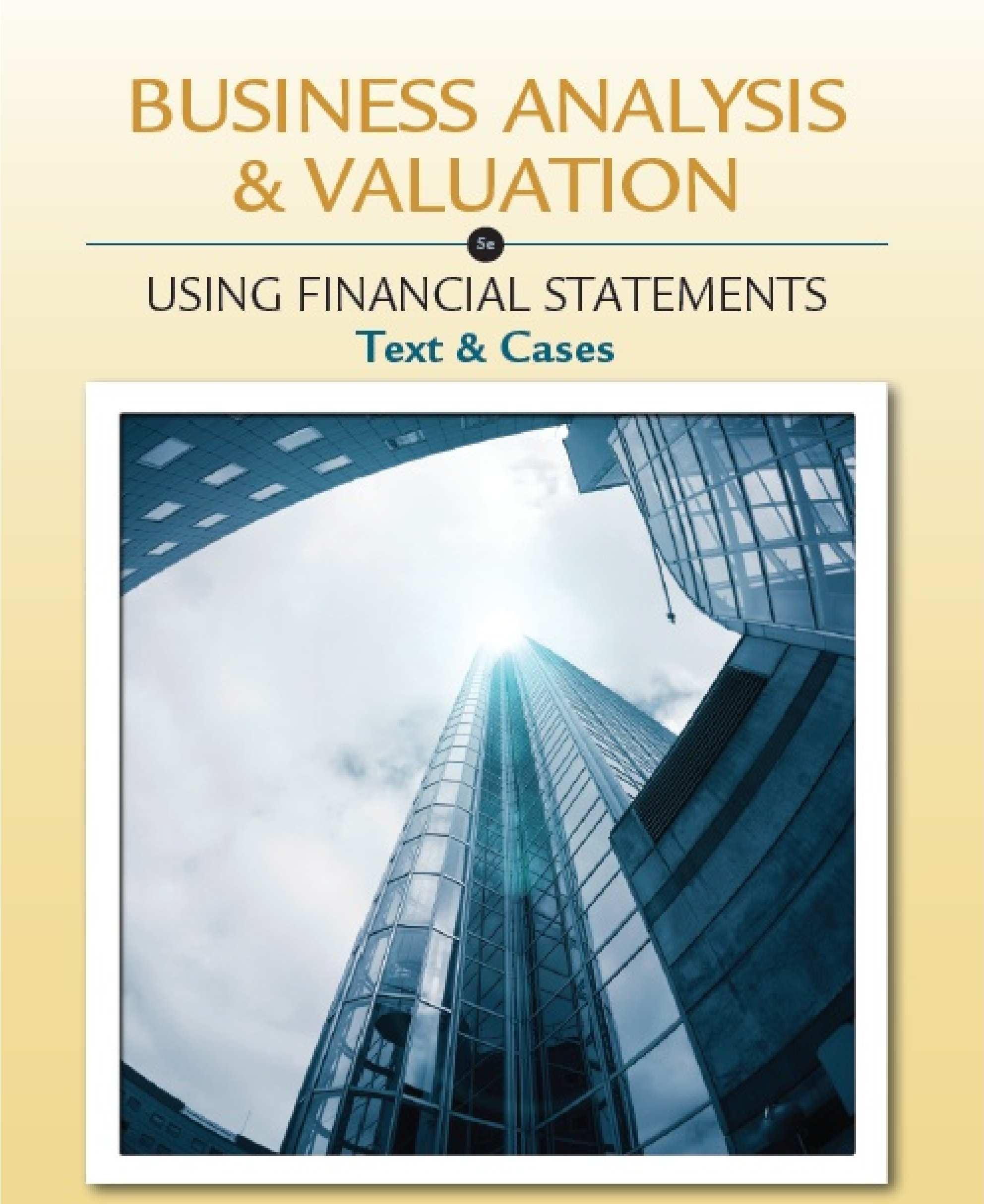


# Chapter 4: Implementing Accounting Analysis

# Key Concepts in Chapter 4

- Recasting financial statements into a template that uses standard terminology makes analysis more meaningful.

- Analyzing elements of the balance sheet for possible distortions allow the analyst to better understand the economic substance of a firm's transactions and financial position.

# Recasting Financial Statements

- Balance sheets, income statements, and statements of cash flows may be recast with standardized line item descriptions to increase their usefulness.
  - Firms can vary in the nomenclature and formats used to report financial results
  - Templates have been designed for each of the three major financial statements to standardize the format and nomenclature
    - **Refer to Tables 4-1, 4-2, and 4-3**

# Asset Distortions

- Assets are defined as resources with probable future benefits. Distortions may generally arise from ambiguities about whether:
  - The firm owns/controls the economic resource
  - Future economic benefits can be measured with reasonable certainty
  - Fair values are higher or lower than book values

# Asset Distortions – Ownership / Control

- Some types of transactions make it difficult to assess the ownership of an asset. For example:
  - Aggressive revenue recognition is likely to affect related asset values
  - Management may differ in opinion with auditors or analysts over the valuation of assets
  - Accounting standards (GAAP and IFRS) may not capture subtleties associated with ownership or control over certain assets

# Asset Distortions – Economic Benefits and Fair Values

- Accounting standards require the immediate expensing of some resource outflows that may have future economic benefits.

- Because considerable judgment is involved in determining whether the value of an asset is impaired, and the amount of the impairment, assets may be misstated.

# Overstated Assets

- Incentives to inflate reported earnings can result in overstated assets. Some of the most common forms include:
  - Delayed write-downs of current or long-term assets
  - Understatement of reserves
  - Accelerated recognition of revenues
  - Understated depreciation/amortization of long-term assets

# Understated Assets

- There may be incentives for earnings to be under-reported, resulting in understated assets.
- Conservatism in standard setting may also result in understated assets.

# Understated Assets: The most Common Causes

- Overstated write-downs of current or long-term assets
- Overestimated reserves
- Overstated depreciation / amortization
- Leased assets off balance sheet
- Discounted receivables off balance sheet
- Key intangible assets not capitalized

# Liability Distortions

- Liabilities are economic obligations requiring future outflows of resources.

- Distortions may generally arise from ambiguities about whether:
  - An obligation has been incurred
  - The proper measurement of an obligation

# Understated Liabilities

- Understated liabilities may arise from:
  - Incentives to overstate earnings or the strength of financial position
  - Difficulties in estimating the amount of future financial commitments

# Understated Liabilities: Likely Conditions

- Liabilities may be understated under some of the following conditions:
  - Aggressive revenue recognition
  - Off balance sheet loans related to receivables
  - Off balance sheet long-term liabilities
  - Pension and post-retirement obligation understatements

# Equity Distortions

- Equity is the residual claim on a firm’s assets held by stockholders.
- Since Assets = Liabilities + Equity, distortions in assets and/or liabilities lead to distortions in equity.
- The nature of hybrid securities needs to be considered to reduce any possible bias in the financial statements.

# Concluding Comments

- Recasting financial statements is an important step to facilitate comparability among financial statements analyzed.
- Analysts should focus on evaluating and adjusting accounting measures that describe the firms' key strategic value drivers.
- It is important to keep in mind that many accounting adjustments will be estimates.