Chapter 3: Overview of Accounting Analysis
The Importance of Accounting Analysis

• Accounting practices govern the types of disclosures made in the financial statements.

• Understanding accounting allows the business analyst to effectively use the financial information disclosed by companies.
Key Concepts in Chapter 3

• Various factors influence the quality of accounting-based financial reports.

• Managers have some discretion in accounting choices used in financial reporting.

• Incentives for the management of financial reporting items must be considered by the analyst.
Accrual Basis Accounting

• Financial reports are prepared using accrual basis accounting instead of cash basis accounting.

• Accounting standards (GAAP or IFRS) defines the following financial statement elements:
  – Revenues
  – Expenses
  – Assets
  – Liabilities
  – Equity
Management’s Responsibility for Reporting Financial Information

• Applying accounting principles is the responsibility of management, who has superior knowledge of a firm’s business.

• Incentives exist for management to distort accounting numbers in their favor
  – Contracts
  – Reputation

• Mitigating effects of the Sarbanes-Oxley Act.
Generally Accepted Accounting Principles (GAAP)

- Private standard setting bodies - FASB for GAAP and IAS for IFRS.

- Accounting standards seek consistency in reporting between firms and over different time periods of the same firm.

- Uniform accounting standards minimize manager’s ability to manipulate financial statement information.

- International harmonization of accounting standards is gaining popularity.
External Auditing of Financial Statements

- Required for publicly traded companies
- Conducted according to standards (GAAS)
- SOX requires external auditors to report to or be overseen by a company’s audit committee
Factors Influencing Accounting Quality

- It is necessary to allow managers some discretion in applying accounting standards.

- As a result, three potential sources of noise and bias in accounting data include:
  1. Noise from accounting rules
  2. Forecast errors
  3. Manager’s accounting choices
Noise From Accounting Rules and Forecast Errors

- The fit between accounting standards and the nature of the firm’s transactions may introduce some distortion in the reported financial statements.

- Management’s estimates may result in accounting forecasting errors reflected in the financial statements.
Manager’s Accounting Choices

• Managers have a number of incentives to choose accounting disclosures that are biased:
  – Debt covenants
  – Compensation contracts
  – Contests for corporate control
  – Tax considerations
  – Regulatory considerations
  – Capital market and stakeholder considerations
  – Competitive considerations
Steps in Performing Accounting Analysis

• **Step 1: Identify Principal Accounting Policies**
  – Key policies and estimates used to measure risks and critical factors for success must be identified.

• **Step 2: Assess Accounting Flexibility**
  – Accounting information is less likely to yield insights about a firm’s economics if managers have a high degree of flexibility in choosing policies and estimates.
Steps in Performing Accounting Analysis
Step 3: Evaluate Accounting Strategy

• Flexibility in accounting choices allows managers to strategically communicate economic information or hide true performance.

• Issues to consider include:
  – Norms for accounting policies with industry peers
  – Incentives for managers to manage earnings
  – Changes in policies and estimates and the rationale for doing so
  – Whether transactions are structured to achieve certain accounting objectives
Steps in Performing Accounting Analysis
Step 4: Evaluate the Quality of Disclosure

• Managers have considerable discretion in disclosing certain accounting information

• Issues to consider include:
  – Whether disclosures seem adequate
  – Adequacy of footnotes to the financial statements
  – Whether MD&A sufficiently explains and is consistent with current performance
  – Whether GAAP restricts the appropriate measurement of key measures of success
  – Adequacy of segment disclosure
Steps in Performing Accounting Analysis
Step 5: Identify Potential Red Flags

• Some issues that warrant gathering more information include:
  – Unexplained transactions that boost profits
  – Unusual increases in inventory or A/R in relation to sales
  – Increases in the gap between net income and cash flows or taxable income
  – Use of R&D partnerships, SPEs or the sale of receivables to finance operations
Steps in Performing Accounting Analysis

• Step 5, continued, more issues that warrant gathering more information:
  – Unexpected large asset write-offs
  – Large fourth quarter adjustments
  – Qualified audit opinions or auditor changes
  – Related party transactions

• Step 6: Undo Accounting Distortions
Steps in Performing Accounting Analysis

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Accounting Analysis Pitfalls

• Conservative accounting may also be misleading.
  – For example, historical cost and accounting for intangible assets

• Not all unusual accounting practices are questionable
  – Earnings management does not necessarily motivate some accounting phenomena that seem unusual
Concluding Comments

• Accounting analysis is an essential step in analyzing corporate financial reports.

• A methodology consisting of six steps in analyzing accounting data was presented in this chapter.

• Research suggests earnings management is not so pervasive as to make earnings data unreliable.