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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.

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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.

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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

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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.

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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.

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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

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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

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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.

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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

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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.

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Steps in Performing Accounting Analysis
Step 3: Evaluate Accounting Strategy

- Flexibility in accounting choices allows mangers 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

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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

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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

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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

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Steps in Performing Accounting Analysis

Step 6: Undo Accounting Distortions

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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

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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.

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