Mitch Smith Case Scenario

Mitch Smith, CFA, is preparing an equity research report on Ubura Technologies. The company is in situated in USA and is following IFRS for the financial reporting purpose. Ubura Technologies has inter-corporate investments in three companies. The investment portfolio of Ubura Technologies is given in Exhibit 1. Ubura Technologies invested in those companies at the beginning of year 2012.

Exhibit 1
Ubura Technologies' Investment Portfolio (in thousands of dollars)

Characteristics	Arc Inc.	Trident Ltd.	Crow Inc.
Classification	Held-to-maturity	Available-for-sale	Held-for-trading
Par value	300	500	200
Acquired cost	280	530	200
Annual coupon rate	4.00%	6.00%	5.00%
Market interest rate	5.00%	5.00%	5.00%
Market value at the end of 2012	290	505	210

Ubura Technologies sold its entire investment portfolio in 1st January 2013. It sold its stake in Arc Inc. for $289,500, Trident Ltd. for $504,200 and Crow Inc. for $210,050.

Glenn Maxwell, a colleague of Mitch Smith, asks him about the reclassification of investments under IFRS. Mitch makes the following statements:

Statement 1: Reclassification of securities out of held-of-trading securities is not allowed
Statement 2: When an available-for-sale security is reclassified to held-to-maturity security, the fair value carrying amount of the security at the time of reclassification becomes its new amortized cost. Any previous gain or loss that had been recognized in other comprehensive income is transferred to profit or loss in the income statement
Statement 3: Reclassification of security from held-to-maturity to available –for-sale can be done only if there has been a change in intention to hold the security till maturity. The difference between the fair value and the amortized cost at the reclassification date will go to the other comprehensive income

Glenn inquires about the impairment of securities as well that how impairment impacts the different type of investments and how the treatment is done in the company's financial statements. Mitch makes the following statements about impairment:

Statement 4: Losses expected as a result of future events are not recognized in the income statement
Statement 5: The disappearance of an active market is an evidence of impairment as the financial instruments are no longer publicly traded
Statement 6: Impairment losses on available-for-sale equity securities cannot be reversed

Mitch also makes the following statements about the impact of impairment on the financial statements:

Statement 7: For held-to-maturity securities, the impairment loss is measured as the security's carrying value and the present value of its estimated future cash flows discounted at the current market interest rate
Statement 8: The carrying amount of the held-to-maturity security, if impaired, can be reduced either directly or using an allowance account
Statement 9: When available-for-sale security becomes impaired, the amount of the cumulative loss to be reclassified is the difference between acquisition cost and current fair value, less any impairment loss that has previously been recognized in profit or loss.

1. What is the balance sheet carrying value of Ubura Technologies at the end of 2012?
   a) $993,000
   b) $995,000
   c) $997,000

2. What is the total value of income realized in income statement as profit or loss in year 2012 from the investment portfolio?
   a) $60,500
   b) $64,000
   c) $65,500

3. What is the total impact of selling the entire investment portfolio in its income statement on 1st January 2013?
   a) -$24,850
   b) -$18,250
   c) -$14,750

4. What of the following statements made by Mitch is least likely to be correct regarding the impairment?
   a) Statement 4
   b) Statement 5
   c) Statement 6

5. Which of the following statements made by Mitch is least likely to be correct regarding the reclassification of securities under IFRS?
   a) Statement 1
   b) Statement 2
   c) Statement 3

6. Which of the following statements made by Mitch is least likely to be correct regarding the impact of impairment on the financial statements under IFRS?
   a) Statement 7
   b) Statement 8
   c) Statement 9

Jared Freeman Case Scenario

Jared Freeman is an auditor who is checking the financial statements of Genesis Mentors. Genesis Mentors is into education industry and has acquired 30% stake in Eduraft, another company in education industry. It is assumed that Genesis Mentors have significant influence but not control. So, Genesis Mentors is using equity method to account for the income from the associate company Eduraft.

It has acquired the stake in Eduraft at the end of year 2009. The information regarding assets and liabilities of Eduraft at the end of year 2009 is given in Exhibit 1. It paid $150 million for the stake.

Exhibit 1
Eduraft at the end of year 2009 (in million dollars)

	Book Value	Fair Value	Difference
Current assets	120	120	0
Plant and equipment	350	400	50
	470	520	50
Liabilities	70	70	0
Net assets	400	450	50

The plant and equipment are depreciated on a straight-line basis and have 5 years of remaining life. Eduraft reported an income of $150 million and paid out dividends of $50 million in year 2010.

In year 2011, Eduraft sold its goods to Genesis Mentors for a profit of $20 million. Genesis Mentors couldn't sell these books to other third party during the year. In the same year, Genesis Mentors also sell goods of $120 million to Eduraft for $180 million. During the year, Eduraft could sell $120 million of those goods to the third party and sold the rest of $60 million in year 2012.

Eduraft reported an income of $200 million and $240 million in year 2011 and 2012. It also paid a dividend of $50 million each in those years.

Jared asks Manish Harodia, CFO of Genesis Mentors, about the accounting principles they are following for reporting purposes. Manish Harodia tells him that Genesis Mentors is following U.S. GAAP.

Manish Harodia is worried about an event that happened at the beginning of year 2013 concerning Eduraft. That will have a material impact on the fair value of the investment made by Genesis Mentors in Eduraft. The future cash flows can be reliably estimated after the impact. The carrying value of the investment in Eduraft comes out to be more than the fair value of the investment. That would lead to impairment in equity. Manish Harodia wants to confirm if in future, the impact is reversed, would they be able to reverse the impairment losses.

Jared Freeman tells him that the reversal of impairment losses in investment in associates is not allowed under U.S. GAAP but once can do that in case of IFRS.

7. What is the value of unamortized excess purchase price at the end of year 2010?
   a) $12 million
   b) $15 million
   c) $27 million

8. What is the total investment in Eduraft in the balance sheet of Genesis Mentors at the end of year 2010?
   a) $177 million
   b) $180 million
   c) $192 million

9. Which of the following reporting standards allow the reversal of impairment losses in investment in associates?
   a) U.S. GAAP
   b) IFRS
   c) None of the above

10. What is the equity income to be reported as a line item on Genesis Mentors' 2011 income statement?
    a) $39 million
    b) $42 million
    c) $45 million

11. What is the impact of dividend income in year 2011 on the equity income for Genesis Mentors?
    a) Increase by $15 million
    b) Decrease by $15 million
    c) No impact

12. What is the equity income to be reported as a line item on Genesis Mentors' 2012 income statement?
    a) $60 million
    b) $72 million
    c) $75 million

John Austin Case Scenario

John Austin, CFA, is an equity research analyst with Value Quest. He is looking at the balance sheet of a company Gatsby Inc. Gatsby Inc. prepares its financial statement in accordance with U.S. GAAP. He wants to compare the performance of this company with other peer group companies. But the other companies are preparing their financial statement in accordance with IFRS and are following the FIFO method to account for their inventory. Gatsby Inc. is using LIFO method to account for its inventory. The financial statements of Gatsby Inc. are given in Exhibit 1.

Exhibit 1
Balance Sheet (in millions of US dollars)

As of 31 December	2012	2011
Cash and cash equivalents	284	195
Accounts receivable	472	488
Inventories	719	689
Total Current Assets	1,475	1,372
Property, plant and equipment	4,025	3,898
Total assets	**5,500**	**5,270**
Total current liabilities	1,455	1,390
Long-term debt	1,100	1,070
Total liabilities	2,555	2,460
Common stock and paid in capital	1,000	1,000
Retained earnings	1,945	1,810
Total shareholders' equity	2,945	2,810
Total liabilities and shareholders' equity	**5,500**	**5,270**

Income Statement (in millions of US dollars)

For the year ended 31 December	2012	2011
Sales	3,512	3,298
Cost of goods sold	2,010	1,862
Depreciation and amortization expense	75	50
SG&A	1,200	1,180
Interest expense	52	46
Income tax expense	90	64
Net income	135	96

The company also reports the following information in its notes to financial statements:
The LIFO reserves as of 31 December 2012 and 2011 are $75 million and $92 million respectively. The LIFO reserve was $70 million as of 31 December 2010.

The marginal tax rate for the company is 40%. The company has not paid any dividends in year 2012 and 2013.

The company is expecting to write down inventory in year 2013. Amly, another analyst, asks Kohn about the probable impact of write down on various ratios. John makes the following statements:

Statement 1: Profitability ratios will decrease
Statement 2: Liquidity ratios will decrease
Statement 3: Activity ratios will increase
Statement 4: Solvency ratios will decrease

Amly further asks John about consistency of inventory costing, inventory write downs and LIFO liquidation. John makes the following statements to explain the things:

Statement 5: The company must be consistent in its accounting policy. If it changes its accounting policy, the change must be justifiable and applied retrospectively to the financial statement. An exception to the retrospective restatements is when a company reporting under U.S. GAAP changes to FIFO from LIFO method.
Statement 6: Inventory write downs are more prominent in case of FIFO method than LIFO method
Statement 7: The reversal of inventory write down may occur under IFRS but are not allowed under U.S. GAAP
Statement 8: LIFO liquidation causes the profitability ratio to be higher for the companies using LIFO method rather than FIFO method in case of inflationary scenario

13. Which of the following statements made by John regarding the probable impact of write downs on various ratios is least likely to be correct?
    a) Statement 2
    b) Statement 3
    c) Statement 4

14. Which of the following statements made by John is least likely to be correct?
    a) Statement 5
    b) Statement 6
    c) Statement 8

15. What would have been the amount of inventory reported as of 31 December 2011 if Gatsby Inc. would have used FIFO method instead of LIFO method to account for the inventory?
    a) $597 million
    b) $781 million
    c) $794 million

16. Under FIFO method for the year ending on 31 December 2012, the net income of Gatsby Inc. would have been higher/lower by an amount of
    a) Lower by $10.2 million
    b) Higher by $10.2 million
    c) Higher by $17.0 million

17. What would have been the impact on the total taxes paid by the firm in 2011 and 2012 if they would have used FIFO instead of LIFO?
    a) Increase by $2.0 million
    b) Increase by $8.8 million
    c) Increase by $15.6 million

18. What would have been the amount of cost of goods sold reported by Gatsby Inc. for the year ending on 31 December 2012?
    a) $1,993 million
    b) $2,022.2 million
    c) $2,027 million

Scott Segley Case Scenario

Scott Segley, CFA level III candidate, is an analyst in Capital IQ. He is doing comparative analysis of Kinsella Corp with its competitors. Kinsella Corp is into construction business. The various ratios of Kinsella Corp and its peer group are given in Exhibit 1.

Exhibit 1

Recent Year Ratios	Kinsella Corp	Peer Group
Interest Coverage Ratio	12.00	13.00
Return on Equity	12.84%	8.25%
Net Profit Margin	27.50%	22.50%

Scott finds out that Kinsella Corp has capitalized its expenditure of $300,000 on a building while other peer group companies have expensed the similar expenditure in their financial statements. The expense is capitalized for 5 years and depreciation is done on a straight line basis.

The recent year's financial statements for Kinsella Corp are given in Exhibit 2.

Exhibit 2
Income Statement (in thousands of USD)

Revenue	1,200
Cash expense	400
Depreciation	200
EBIT	600
Interest expense	50
Earnings before tax	550
Tax at 40%	220
Net Income	330

Balance Sheet

Cash	720
PP&E (net)	2,400
Other assets	780
Total assets	3,900
Total liabilities	1,000
Retained earnings	1,700
Common stocks	1,200
Total shareholders' equity	2,900
Total liabilities and shareholder's equity	3,900

The beginning value of the shareholders' equity at the starting of the year was $2,570.

The manager of Scott, David Casey, asks him about the impact of depreciation methods chosen by companies on the various ratios. He specifically asks what would have the impact on the ratios if Kinsella Corp would have used double declining depreciation methods rather than straight line method. Scott makes the following statements:

Statement 1: The asset turnover ratio of Kinsella Corp would increase in initial years if it uses the double declining method of depreciation
Statement 2: The net profit margin of Kinsella Corp would decrease in initial years on choosing the double declining method of depreciation
Statement 3: The net income of Kinsella Corp would be lower in later years on choosing the double declining method of depreciation

19. What is the interest coverage ratio for Kinsella Corp considering that it expenses that expenditure on building rather than capitalizing it?
   a) 16.0
   b) 13.2
   c) 7.2

20. What is the return on equity for Kinsella Corp assuming that it expenses the expenditure on that building rather than capitalizing it? Use beginning book value for equity for calculation.
   a) 9.11%
   b) 8.17%
   c) 7.23%

21. What is the net profit margin for Kinsella Corp assuming that it expenses the expenditure on that building rather than capitalizing it?
   a) 19.50%
   b) 17.50%
   c) 15.50%

22. What would have been the impact on cash flow from investing activities if Kinsella Corp would have expensed the expenditure on that building rather than capitalizing it?
   a) Increase in cash flow from investment by $300,000
   b) Decrease in cash flow from investment by $300,000
   c) Increase in cash flow from investment by $240,000

23. What would have been the impact on cash flow from operating activities if Kinsella Corp would have expensed the expenditure on that building rather than capitalizing it?
   a) Decrease in cash flow from operations by $204,000
   b) Decrease in cash flow from operations by $180,000
   c) Increase in cash flow from operations by $180,000

24. Which of the following statements made by Scott is least likely to be accurate?
   a) Statement 1
   b) Statement 2
   c) Statement 3

Danny Klucka Case Scenario

Danny Klucka is an analyst with Marcus Investments. He is looking at the financial statements of Circat Inc. Circat Inc. bought a machine at $300,000 for its operations. The accumulated depreciation of the machine is $50,000 so far. The expected undiscounted future cash flows for the machine are $240,000. The value in use for the machine is $250,000. The selling cost for the machine is $20,000. The fair value of the machine is $220,000. Circat Inc. is following U.S. GAAP for its reporting purposes.

His colleague, Sarah, asks him about the impact of impairment on various financial ratios and tax payment. Danny makes the following statements:

Statement 1: An impairment of an asset would lead to higher asset turnover in the subsequent years after the impairment
Statement 2: An impairment of an asset would lead to decrease in tax payment in the year of impairment
Statement 3: An impairment of an asset would lead to a lower asset base in the subsequent years after the impairment

Circat Inc. also had impaired an asset held for sale 3 months ago. An impairment loss of $3,500 was reported in the income statement. Now the fair value of the asset has again risen up by $4,500 and also the cost to sell has also increased by $1,500.

Sarah asks Danny about the impact of capitalizing an asset on the various ratios. Danny makes the statements which are summarized in Exhibit 1.

Exhibit 1

Ratios	Year of Capitalization	Subsequent Years
Return on assets	Higher	Lower
Debt to equity ratio	Lower	Higher
Interest coverage ratio	Higher	Lower

Circat Inc. had depreciated an asset using a straight-line method of depreciation. The asset was bought at $50,000 and had a total estimated useful life of 10 years. Now, after 4 years, the carrying value of asset is 34,000. Now, the management has decided to increase the total salvage value by $4,000.

25. What is the total impairment loss reported by Circat Inc. for the machine?
   a) $10,000
   b) $20,000
   c) $30,000

26. What would have been total impairment loss reported by Circat Inc. under IFRS?
   a) $50,000
   b) $30,000
   c) No loss

27. Which of the following statements made by Danny is least likely to be correct about the impact of impairment on financial ratios and tax payment?
   a) Statement 1
   b) Statement 2
   c) Statement 3

28. What is the total upward revaluation done by Circat Inc. for the asset held for sale?
   a) 0
   b) $3,000
   c) $3,500

29. Which of the entries in Exhibit 1 is least likely to be correct?
   a) Return on assets
   b) Debt to equity ratio
   c) Interest coverage ratio

30. What is the depreciation of the machine in the 5^{th} year?
   a) $5,000
   b) $4,000
   c) $3,333