Financial Reporting and Analysis

2

Lecture

Lecture 2 agenda

Financial Reporting and Analysis

Financial Reporting Environment

Factors affecting statutory financial reports

Nature and purpose of Accounting

Objectives

Qualities of accounting information

Principles

Relevance and limitations

Accruals: Cornerstone of Accounting

Relevance of accruals

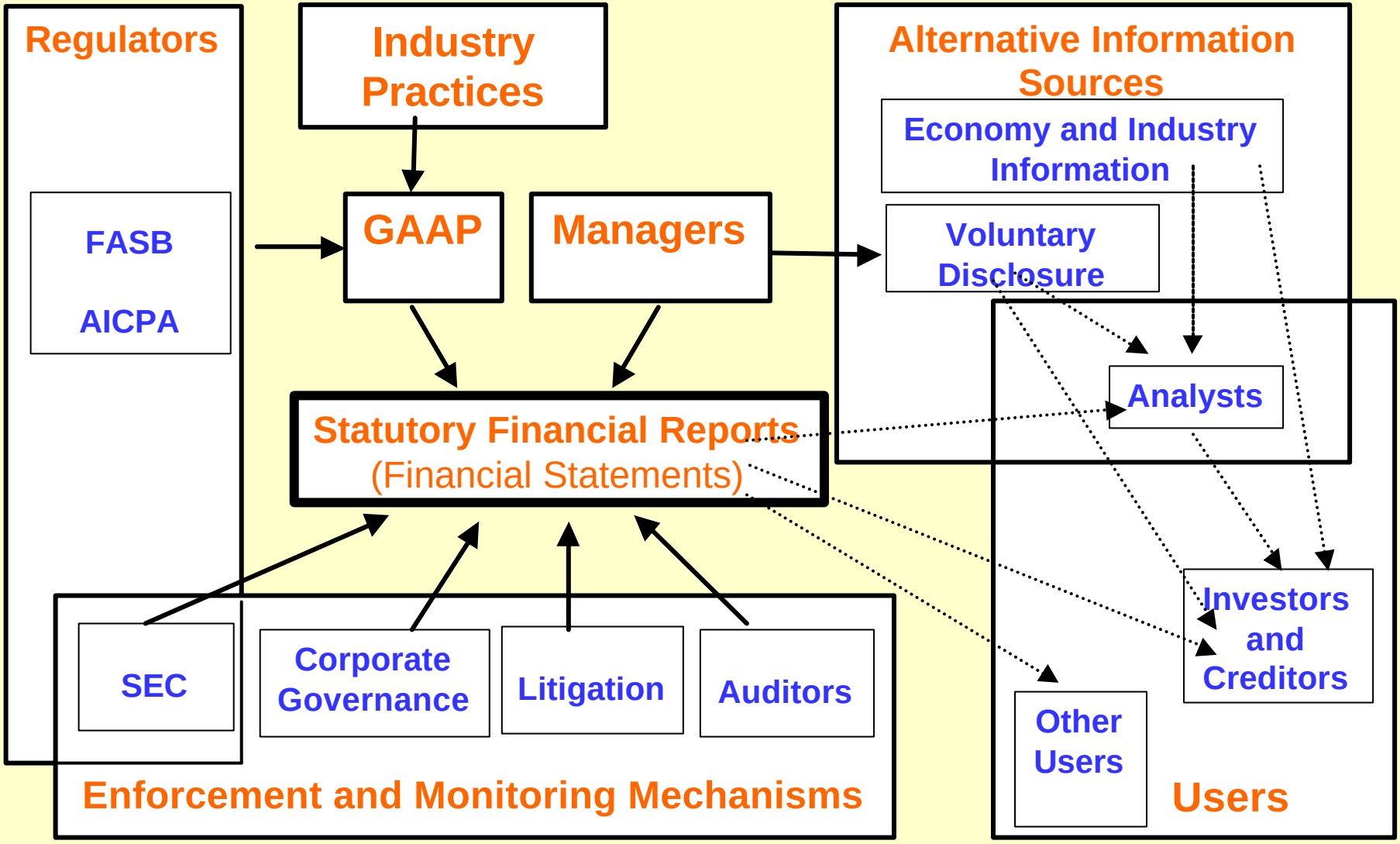
Analysis and Implications of accruals

Introduction to Accounting Analysis

Need for Accounting Analysis

Process of Accounting Analysis

Financial Reporting Environment



Environmental Factors

GAAP

Generally Accepted Accounting Principles

- **Rules and guidelines of financial accounting: collection of standards, pronouncements, opinions, interpretations, and practice guidelines set by professional and statutory bodies.**
- **Determine measurement and recognition policies such as how assets are measured, when liabilities are incurred, when revenues and gains are recognized, when expenses and losses are incurred, what information must be provided in the notes.**

Financial Accounting

Objectives

Stewardship

- Safeguard assets
- Increase equity value
- Protect creditors

\ Accountability & Performance Measurement

Historical Emphasis
(but still important)

Information Perspective

- Amount
- Timing
- Uncertainty

} …of prospective net cash inflows

\ Predictability & Decision Usefulness

Modern Emphasis

Financial Accounting

Desirable qualities of accounting information

- **Relevance** – capacity of information to affect a decision. It implies:
  - to have ***predictive*** value
  - to have ***feedback*** value
  - ***Timeliness*** (to be reported before it loses its capacity to affect decision
- **Reliability** –
  - ***Verifiability***: means that the information is confirmable
  - ***Representational faithfulness***: information reflects reality
  - ***Neutrality***: truthful and unbiased
- **Comparability** – information is measured in a similar manner across company
- **Consistency** – the same method is used for similar transaction across time.

Financial Accounting

Important Accounting Principles

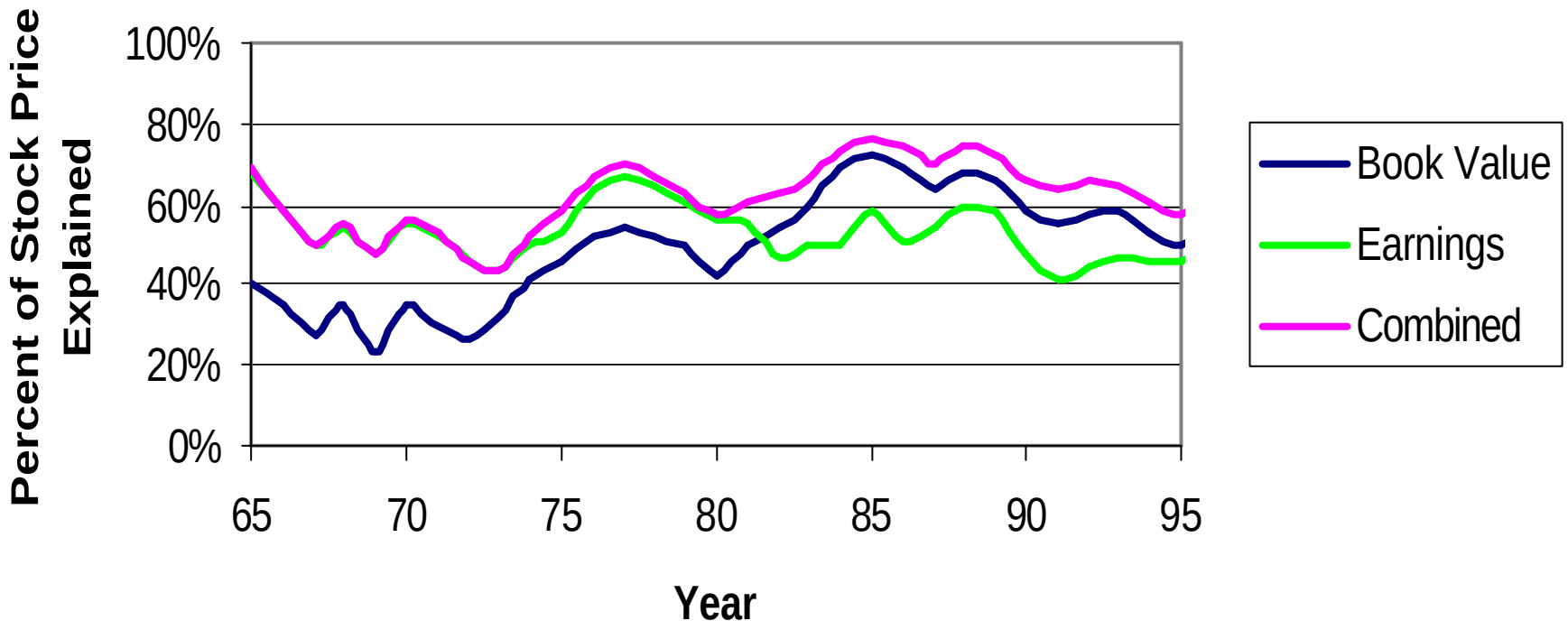
- **Double Entry** – governs the recording function: duality from accounting equation, A=L+E
- **Historical Cost** – it represents fair & objective values
- **Accrual Accounting** - recognize revenues when earned, expenses when incurred, regardless whether or not cash flows occur contemporaneously.
- **Full Disclosure** – measure and/or disclose material events and transactions: an analyst often desires details of how the numbers are determined
- **Materiality** - threshold when information impacts decision making
- **Conservatism** - reporting or disclosing the least optimistic information about uncertain events and transactions

FASB

Financial Accounting

Relevance of Accounting Numbers

Relation between Accounting Numbers and Stock Prices



Financial Accounting

Limitations of Accounting Numbers

- **Timeliness - periodic disclosure, not real-time basis**
- **Frequency - quarterly and annually**
- **Forward Looking - limited prospective information**

Accruals--The Cornerstone

Foundations of Accrual Accounting

Revenue Recognition – recognize revenues when

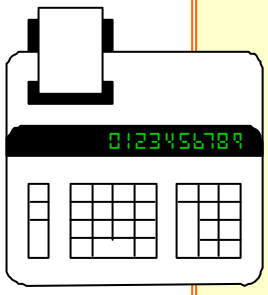
(1) Earned

(2) Realized or Realizable

Expense Matching – match with corresponding revenues

-Product costs: expenses that arise in production of a product/service

-Period costs: matched with revenues of the period



Accruals--The Cornerstone

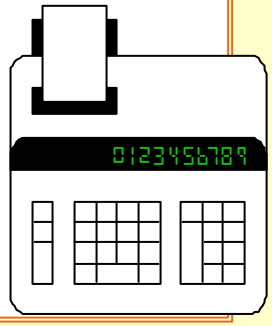
Relation between Cash Flows and Accruals

- Accrual and cash accounting differ primarily because of timing differences in recognizing cash flow consequences of business activities and events
- Over the life of a company, cash flows and accrual income are equal, because the time and matching problems are resolved.
- **Operating Cash Flow**: refers to cash from a company's ongoing operating activities.
- **Free cash flow**: reflect the added effects of investments and divestments in operating assets (cash that is free to be paid to debt and debity holders)
- **Net cash flow**: is the change in the cash amount balance

Accruals--The Cornerstone

Relation between Cash Flows and Accruals

	Operating cash flow (OCF)
-/+	Cash investment & divestment in operating assets
=	Free cash flow (FCF)
+/-	Financing cash flows (including investment & divestment in financing assets)
=	Net cash flow (NCF)



Accruals--The Cornerstone

Net Income = Operating Cash Flow + Accruals

Accruals--The Cornerstone

Short-Term and Long-Term Accruals

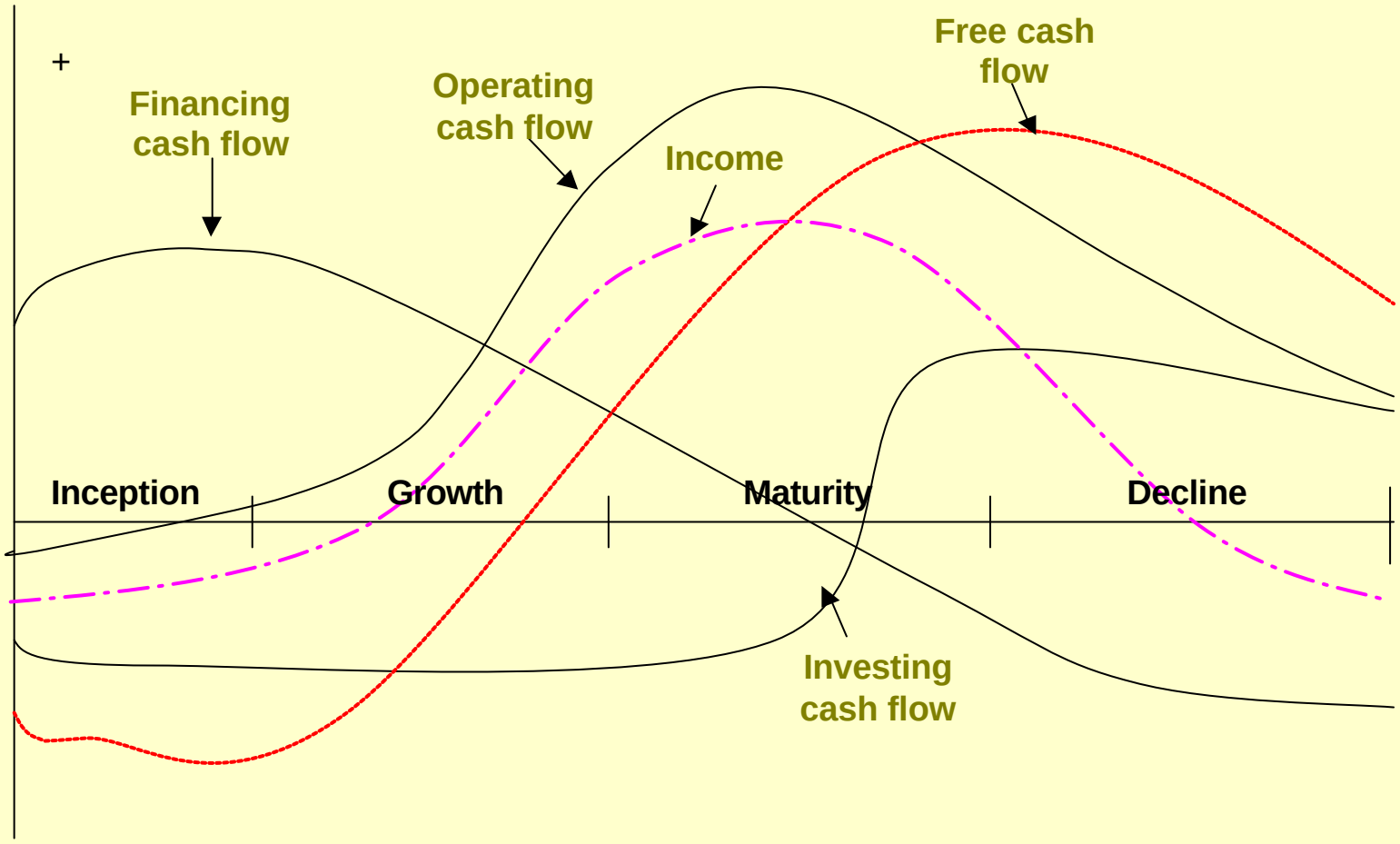
Short-Term Accruals: Yield current assets and current liabilities (also called *working capital accruals*)

Long-Term Accruals: Yield non-current assets and non-current liabilities (arise mainly from *capitalization*)

Note: Analysis research suggests short-term accruals are more useful in company valuation

Accruals--The Cornerstone

Relevance of Cash Flows and Income over a Company's Life Cycle



Accounting Analysis

Process of evaluating the extent to which a company's accounting numbers reflect economic reality

- **Precondition for an effective financial analysis: the quality of financial analysis, and the inferences drawn, depends on the quality of the underlying accounting information**

- **It is the process an analyst uses to identify and assess accounting distortions in a company's financial statements**

Accounting Analysis

Demand for Accounting Analysis

- **Adjust for *accounting distortions* so financial reports better reflect economic reality**
- **Adjust general-purpose financial statements to meet specific *analysis objectives* of a particular user**

Accounting Analysis

Sources of Accounting Distortions

- ***Accounting Standards*** **– attributed to *(1)* political process of standard-setting, *(2)* accounting principles and assumptions, and *(3)* conservatism**
- ***Estimation Errors*** **– attributed to estimation errors inherent in accrual accounting**
- ***Reliability vs Relevance*** **– attributed to over-emphasis on reliability at the loss of relevance**
- ***Earnings Management*** **– attributed to window-dressing of financial statements by managers to achieve personal benefits**

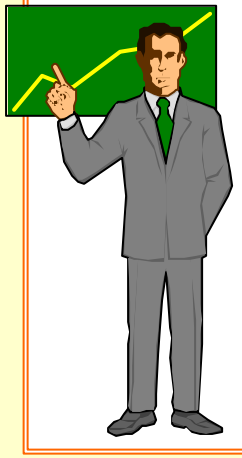
Accounting Analysis

Sources of Analysis Objectives

- **Comparatives Analysis – demand for financial comparisons across companies and/or across time**
- **Income Measurement -- demand for (1) equity wealth changes and (2) measure of earning power. These correspond to two alternative income concepts**

  (1) Economic Income (or empirically, *economic profit*)

  (2) Permanent Income (or empirically, *sustainable profit*)



Accounting Analysis

Process of Accounting Analysis

Accounting analysis involves several inter-related processes and tasks that can be grouped into two broad areas:

Evaluating Earning Quality –

- **Identify and assess key accounting policies**
- **Evaluate extent of accounting flexibility**
- **Determine the reporting strategy**
- **Identify and assess red flags**

Adjusting Financial Statements --

- **Identify, measure, and make necessary adjustments to financial statements to better serve one's analysis objectives; Chapters 3-6 focus on adjusting (recasting) the statements**