Lecture Three – Accounting Analysis

Note; Focuses on Step 2 of the 5 step process.
- Accounting analysis and financial analysis

Accounting Analysis

Assess the degree to which the firm's accounting reflects the underlying business reality.
- This is done by Identifying any accounting distortions and evaluating their impact on profits and the sustainability of profits.

Having identified any accounting distortions, analysts can then adjust a firm's accounting numbers using cash flow and footnote information to "undo" the distortions.

- This is what we are measuring for our company;
- Note; talking about ;

1. Error, and
2. Bias

Not Fraud!!

Introduction

- When looking at a business we must first understand it – industry and strategy analysis
- But, we also observe the business through the financial statements
- The purpose of Accounting Analysis is to evaluate the degree to which the firm's accounting captures its underlying business reality.

Question – Does the accounting numbers match the business reality/nature of the firm?

Prelude to a quality analysis

- Understand the business
  - What the business is doing

- Understand the accounting policy

- Understand the business areas where accounting quality is most doubtful
  - Areas where the accounting is not so easy to do – error – bias.

- Understand situations in which management are particularly tempted to manipulate
  - Eg; union negotiations – company will try and make themselves look as bad as possible.

Financial Reporting – The institutional framework

The basic features of financial reporting:

- Accrual accounting
  - Every accrual is a guess of the future

- Delegation of reporting to management

- Generally accepted accounting principles (GAAPs)

- Eg; inventory method (LIFO) - cant be used In Australia
- Accounting standards limit choice
- However, this may not reflect the true representation of the company.

Increased uniformity from accounting standards, however, comes at the expense of reduced flexibility of managers to reflect genuine business differences in a firm's accounting decisions.

- External auditing
- Verification of the integrity of the reported financial statements by someone other than the preparer.

- Legal liability

Factors Influencing Accounting Quality;

It is not optimal to use accounting regulation to completely eliminate managerial flexibility.

There are 3 potential sources of noise and bias in accounting data; Noise introduced by;

- Rigidity in Accounting rules
- Random forecast errors
- Accruals
- Manager's accounting choices (systematic reporting choices).
- Accounting-based debt covenants
- Management compensation
- Tax considerations
- Decisions to influence regulatory outcomes.
- Level of disclosure

Flash Points: Accounting Areas where **Error** is More Likely

Industry	Flash Point
Banking	Credit losses: quality of loan loss provisions
Computer hardware	Technological change: quality of receivables and inventory
Computer software	Market ability of products: quality of capitalized r&d
Retailing	Credit losses: quality of net accounts receivable Inventory obsolescence: quality of carrying values of inventory Rebate programs: quantity of sales and estimated liabilities
Manufacturing	Warranties: quality of warranty liabilities Product liability: quality of estimated liabilities
Automobiles	Overcapacity: quality of depreciation allowances
Telecommunications	Technological change: quality of depreciation allowances
Equipment leasing	Lease values: quality of carrying values for leases
Tobacco	Liabilities for health effects of smoking: quality of estimated liabilities
Drugs	R&D: quality of R&D expenditures Product liability: quality of estimated liabilities
Airlines	Frequent flier programs: estimated liabilities for travel awards
Real estate	Property values: quality of carrying values for real property
Aircraft and ship manufacturing	Revenue recognition: quality of estimates under percentage of completion method and "program accounting"
Subscriber services	Development of customer base: quality of capitalized promotion costs Subscriptions paid in advance: quality of deferred revenue

Due to guesses – full of error – links to bias – produces further problem

Identify the material choices

Article titled “Evidence of Earnings management from the provision of bad debts.

Flash Points : Institutional Situations where manipulation is more likely

- The firm is in the process of raising capital or renegotiating borrowing. Watch public offerings
- Debt covenants are likely to be violated
    - If firms need to refinance
    - Debt/Equity Ratio

- A management change
    - During the GFC this was very common
    - Asset impairment decisions
    - Big Bath accounting – done to make the new management look better.

- An auditor change

- Management rewards (like bonuses) are tied to earnings
    - Look at the directors report – Remuneration report – see if the top management get large bonuses.

- A weak governance structure: inside management dominate the board; there is a weak audit committee or none at all

- Transactions are with related parties rather than at arm's length
    - Read;
    1. Related party notes
    2. Contingent liability notes

- Special events such as union negotiations

- The firm is "in play" as a takeover target

- Tax considerations
    - Tax changes

Problematic Accounting Quality?

- A change in accounting policies or estimates
- An earnings surprise
- Constant sales or falling sales
- Earnings growing faster than sales
- Small profits (that might be losses without manipulation)
    - Most of these firms don’t actual produce small profits – in fact it was a <u>small loss</u> but they just push it up to look a little better.

- Differences in profit for tax reporting and financial reporting
    - Tax Note in the financial report

- Differences between profit and cash flows from operations
    - Cash flow note

The Impacts of Manipulation

1. Borrowing income from the future
    - Increase in current revenue
    - Decrease in current expenses

   Both increase current assets

2. Banking income for the future
    - Decrease current revenue
    - Increase current expenses

   Both reduce current assets

Distinguish:

- Conservative Accounting
  vs.
- Liberal Accounting

A matter of Accounting Policy

- Aggressive Accounting
  vs.
- Big Bath Accounting

A matter of short-term application of accounting that will reverse

Companies manipulate to look both;

- Better; and
- Worse

Conservative vs. Liberal Accounting

- Conservative Accounting – Accounting conservatism is a branch of accounting that requires a high degree of verification before making a legal claim to any profit. Accounting conservatism will recognize all probable losses as they are discovered and most expenditures as they are incurred.
    - Conservative accounting methods: These accounting methods delay the recording of revenue and accelerate the recording of expenses. Profit is reported slowly.

- Liberal Accounting – These accounting methods accelerate the recording of revenue and delay the recording of expenses. Profit is reported quickly.

In general terms, conservative accounting methods are pessimistic, and liberal methods are optimistic. The choice of accounting methods also affects the values reported for assets, liabilities, and owners' equities in the balance sheet.

Aggressive vs. Big Bath Accounting

- Aggressive Accounting –refers to an accounting department's deliberate and purposeful tampering with its company's financials in order to outwardly characterize its revenues as higher than they truly are.

- Big Bath Accounting - Big Bath in accounting is an earnings management technique whereby a one-time charge is taken against income in order to reduce assets, which results in lower expenses in the future. The write-off removes or reduces the asset from the financial books and results in lower net income for that year.

Steps in Performing Accounting Analysis (6 steps)

1. <u>Identify key (principal) accounting policies</u>

    - Identify and evaluate the policies and estimates the firm uses to measure critical business factors and key risks

<u>Note;</u> these are 'big ticket' items

2. <u>Assess accounting flexibility</u>

    - Understand flexibility and resulting information content

- If managers have little flexibility in choosing accounting policies and estimates related to their key success factors, accounting data are likely to be less informative for understanding the firm's economics.

<u>Note;</u> these are the range of choices that the firm could have chosen from.

3. <u>Evaluate accounting strategy</u>

When managers have accounting flexibility, they can use it either to communicate their firm's economic situation or to hide true performance.

- How to the firms accounting policies Compare to industry norms
- Do management have incentives to manipulate?
- Any changes in policies / estimates?
- What is the history of accounting adjustments?
- Are any transactions structured only for an accounting outcome?
    - Accounting adjustments – multiple years ? – earnings smoothing ?
    - Do they explain what happened?

<u>Note;</u> this step is about telling what we think of the firms accounting policies (choices)
We should also fund another company that use the same policies/stategies and see if there are any major differences.

- Eg; Cost leader/Differentiation
- Look at differences as well as similarities

- We should put anything we find on this step in the 'Factiva search'

4. Evaluate the quality of disclosure

- Is there adequate disclosure?
- Does Note 1 adequately explain the key accounting policies and assumptions?
- Does the firm explain its current performance?

- **If accounting rules are restrictive, are there other disclosures made by the firm?**

    - Note; this is the only one that isn't the job of the auditor.

- What is the quality of the segment disclosure?
- How forthcoming are management about bad news?
- How good is the firm's investor relations program?

5. Identify potential red flags (accounting distortions)

Note; these are anything unusual/ problematic pointing to questionable accounting;

These indicators suggest that an analyst should examine certain items more closely or gather more information on them.

- Qualified audit reports
- Unexplained changes in accounting
- Unexplained transactions that increase profit
- Unusual increases in accounts receivable and / or inventories vs. sales
- Gap between profit and cash from operations over time
- Gap between profit and taxable income over time
- Related party transactions
- Unexpected large write-offs

Note; everything we list for step 5, we must explain how these are going to/should be fixed in step 6.

- If nothing – "Nothing to report"

6. Undo any accounting distortions

Fix problems in step 5.

Restate the reported numbers to reduce the distortion to the extent possible.

Two ways to fix;
1. Journal Entry
2. Alter Ratios

If there is an impairment, you cant do step 1, it will then affect ratios.

Done by using the firm's cash flow statement and the financial statement footnotes.

A word of Warning

- Conservative vs. liberal accounting
- Conservative accounting is not the same as good accounting.
- Not all unusual accounting is questionable
  - That is, if it is consistent – it doesn't necessarily matter

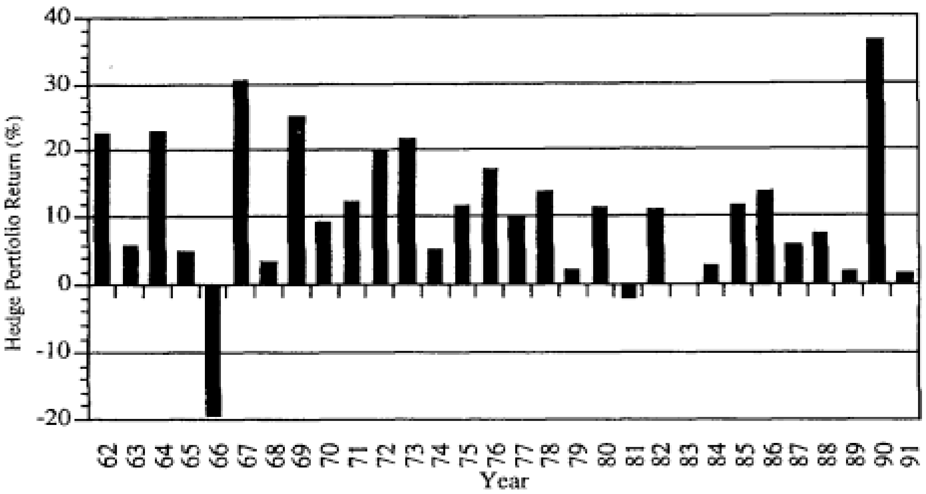
- External audit
  - Auditors provide assurance

IPOs and Manipulation

Diagnostic (%)	Year of IPO	Year after IPO 1	2	3	4	5	6
Net income/sales	4.6	2.8	2.1	1.6	1.3	1.3	1.8
Abnormal accruals/book value	5.5	1.6	-0.4	-0.8	-2.0	-1.4	-2.7
Allowance for uncollectibles/gross accounts receivable	2.91	3.32	3.46	3.62	3.81	3.77	3.85

Note; with IPOs, companies will want to look as good as possible, and therefore boost numbers.
- This is shown with the "year of IPO' numbers – higher than the "years after IPO' numbers – the second set of numbers are a lot more accurate.

Abnormal Returns to Quality Analysis



3 Problems with this research;

1. Doesn't Include risk
2. No brokerage fees

3. Time Period (1962-1991)

- This period is pre internet – information flowed much slower – share price changed slower.

The value of Accounting Information

- Why use accounting information?

- Accounting data and accounting analysis are not likely to be useful for investors.

- Value in earnings
  - Also known as return on equity.
  - Better than cash flows
  - Therefore financial statements are better than financial information
  - Next period's earnings and ROE performance are more relevant information for investors than cash flow performance.

- Value in cash flow
  - Don't show future cash flows accurately.

Summary

- When looking at a business we must <u>first understand it</u> – industry and strategy analysis. But, we also observe the business through the financial statements.

- Consequently, we must <u>understand how the business operates</u>, and how those operations are represented in the financial statements

- Further, we <u>must understand how well a firm's accounting measures the underlying business reality</u>