantify magnitude of the exceptions, use their numbers in financial statement analysis.

Exhibit 4.1 Unqualified Opinion with No Explanatory Paragraph

We have audited the accompanying balance sheet of ABC Company as of December 31, 2001, and the related statements of income, retained earnings, and cash flow for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes an examination, on a test basis, of evidence supporting the amounts and disclosures in the financial statements. An audit also includes an assessment of the accounting principles used and significant estimates made by management, as well as an evaluation of the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 2001, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

Exhibit 4.2 Unqualified Opinion with Explanatory Paragraph

The accompanying financial statements have been prepared assuming that ABC Company will continue as a going concern. As discussed in note 1 to the financial statements, ABC Company has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubt about the entity's ability to continue as a going concern. Management's plans in regard to these matters are also described in note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

If substantial doubt exists about the company's ability to continue as a going concern for a period of one year from the balance sheet date, the auditors will modify their unqualified report by adding a final paragraph such as the one in exhibit 4.2.

Review engagement

Auditor applies certain analytical procedures to the financial statements prepared by company management to provide limited negative assurance that there are no material modifications that should be made. Since no audit is performed, there is no audit opinion.

Exhibit 4.3 Adverse Opinion

We have audited the accompanying balance sheet of ABC Company as of December 31, 2001, and the related statements of income, retained earnings, and cash flow for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes an examination, on a test basis, of evidence supporting the amounts and disclosures in the financial statements. An audit also includes an assessment of the accounting principles used and significant estimates made by management, as well as an evaluation of the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As a result of the audit, we determine that the company has a material amount of operating leases that are properly capital leases. Consequently, the company should increase its capital assets by the amount of equipment it has obtained under the capital leases and increase the amount of long-term debt it records in the liabilities section of the balance sheet.

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in all material respects, the financial position of ABC Company as of December 31, 2001, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Exhibit 4.4 Disclaimer Opinion

We were engaged to audit the balance sheet of ABC Company as of December 31, 2001, and the related statements of income, retained earnings, and cash flow for the year then ended. These financial statements are the responsibility of the company's company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes an examination, on a test basis, of evidence supporting the amounts and disclosures in the financial statements. An audit also includes an assessment of the accounting principles used and significant estimates made by management, as well as an evaluation of the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Because the company did not maintain adequate records with respect to inventory values, we were unable to verify inventory balances and related expense amounts. The scope of our work was not sufficient to express an opinion on the financial statements referred to previously.

Exhibit 4.5 Qualified Opinion

We have audited the accompanying balance sheet of ABC Company as of December 31, 2001, and the related statements of income, retained earnings, and cash flow for the year then ended. These financial statements are the responsibility of the company's company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as stated in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes an examination, on a test basis, of evidence supporting the amounts and disclosures in the financial statements. An audit also includes an assessment of the accounting principles used and significant estimates made by management, as well as an evaluation of the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We did not have access to the company's records prior to 2001 so that we could not properly verify ending inventory balances for 2000 by means of other auditing procedures.

In our opinion, except for the effects of such inventory adjustments, if any, that might have been determined to be necessary had we been able to verify the amounts in question, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 2001, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

TABLE 4.2 Structure of an Audit Report

Nature of service	Comparative level of assurance provided by the auditor	Nature of service
Auditing		
Audit	High, but not absolute assurance	Positive assurance on assertion(s)
Related Services		
Review	Moderate assurance	Negative assurance on assertion(s)
Agreed-upon procedures	No assurance	Factual findings of procedures
Compilation	No assurance	Identification of information

A"'review" is an engagement in which an auditor is asked to carry out procedures that provide a moderate level of assurance on financial information–a lower level of assurance than that provided by an audit. The procedures, consisting primarily of inquiry and analytical review, are performed to provide auditors with a reasonable basis for stating whether anything has come to their attention that causes them to believe that the financial statements do not give a true and fair view in accordance with the identified basis of accounting.

Auditors are often engaged to perform reviews of interim (for example, half-yearly or quarterly) financial statements prepared under IAS 34. One of the options available under IAS 34 is to provide condensed interim financial information, rather than full interim financial statements. Condensed information does not, by its nature, provide all the information necessary to gain a full understanding of the financial position and results. It is therefore not normally possible for the auditor to report that such condensed information gives a true and fair view. The auditor instead reports that the information has been properly prepared in accordance with IAS 34.

Unaudited Financial Statements

Agreed-upon procedures are those adopted when an auditor is engaged to apply procedures that the auditor and client have agreed upon. The auditor's report lists the factual findings from these procedures, but provides no general assurance whether the information complies with an accounting framework. Examples of this type of service are due diligence reports in the context of mergers and acquisition activity, and reviews of compliance with contractual arrangements.

Pro forma statements are "what if" financial statements. They are financial statements prepared with or without the accounting effects of certain transactions, and are generally one-time procedures. Examples include business combinations, significant write-downs of

assets, and the like. Pro forma statements do not comply with U.S. GAAP, IAS, or local GAAP. They are not audited.

In a compilation, an accountant engaged is required to collect, classify, and summarize financial information. No audit procedures are place, and no assurance is expressed in the report. An auditor presents the financial information that has been prepared by management but does not express an opinion on the financials.

In financial statements that have been restated for hyperinflation, IAS 29 has been applied, and statements can be audited.

Client-prepared statements are prepared and presented by management, with no independent review or involvement.

Projections present a company's financial position, income statement, and cash flow statement for future periods based on one or more hypothetical assumptions.

CHAPTER 5

Accounting and Financial Reporting Covenants in Investment Agreements

This Section of the manual chapter provides examples of typical accounting, financial reporting, and audit covenants that are usually included in investment agreements. Exhibits 5.1 through 5.4 are samples of covenants currently in use; the covenants may change over time. A newer version of the covenants may be available in the legal and/or credit departments. Table 5.1 provides definitions of ratios and terms from investment agreements with general manufacturing companies.

Exhibit 5.1 Example of Accounting and Auditing Covenants

Unless IFC [International Finance Corporation] otherwise agrees, the borrower shall prepare all financial statements and calculations in accordance with International Financial Reporting Standards (IFRS).

- Maintain an accounting and cost-control system, management information system, and books of account and other records, which together adequately reflect truly and fairly the financial condition of the Borrower.
- Maintain a firm of internationally recognized independent public accountants acceptable to IFC as Auditors; irrevocably authorize the Auditors (whose fees and expenses shall be for the account of the Borrower) to communicate directly with IFC at any time regarding the Borrower's accounts and operations, and provide to IFC a copy of that authorization; and, no later than thirty (30) days after any change in Auditors, issue a similar authorization to the new Auditors and provide a copy thereof to IFC.
- Permit IFC representatives to inspect all sites and to access its books and accounts and employees, contractors, and subcontractors.

Exhibit 5.2 Example of Reporting Covenants

Annual Requirements

Within 90 days after the end of each financial year, the Borrower shall deliver to IFC:

- Copies of Borrower's audited consolidated and unconsolidated financial statements for that financial year, together with the auditors' report on them.
- A management letter from the auditors with respect to that financial year.
- A report (in a pre-agreed form) signed by the Borrower's chief financial officer (CFO) and reviewed by the Borrower's financial auditors concerning compliance with financial covenants under the Loan Agreement (including a clear methodology of the calculation of such covenants).
- An annual operations review (in a pre-agreed form) describing major activities and changes affecting the Borrower, capital investments, achievement against operational targets, and market conditions and providing a capital and operating budget for the next financial year.
- A certification from the Borrower's CFO that all transactions by the Borrower with affiliates were arm's length.

Quarterly Requirements

Within 45 days after the end of each calendar quarter, the Borrower shall deliver to IFC:

- Copies of Borrower's unaudited consolidated and unconsolidated financial statements for such quarter, certified by the Borrower's CFO.
- Until the Project Completion Date, a progress implementation report (in a pre-agreed form), including any factors that have or could reasonably be expected to have a Material Adverse Effect.
- After the Project Completion Date, a report (in a pre-agreed form) on factors that have or could reasonably be expected to have a Material Adverse Effect.
- A report (in a pre-agreed form) signed by the Borrower's CFO concerning compliance with financial covenants under the Loan Agreement (including a clear methodology of the calculation of such covenants).

Other Requirements

- Environmental reporting requirements, including (ii) deliver an annual monitoring report (in a pre-agreed form) within 90 days of each financial year, and (ii) notify IFC of any serious environmental, health, or safety incident no later than 3 days after its occurrence.
- Deliver to IFC copies of any management letter or other communication sent by the financial auditors of the Borrower.
- Promptly notify IFC of (a) proposed changes in the Project or in the Borrower's business; (b) any event that may have a Material Adverse Effect; (c) any litigation, arbitration, or administrative proceedings that may have a Material Adverse Affect; and (d) any event of default or potential event of default.
- Provide, in a timely manner, insurance certificates and other insurance information.
- Provide such other information as IFC from time to time requests about the Borrower, its assets, and the Project.

Exhibit 5.3 Example of Covenants in Investment Agreement with General Manufacturing Company

Negative Covenants

Unless IFC otherwise agrees in writing, the Borrower shall not:

- Declare or pay any dividend or make a payment under any subordinated debt (including shareholder loans) unless:
  - the Project Completion Date has occurred;
  - in the case of dividends, such payment would be made out of retained earnings;
  - the Prospective Debt Service Coverage Ratio is not less than 1.3;
  - such payment is made within 30 days after an Interest Payment Date; and
  - after giving effect to such payment:
    - i. no event of default or potential event of default exists or is continuing
    - ii. the Current Ratio is not less than 1.3
    - iii. the Liabilities to Tangible Net Worth Ratio is not more than 1.7
    - iv. the Balance Sheet Liabilities to Tangible Net Worth Ratio is not more than 1.5
- Incur expenditures other than as required to carry out the Project and conduct operations, except after the Project Completion Date and not in excess of $5,000,000 equivalent per financial year.
- Incur or maintain any Financial Debt other than existing Financial Debt, the IFC Loan and additional Financial Debt provided for in the Financial Plan. The additional Financial Debt will be a subject to financial ratio tests such as Peak Debt Service Coverage Ratio.
- Guarantee or assume the Liabilities of others.
- Enter into leases other than Financial Leases, if the aggregate payments are in excess of $4,000,000 in any financial year.
- Permit liens on property other than the Security and certain tax liens.
- Enter into derivative transactions.
- Enter into transactions except on an arm's arm's length basis.
- Enter into exclusive sales or purchasing agency arrangements.
- Change its constitutive documents, the Financial Plan, or the nature or scope of the Project.
- Amend or waive, any of the Transaction Documents.
- Merge, consolidate, reorganize, or dispose of its assets.
- Form any subsidiary.
- Use proceeds of the IFC Loan in countries that are not members of the World Bank.
- Make any payments to government or political officials to influence acts or decisions in order to obtain improper benefits or advantages.

Exhibit 5.4 Example of Covenants in Investment Agreement with a Bank

Subscription Agreement

Negative Covenants

Unless IFC otherwise agrees, the Borrower shall not:

- Declare or pay any dividend or make any distribution on its share capital, or repurchase or redeem its shares, except out of profits earned in the preceding financial year, and then only if: (1) no Event of Default or Potential Event of Default is occurring; and (2) after the payment or distribution, the Borrower would be in compliance with the financial covenants and other terms of this Agreement.
- Create or permit to exist any Lien on any property, revenues or other assets, present or future, of the Borrower except any tax or other statutory lien, provided that such lien shall be discharged within 30 days after the date it is created or arises.
- Enter into any management, partnership, profit sharing, or royalty agreement or other similar arrangement whereby the Borrower's Borrower's business or operations are managed by, or its income or profits are shared with, any other Person.
- Enter into any material transaction, except in the ordinary course of business on ordinary commercial terms and on the basis of arm's-length arrangements.
- Prepay (whether voluntarily or involuntarily) or repurchase any Long-Term Debt (other than the Loan) pursuant to any provision of any agreement or note with respect to that Long-Term Debt unless: (1) that Long-Term Debt is refinanced using new Long-Term Debt on terms and conditions (as to interest rate, other costs, and tenor) at least as favorable to the Borrower as those of the Long-Term Debt being refinanced; or (2) the Borrower gives IFC at least thirty (30) days' advance notice of its intention to make the proposed prepayment and, if IFC so requires, contemporaneously prepays a proportion of the Loan equivalent to the proportion of the part of the Long-Term Debt being prepaid, such prepayment to be made in accordance with the provisions of the Prepayment Section of the Legal Agreement, except that there shall be no minimum amount or advance notice period for that prepayment.
- Change its Foundation Documents in any manner which would be inconsistent with the provisions of the Legal Agreement, reduce its capital, or change its Financial Year.
- Change the nature or scope of the Project or of the Borrower's business or operations.
- Undertake or permit any merger, spin-off, consolidation, or reorganization; or, except for assets acquired in the enforcement of security created in favor of the Borrower, sell, transfer, lease, or otherwise dispose of all or a substantial part of its assets, whether in a single transaction or a series of transactions, related or otherwise.

Exhibit 5.4 Example of Covenants in Investment Agreement with a Bank *(Continued)*

- Enter into any arrangement to guarantee or in any way to become obligated for all or any part of any financial or other obligation of another person, other than any such agreement or arrangement entered into by the Borrower in the ordinary course of its banking business.
- Terminate, amend, or grant any waiver with respect to any provision of the Legal Agreement; or
- Enter into any transaction involving, or for the benefit of, any of the individuals or entities listed on the UN Lists, or on any other UN sanctions list promulgated pursuant to UN Security Council resolutions in connection with money laundering or anti-terrorism measures.

Financial Covenants

The Borrower shall ensure that it is in compliance at all times with the following financial covenants on a consolidated basis (unless more stringent requirements are established by any Authority, in which case those shall prevail):

- Risk Weighted Capital Adequacy Ratio shall be no less than four percentage points above the minimum required by the BIS Guidelines.
- Classified Loans and other credit exposures, including off–balance sheet items with well-defined credit weaknesses, less loss provisions created on such exposures shall not be greater than 25 percent of the Borrower's Available Capital.
- The Borrower's three-month maturity gap, defined as total Liabilities falling due within 90 days less Assets which mature within 90 days, should be less than 100 percent of the Borrower's Available Capital.
- Aggregate Foreign Currency Short Open Position shall not exceed 25 percent of the Borrower's Available Capital; netting across currencies shall not be permitted.
- Aggregate exposure (on–balance and off–balance sheet) to all Related Parties shall not exceed 25 percent of Available Capital.
- The Borrower's single client exposure (on-balance and off-balance sheet) shall not exceed 25 percent of the Borrower's Available Capital.;
- Aggregate Large Exposures shall not exceed 400 percent of Available Capital.
- The Borrower's exposure (on–balance and off–balance sheet items) to any single Economic Group shall not exceed 25 percent of Borrower's Available Capital.
- The sum of fixed assets and equity participations shall not exceed the Borrower's Available Capital.

TABLE 5.1 Selected Definitions of Ratios and Terms from Investment Agreements with General Manufacturing Companies

Term	Definition
Balance sheet liabilities	Liabilities reflected on the balance sheet of the borrower
Current assets	The aggregate of the Borrower's cash, investments classified as "held for trading," investments classified as "available for sale," trade and other receivables realizable within one year, inventories and prepaid expenses that are to be charged to income within one year
Current liabilities	The aggregate of all liabilities of the Borrower falling due on demand or within one year (including the portion of Long-term Debt falling due within one year)
Current ratio	The result obtained by dividing Current Assets (less prepaid expenses) by Current Liabilities
Financial debt	Any indebtedness of the Borrower for or in respect of: • Borrowed money • The outstanding principal amount of any bonds, debentures, notes, loan stock, commercial paper, acceptance credits, bills or promissory notes drawn, accepted, endorsed or issued by the Borrower • The deferred purchase price of assets or services (except trade accounts that are payable in the ordinary course of business [within [ ] days of the date they are incurred and which are not overdue]); • Noncontingent obligations of the Borrower to reimburse any other person for amounts paid by that person under a letter of credit or similar instrument (excluding any letter of credit or similar instrument issued for the benefit of the Borrower with respect to trade accounts that are payable in the ordinary course of business [within [ ] days of the date of determination and which are not overdue]) • The amount of any liability in respect of any Financial Lease • Amounts raised under any other transaction having the financial effect of a borrowing and that would be classified as a borrowing (and not as an off–balance sheet financing) under the Accounting Standards • The amount of the Borrower's obligations under derivative transactions entered into in connection with the protection against or benefit from fluctuation in any rate or price (but only the net amount owing by the Borrower after marking the relevant derivative transactions to market) • Any premium payable on a [mandatory] redemption or replacement of any of the foregoing items • The amount of any liability in respect of any guarantee or indemnity for any of the foregoing items incurred by any other person.
Financial lease	Any lease or hire purchase contract that would, under the Accounting Standards, be treated as a finance or capital lease
Liabilities	The aggregate of all obligations (actual or contingent) of the Borrower to pay or repay money, including, without limitation: 1. Financial Debt 2. The amount of all liabilities of the Borrower (actual or contingent) under any conditional sale or a transfer with recourse or obligation to repurchase, including, without limitation, by way of discount or factoring of book debts or receivables

TABLE 5.1 Selected Definitions of Ratios and Terms from Investment Agreements with General Manufacturing Companies (*Continued*)

Term	Definition
Liabilities (*Continued*)	3. Taxes (included deferred taxes) 4. Trade accounts that are payable in the ordinary course of business (including letters of credit or similar instruments issued for the benefit of the Borrower in respect of such trade accounts) 5. Accrued expenses, including wages and other amounts due to employees and other services providers 6. The amount of all liabilities of the Borrower howsoever arising to redeem any of its shares 7. To the extent not included in the definition of Financial Debt, the amount of all liabilities of any person to the extent the Borrower guarantees them or otherwise obligates itself to pay them.
Long-term debt	That part of Financial Debt the final maturity of which, by its terms or the terms of any agreement relating to it, falls due more than one year after the date of its incurrence
Material adverse effect	A material adverse effect on: • The Borrower, its assets, or properties • The Borrower's business prospects or financial condition • The implementation of the Project, the Financial Plan, or the carrying on of the Borrower's business or operations • The ability of the Borrower to comply with its obligations under this Agreement, any other Transaction Document or Project Document
Net income	For any financial year, the excess (if any) of gross income over total expenses (provided that income taxes shall be treated as part of total expenses) appearing in the audited financial statements for such financial year
Non-cash items	For any financial year, the net aggregate amount (which may be a positive or negative number) of all non-cash expenses and non-cash credits that have been subtracted or, as the case may be, added in calculating Net Income during that financial year, including, without limitation, depreciation, amortization, deferred taxes, provisions for severance pay of staff and workers, and credits resulting from revaluation of the assets' book value
Peak debt service coverage ratio	The ratio obtained by dividing: • The aggregate, for the financial year most recently ended prior to the relevant date of calculation for which audited financial statements are available, of (a) Net Income for that financial year, (b) Non-Cash Items and (c) the amount of all payments that were due during that financial year on account of interest and other charges on Financial Debt[a] (to the extent deducted from Net Income); by

a. Financial Debt includes Financial Leases. Lease payments will have been apportioned by the Borrower and its auditors between the finance charge and the reduction of the outstanding lease liability (essentially corresponding to interest and principal payments). The numerator of the Peak or Prospective DSCR should add back to Net Income the finance charge and the amortization of the asset (i.e., depreciation). The denominator of the Prospective DSCR should include the entire lease payment due in the current financial year, and the denominator of the Peak DSCR should include the entire lease payment due in the financial year with the highest aggregate principal payments on Long-term Debt (including Financial Leases).

(*Continued*)

TABLE 5.1 Selected Definitions of Ratios and Terms from Investment Agreements with General Manufacturing Companies (*Continued*)

Term	Definition
Peak debt service coverage ratio (*Continued*)	• The aggregate of (a) the highest aggregate amount in any financial year, after the financial year described in clause (i) above until the final scheduled maturity of the IFC Loan, of all scheduled payments (including balloon payments) falling due on account of principal of Long-term Debt and interest and other charges on all Financial Debt and (b) without double counting any payment already counted in the preceding subclause (a), any payment required to be made to any debt service account in such financial year under the terms of any agreement providing for Financial Debt where, for the purposes of clause (ii) above: (x) subject to subclause (y), for the computation of interest payable during any period for which the applicable rate is not yet determined, that interest shall be computed at the rate in effect at the time of the relevant date of calculation (y) interest on Short-Term Debt in such financial year shall be computed by reference to the aggregate amount of interest thereon paid during the financial year in which the relevant date of calculation falls up to the end of the period covered by the latest quarterly financial statements prepared by the Borrower multiplied by a factor of 4, 2, or 4/3 depending on whether the computation is made by reference to the financial statements for the first quarter, the first two quarters or the first three quarters, respectively.
Prospective debt service coverage ratio	The ratio obtained by dividing: • The aggregate, for the financial year most recently ended prior to the relevant date of calculation for which audited financial statements are available, of (a) Net Income for that financial year, (b) Non-Cash Items, and (c) the amount of all payments that were due during that financial year on account of interest and other charges on Financial Debt (to the extent deducted from Net Income); by • The aggregate of (a) all scheduled payments (including balloon payments) that fall due during the financial year in which the relevant date of calculation falls on account of principal of Long-Term Debt and interest and other charges on all Financial Debt and (b) without double counting any payment already counted in the preceding subclause (a), any payment made or required to be made to any debt service account under the terms of any agreement providing for Financial Debt [but excluding voluntary prepayments]; where, for the purposes of clause (ii) above: (x) subject to subclause (y) below, for the computation of interest payable during any period for which the applicable rate is not yet determined, that interest shall be computed at the rate in effect at the time of the relevant date of calculation (y) interest on Short-Term Debt payable in the financial year in which the relevant date of calculation falls shall be computed by reference to the aggregate amount of interest thereon paid during that financial year up to the end of the period covered by the latest quarterly financial statements prepared by the Borrower multiplied by a factor of 4, 2, or 4/3, depending on whether the computation is made with reference to the financial statements for the first quarter, the first two quarters, or the first three quarters, respectively

TABLE 5.1 Selected Definitions of Ratios and Terms from Investment Agreements with General Manufacturing Companies *(Continued)*

Term	Definition
Short-term debt	All Financial Debt other than Long-Term Debt
Tangible net worth	The aggregate of: • The amount paid up [or credit as paid up] on the share capital of the Borrower; and (b) the amount standing to the credit of the reserves of the Borrower (including, without limitation, any share premium account, capital redemption reserve funds and any credit balance on the accumulated profit and loss account); after deducting from that aggregate: (x) any debit balance on the profit and loss account or impairment of the issued share capital of the Borrower (except to the extent that deduction with respect to that debit balance or impairment has already been made) (x) amounts set aside for [dividends or] taxation (including deferred taxation) (x) amounts attributable to capitalized items such as goodwill, trademarks, deferred charges, licenses, patents, and other intangible assets • If applicable, that part of the net results of operations and the net assets of any subsidiary of the Borrower attributable to interests that are not owned, directly or indirectly, by the Borrower.

APPENDIX A

IFRS versus U.S. GAAP

Description	IFRS	U.S. GAAP
Financial Statements		
Balance sheet	Does not prescribe a particular format. A liquidity presentation of assets and liabilities is used, instead of a current/noncurrent presentation, only when a liquidity presentation provides more relevant and reliable information.	Entities may present either a classified or nonclassified balance sheet. Items on the the balance sheet are generally presented in decreasing order of liquidity. Public companies should follow SEC regulations.
Income statement	Does not prescribe a standard format, although expenditure is presented in one of two formats (function or nature).	Present as either a single-step or multiple-step format. Expenditures are presented by function. Public companies should follow SEC regulations.
Extraordinary items	Prohibited.	Defined as being both infrequent and unusual, and are rare. Negative goodwill is presented as an extraordinary item.
Statement of recognized income and expense (SoRIE)/Other comprehensive income and statement of accumulated other comprehensive income	A SoRIE can be presented as a primary statement, in which case a statement of changes in shareholders' equity is not presented. Alternatively, it may be disclosed separately in the primary statement of changes in shareholders' equity.	Total comprehensive income and accumulated other comprehensive income are disclosed, presented either as a separate primary statement or combined with the income statement or with the statement of changes in stockholders' equity.
Statement of changes in share (stock) holders' equity	Statement shows capital transactions with owners, the movement in accumulated profit and a reconciliation of all other components	Similar to IFRS except statement is presented as a primary statement; SEC rules allow certain information to be included in the

Description	IFRS	U.S. GAAP
Financial Statements *(Continued)*		
Statement of changes in share (stock) holders' equity *(Continued)*	of equity. The Statement is presented as a primary statement except when a SoRIE is presented; in that case, only disclosure applies.	notes and not in the primary statement.
Cash flow statements: format and method	Standard headings, limited flexibility in content. Use direct or indirect method.	Headings similar to IFRS, but more specific guidance for items included in each category. Direct or indirect method used; SEC encourages the direct method.
Assets		
Acquired intangible assets	Capitalized if recognition criteria are met; amortized over useful life. Intangibles assigned an indefinite useful life are not amortized but reviewed at least annually for impairment. Revaluations are permitted in rare circumstances.	Similar to IFRS, except revaluations are not permitted.
Internally generated intangible assets	Research costs are expensed as incurred. Development cost is capitalized and amortized only when specific criteria are met.	Research and development costs are expensed as incurred. Some software and website development costs are capitalized.
Property, plant, and equipment (PP&E)	Historical cost or revalued amounts are used. Regular valuations of entire classes of assets are required when revaluation option is chosen.	Historical cost is used; revaluations are not permitted.
PP&E: Subsequent measurement	The *cost model* requires an asset to be carried at cost less accumulated depreciation and impairment. However, *revaluation* of PPE at fair value is permitted under the alternative treatment. The revaluation model should be applied to an entire class of assets. The increase of an asset's carrying amount as a result of a revaluation is credited directly to equity under the heading "revaluation surplus," unless it reverses a revaluation decrease for the same	PPE is carried at cost less accumulated depreciation and impairment losses. Revaluations are not permitted. Consistent with IFRS, impairment testing is performed whenever events or changes in circumstances suggest the carrying value of an asset is not recoverable

Description	IFRS	U.S. GAAP
Assets *(Continued)*		
PP&E: Subsequent measurement *(Continued)*	asset, previously recognized as an expense. In this case, it is recognized in the income statement. A revaluation decrease is charged directly against any related revaluation surplus for the same asset; any excess is recognized as an expense. Disclosures of the historical cost equivalent (cost and accumulated depreciation) of assets carried at revalued amounts are required.	
PP&E: Frequency of revaluations	Revaluations have to be kept sufficiently up to date so that the carrying amount does not differ materially from the fair value. This requires regular revaluations of all PPE in the relevant class when the revaluation policy is adopted. At each year-end, management should consider whether fair value is materially different from carrying value.	Not applicable.
Leases: classification	A lease is a finance lease if substantially all risks and rewards of ownership are transferred. Substance rather than form is important.	Similar to IFRS, but with more extensive form-driven requirements.
Leases: lessor accounting	Amounts due under finance leases are recorded as a receivable. Gross earnings allocated to give constant rate of return based on (pre-tax) net investment method.	Similar to IFRS, but with specific rules for leveraged leases.
Impairment of assets	If impairment is indicated, assets are written down to higher of fair value less costs to sell and value in use based on discounted cash flows. Reversal of impairment losses is required in certain circumstances.	Impairment is assessed on undiscounted cash flows for assets to be held and used. If less than carrying amount, impairment loss is measured using market value or discounted cash flows. Reversals of losses is prohibited.

Description	IFRS	U.S. GAAP
Assets *(Continued)*		
Capitalization of borrowing costs	Permitted as a policy choice for all qualifying assets, but not required.	Required.
Inventories	Carried at lower of cost and net realizable value. FIFO or weighted average method is used to determine cost. LIFO is prohibited. Reversal is required for subsequent increase in value of previous write-downs.	Similar to IFRS; however, use of LIFO is permitted. Reversal of write-down is prohibited.
Biological assets	Measured at fair value less estimated point-of-sale costs.	Not specified. Generally historical cost used.
Financial assets: measurement	Depends on classification of investment: if *held to maturity* or *loans and receivables,* they are carried at amortized cost; otherwise at fair value. Unrealized gains/losses on *fair value through profit or loss* classification (including trading securities) is recognized in income statement. Unrealized gains and losses on *available-for-sale* investments are recognized in equity.	Accounting model similar to IFRS, with numerous detailed differences in application; for example, no ability to designate financial assets at fair value through profit or loss.
Held-to-maturity investments Financial assets held with a positive intent and ability to hold to maturity. Include assets with fixed or determinable payments and maturities. Do not include equity securities, as they have an indefinite life.	An entity should have the "positive intent and ability" to hold a financial asset to maturity, not simply a present intention. When an entity sells more than an insignificant amount of assets (other than in limited circumstances), classified as held to maturity, it is prohibited from using the held-to-maturity classification for two full annual reporting periods (known as tainting). The entity should also reclassify all its held-to-maturity assets as available-for-sale assets. Measured at amortized cost using the effective-yield method.	Similar to IFRS, although US GAAP is silent about when assets cease to be tainted. For listed companies, the SEC states that the taint period for sales or transfers of held-to-maturity securities should be two years.

Description	IFRS	U.S. GAAP
Assets *(Continued)*		
Loans and receivables Financial assets with fixed or determinable payments not quoted in an active market. May include loans and receivables purchased, provided their intention is similar, but not interests in pools of assets (for example, mutual funds).	Measured at amortized cost.	Does not define a loan and receivable category. Focuses on the definition of a security. Industry-specific guidance may also apply.
Financial assets at fair value through profit or loss Two subcategories: financial assets held for trading (see below), and those designated to the category at inception. Any financial asset may, on initial recognition, be classified as fair value through profit or loss provided it meets certain criteria.	An irrevocable decision to classify a financial asset at fair value, with changes in fair value recognized in the income statement, provided it results in more relevant information because either: (a) it eliminates or significantly reduces a measurement or recognition inconsistency; (b) a group of financial assets, financial liabilities or both is managed and performance is evaluated on a fair value basis; or (c) the contract contains one or more substantive embedded derivatives.	No option to designate financial assets at fair value with changes in fair value recognized in the income statement.
Available-for-sale financial assets Include debt and equity securities designated as available for sale, except those equity securities classified as held for trading, and those not covered by any of the above categories.	Measured at fair value. Changes in fair value are recognized net of tax effects in equity (i.e., presented in a statement of changes in shareholders' equity or in a SoRIE) and recycled to the income statement when sold, impaired, or collected. Foreign exchange gains and losses on debt securities are recognized in the income statement.	Similar to IFRS, except unlisted equity securities are generally carried at cost. Exceptions apply for specific industries. Changes in fair value are reported in other comprehensive income. Foreign exchange gains and losses on debt securities are recognized in equity.

Description	IFRS	U.S. GAAP
Liabilities		
Provisions: general	Provisions relating to present obligations from past events are recorded if outflow of resources is probable and can be reliably estimated.	Similar to IFRS, with rules for specific situations such as environmental liabilities, loss contingencies.
Provisions: restructuring	Restructuring provisions are recognized if detailed formal plan announced or implementation effectively begun.	Recognition of liability based solely on commitment to plan is prohibited. In order to recognize, restructuring plan has to meet the definition of a liability, including certain criteria regarding likelihood that no changes will be made to plan or that plan will be withdrawn.
Government grants	Recognized as deferred income and amortized. Entities may offset capital grants against asset values.	Similar to IFRS, except when conditions are attached to grant. In this case, revenue recognition is delayed until such conditions are met. Long-lived asset contributions recorded as revenue in the period received.
Finance leases	Requires recognition of an asset held under a finance lease with a corresponding obligation for future rentals, at an amount equal to the lower of the fair value of the asset and the present value of the future minimum lease payments (MLPs) at the inception of the lease. The asset is depreciated over its useful life or the lease term if shorter. However, this is only permitted if there is no reasonable certainty of the lessee obtaining ownership of the asset. The interest rate implicit in the lease is normally used to calculate the present value of the MLPs. The lessee's incremental borrowing rate may be used if the implicit rate is unknown.	Similar to IFRS, except that the lessee's incremental borrowing rate is used to calculate the present value of the MLPs, excluding the portion of payments representing executory costs, unless it is practicable to determine the rate implicit in the lease and the implicit rate is lower than the incremental borrowing rate. If the incremental borrowing rate is used, the amount recorded as the asset and obligation is limited to the fair value of the leased asset. Asset amortization is consistent with IFRS.
Operating leases	The rental expense under an operating lease is generally recognized on a straight-line basis over the lease term	Similar to IFRS

Description	IFRS	U.S. GAAP
Liabilities *(Continued)*		
Leases: lessee accounting, sale and leaseback transactions	For finance leases, profit arising on sale and finance leaseback is deferred and amortized. If an operating lease arises, profit recognition depends on whether the transaction is at fair value. Substance/linkage of transactions is considered.	Timing of profit and loss recognition depends on whether seller relinquishes substantially all or a minor part of the use of the asset. Losses are immediately recognized. Specific strict criteria are considered if the transaction involves real estate.
Financial liabilities: classification	Capital instruments are classified, depending on substance of issuer's obligations, as either liability or equity. Mandatorily redeemable preference shares are classified as liabilities.	Similar to IFRS but certain redeemable instruments are permitted to be classified as "mezzanine equity" (i.e., outside of permanent equity). Mandatorily redeemable instruments with a date or event certain redemption are classified as a liability.
Financial liabilities: measurement	Convertible debt is measured at fair value on initial recognition, which is usually the consideration received plus incremental and directly attributable costs of issuing the debt. There are two categories of financial liabilities: those that are recognized at fair value through profit or loss (includes trading), and all others. All derivatives that are liabilities (except qualifying hedging instruments) are trading liabilities. Other trading liabilities may include a short position in securities. Financial liabilities at fair value through profit or loss (including trading) are measured at fair value (the change is recognized in the income statement for the period). Financial liabilities aside from those that are trading can only be designated at fair value through profit or loss (provided they meet certain criteria). All other (nontrading) liabilities are carried at amortized cost using the effective interest method.	Similar to IFRS. Incremental and directly attributable costs of issuing debt are deferred as an asset and amortized using the effective interest method. There are also specific measurement criteria for certain financial instruments. Entities cannot use the fair value option to designate at initial recognition a financial liability at fair value through profit or loss.

Description	IFRS	U.S. GAAP
Liabilities *(Continued)*		
Convertible debt	"Split accounting" is used for convertible instruments where the conversion is a fixed amount of cash for a fixed number of shares. The proceeds are allocated between the two components; the equity conversion rights are recognized in equity and the liability recognized in liabilities at fair value calculated by discounting at a market rate for a nonconvertible debt. Certain embedded derivatives may have to be bifurcated.	For conventional convertible debt, the instrument is treated as one unit and recorded as a liability in its entirety (no recognition is given to the equity component), unless the instrument contains a beneficial conversion feature that requires separation. Similar to IFRS, certain embedded derivatives may have to be bifurcated.
Equity instruments: recognition and classification	An instrument is classified as equity when it does not contain an obligation to transfer economic resources. Preference shares that are not redeemable, or that are redeemable solely at the option of the issuer, and for which distributions are at the issuer's discretion, are classified as equity. Only derivative contracts that result in the delivery of a fixed amount of cash, or other financial asset for a fixed number of an entity's own equity instruments, are classified as equity instruments. All other derivatives on the entity's own equity are treated as derivatives.	Shareholders' equity is analyzed between capital stock (showing separate categories for nonredeemable preferred stock and common stock) and other categories of shareholders' equity. Mandatorily redeemable financial instruments (date or event certain redemption), obligations to repurchase own shares by transferring assets and certain obligations to issue a variable number of shares are not classified as equity but are considered to be liabilities. Unlike IFRS, certain derivatives of an entity's own shares that are or may be net share-settled can be classified as equity.
Revenue Recognition		
Revenue recognition	There is a standard on revenue recognition. The standard describes specific criteria for the sale of goods, the rendering of services and interest, royalties, and dividends. The revenue recognition criteria common to each of these are the probability that the economic benefits associated with the transaction will flow to the entity and that the revenue and costs can be measured reliably.	The guidance is extensive. There are a number of different sources of revenue recognition guidance, such as FAS, SABs, SOPs, EITFs and AAERs. U.S. GAAP focuses more on revenues being realized (either converted into cash or cash equivalents, or the likelihood of its receipt being reasonably certain) and earned (no material transaction pending and the related performance has

Description	IFRS	U.S. GAAP
Revenue Recognition (*Continued*)		
Revenue recognition (*continued*)		occurred). Revenue recognition involves an exchange transaction. Additional guidance for SEC registrants sets out criteria that an entity should meet before revenue is realized and earned.
Construction contracts	Accounted for using percentage-of-completion method. Completed contract method is prohibited.	Similar to IFRS; however, completed contract method is permitted in rare circumstances.
Expense Recognition		
Interest expense	Recognized on an accrual basis. Effective yield method is used to amortize non-cash finance charges.	Similar to IFRS.
Employee benefits: pension costs, defined-benefit plans	Projected unit credit method is used to determine benefit obligation and record plan assets at fair value. Actuarial gains and losses can be deferred.	Similar to IFRS but with several areas of differences in the detailed application (see below).
Employee benefits: pension costs, valuation of plan assets	Measured at fair value or using discounted cash flows if market prices are unavailable. Insurance contracts measured at fair value. Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations.	Similar to IFRS, except for differences resulting from the expected long-term rate of return applied to market related value of plan assets (see expected return on plan assets below). Contracts (other than purchases of annuities) are measured at fair value. If the contract has a determinable cash surrender value or conversion value, that value is used.
Employee benefits: pension costs, expected return on plan assets	Based on market expectations at the beginning of the period for returns over the entire life of the related obligation. Reflects changes in the fair value of plan assets as a result of actual contributions and benefits paid. The rate is applied to the fair value of plan assets.	Based on market conditions and nature of the assets. Includes changes in plan assets due to contributions and benefit payments. The rate is applied to the market-related value of the plan assets, which is either the fair value or a calculated value (which incorporates asset-related gains and losses over a period of no more than five years).

Description	IFRS	U.S. GAAP
Expense Recognition *(Continued)*		
Employee share compensation	Expense for services purchased is recognized. Corresponding amount is recorded either as a liability or an increase in equity, depending on whether transaction is determined to be cash- or equity-settled. Amount to be recorded is measured at fair value of shares or share options granted.	Similar model to IFRS. Compensation expense is generally recognized based on fair value of awards at grant date. Several areas of difference exist in application.
Derivatives and Hedging		
Derivatives and other financial instruments: cash flow and fair value hedges	Derivatives and hedge instruments are measured at fair value; changes in fair value are recognized in income statement except for effective portion of cash flow hedges, where the changes are deferred in equity until effect of underlying transaction is recognized in income statement. Gains/losses from hedge instruments that are used to hedge forecast transaction may be included in cost of nonfinancial asset/liability (basis adjustment).	Similar to IFRS, except no "basis adjustment" on cash flow hedges of forecast transactions.
Derivatives and other financial instruments: net investment hedges	Effective portion of gains/losses on hedges of net investments is recognized in equity; ineffective portion is recorded in income statement. Gains/losses held in equity are transferred to income statement on disposal or partial disposal of investment.	Similar to IFRS. Gains/losses are transferred to income statement upon sale or complete or substantially complete liquidation of investment.
Other Information		
Functional currency: determination	If indicators are mixed and functional currency is not obvious, judgment is used to determine functional currency that most faithfully represents economic results of entity's operations by focusing on currency of primary economic environment in which entity operates.	Similar to IFRS; however, no specific hierarchy of factors to consider. In practice, currency in which cash flows are settled is often key consideration.

Description	IFRS	U.S. GAAP
Other Information *(Continued)*		
Presentation currency	When financial statements are presented in the currency other than the functional currency, assets and liabilities are translated at exchange rate at balance sheet date. Income statement items are translated at exchange rate at dates of transactions, or average rates if rates do not fluctuate significantly.	Similar to IFRS.
Hyperinflationary economy: definition	Hyperinflation is indicated by characteristics of economic environment of country, which include population's attitude towards local currency and prices linked to price index; and if cumulative inflation rate over three years is approaching, or exceeds, 100%.	Hyperinflation is generally indicated by cumulative three-year inflation rate of approximately 100% or more.
Hyperinflationary economy: measurement	Entities that have as functional currency the currency of hyperinflationary economy restate financial statements using a measurement unit current at balance sheet date.	Generally does not permit inflation-adjusted financial statements; instead requires use of reporting currency (U.S. dollar) as functional currency. Foreign issuers that use IFRS are permitted to omit quantification of any differences that would have resulted from application of FAS 52.
Earnings per share: Diluted	Weighted average potential dilutive shares are used as denominator for diluted EPS. "Treasury share" method is used for share options/warrants.	Similar to IFRS.
Related-party transactions: definition	Determined by level of direct or indirect control, joint control, and significant influence of one party over another or common control by another entity.	Similar to IFRS.
Segment reporting: scope and basis of formats	Public entities: primary and secondary (business and geographic) segments are reported on basis of risks and returns and internal reporting structure.	Public entities (SEC registrants): reported on basis of operating segments, which are based on manner in which chief operating decisionmaker evaluates financial

Description	IFRS	U.S. GAAP
Other Information *(Continued)*		
Segment reporting: scope and basis of formats *(Continued)*		information for purposes of allocating resources and assessing performance.
Post–balance sheet events	Financial statements are adjusted for subsequent events, providing evidence of conditions at balance sheet date and materially affecting amounts in financial statements (adjusting events). Nonadjusting events are disclosed.	Similar to IFRS.
Interim financial reporting	Contents are prescribed and basis should be consistent with full-year statements. Frequency of reporting (e.g., quarterly, half-year) is imposed by local regulator or at discretion of entity.	Similar to IFRS. Additional quarterly reporting requirements apply for SEC registrants (domestic U.S. entities only) and half-year reporting requirements for certain foreign private issuers.
Insurance and reinsurance contract: measurement, loss recognition. income statement presentation	An entity may retain the accounting policy under previous GAAP (i.e., national GAAP), subject to minimum requirements. Requires a liability adequacy test. Guaranteed options are considered in liability adequacy test. "Shadow" adjustments resulting from assumed realization of unrealized gains or losses on investments recorded in equity are reflected in equity, if such accounting is elected. Otherwise, any deficiency resulting from the assumed realization of unrealized gains or losses is reflected through the income statement. Insurance revenues and costs may not be offset by the effects of reinsurance transactions.	Detailed measurement guidance exists for different types of insurance and reinsurance contracts. Similar test is required (referred to as the "premium deficiency" test). Explicit guidance exists for accruing liabilities for guaranteed life insurance and annuity options; they are also considered in premium deficiency test. "Shadow" adjustments (including "shadow" premium deficiency adjustments) resulting from assumed realization of unrealized gains or losses on investments recorded in equity are reflected in equity. Insurance revenues and costs are offset by the effects of reinsurance transactions.
Oil and gas, and mining	Entity may choose to capitalize exploration and evaluation activities under one of two methods: the framework or entity's existing policy if management consider it relevant and reliable.	Entity may choose to capitalize exploration and evaluation activities under one of two methods: successful efforts or full-cost method.

Description	IFRS	U.S. GAAP
Other Information *(Continued)*		
Historical cost	Historical cost is the main accounting convention. However, IFRS permits the revaluation of intangible assets, property, plant, and equipment (PPE) and investment property. IFRS also requires certain categories of financial instruments and certain biological assets to be reported at fair value.	Prohibits revaluations except for certain categories of financial instruments, which have to be carried at fair value.

APPENDIX B

Financial Ratios

Ratios	Formula	Purpose or Use
Liquidity Ratios		
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Measure short-term debt-paying ability
Quick or acid-test ratio	$\frac{\text{Cash, marketable Securities, \& receivable (net)}}{\text{Current liabilities}}$	Measures immediate short-term liquidity
Current cash debt coverage ratio	$\frac{\text{Net cash provided by operating activities}}{\text{Average current liabilities}}$	Measures a company's ability to pay off its current liabilities in a given year from its operations
Asset Management Ratios		
Receivables turnover	$\frac{\text{Net sales}}{\text{Average trade receivables (net)}}$	Measures liquidity of receivables
Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Average Inventory}}$	Measures liquidity of inventory
Fixed assets turnover	$\frac{\text{Fixed assets turn over}}{\text{Average net fixed assets}}$	Measures how efficiently assets are used to generate sales
Coverage Ratios		
Debt ratio	$\frac{\text{Total debt}}{\text{Total assets}}$	Measures the percentage of total assets provided by creditors

Ratios	Formula	Purpose or Use
Coverage Ratios (*Continued*)		
Times-interest-earned (TIE) ratio	$\frac{\text{Income before interest charges and taxes (EBIT)}}{\text{Interest charge}}$	Measures ability to meet interest payments as they come due
EBITDA coverage ratio	$\frac{\text{EBITDA + Lease payments}}{\text{Interest + Principal + Lease Payments}}$	Measures ability to meet fixed financial charges
Cash debt coverage ratio	$\frac{\text{Net cash provided by operating activities}}{\text{Average total liabilities}}$	Measures a company's ability to repay its total liabilities in a given year from its operations
Book value per share	$\frac{\text{Common stockholders' equity}}{\text{Outstanding shares}}$	Measures the amount each share would receive if the company were liquidated at the amounts reported on the balance sheet
Profitability Ratios		
Profit margin on sales	$\frac{\text{Net income available to common stockholders}}{\text{Net sales}}$	Measures net income generated by each dollar of sales
Return on Asset (ROA)	$\frac{\text{Net income available to common stockholders}}{\text{Average total assets}}$	Measures overall profitability of assets
Return on Common Equity (ROE)	$\frac{\text{Net income available to common stockholders}}{\text{Average Common equity}}$	Measures profitability of owners' investment
Earnings per share	$\frac{\text{Net income available to common stockholders}}{\text{Weighted shares outstanding}}$	Measures net income earned on each share of common stock
Price/Earnings (P/E) ratio	$\frac{\text{Price per share}}{\text{Earnings per share}}$	Measures the ratio of the market price per share to earnings per share
Payout ratio	$\frac{\text{Cash dividends}}{\text{Net income}}$	Measures percentage of earnings distributed in the form of cash dividends

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