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FINANCE AND INFORMATION MANAGEMENT/ INFORMATION TECHONOLOGY

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ACCOUNTING ANALYSIS: ACCOUNTING ADJUSTMENTS (CHAPTER 4)

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fairness • professionalism • commitment • compassion • excellence
transparency • honesty • integrity • respect • accountability

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KEY CONCEPTS

- Accounting Adjustment
- Asset distortions
- 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.

ACCOUNTING ADJUSTMENT

- **What is Accounting Adjustments?**
  - In accounting, adjustments refer to the necessary **modifications** to **financial statements** to **ensure accuracy and compliance** with **accounting principles.**
  - These adjustments are made at the end of an accounting period, typically at the close of a fiscal year, to reflect the true financial position of a business.

ACCOUNTING ADJUSTMENT

- **Why is it important or used in Accounting?**
  - The primary purpose of accounting adjustments is to align financial statements with the accrual basis of accounting, which recognizes revenue when earned and expenses when incurred rather than when the cash is received or paid.
  - By making these adjustments, businesses can provide a more accurate representation of their financial health and performance.

BENEFITS OF ACCOUNTING ADJUSTMENT

- **Accurate Financial Reporting:** Adjustments help present a more accurate and reliable picture of a company's financial position. This is crucial for stakeholders, including investors, creditors, and management, who rely on financial statements for decision-making.
- **Compliance with Accounting Standards:** Many accounting standards and regulations, such as Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), require businesses to make adjustments to ensure adherence to specific accounting rules and principles.
- **Comparability:** Adjusted financial statements enhance the comparability of financial data across different periods, enabling stakeholders to analyze trends and make informed decisions based on consistent and reliable information.

DRAWBACKS OF ACCOUNTING ADJUSTMENT

- **Complexity:** The process of making accounting adjustments can involve a detailed analysis of various accounts and transactions. This complexity may increase the likelihood of errors if not handled carefully.
- **Time-Consuming:** Adjustments often require significant time and effort, particularly for businesses with intricate financial transactions. This can be a challenge for companies operating in fast-paced environments.

ACCOUNTING ADJUSTMENT EXAMPLES

- Incorporating or subtracting from an allowance for doubtful accounts or an inventory obsolescence reserve.
- Recognizing earnings from sources for which bills have not yet been sent.
- Revenue that has been invoiced but has not yet been earned is deferred.
- Recognizing Expenses Before Receiving Supplier Invoices
- Putting the writing off costs until the business uses the corresponding asset later.
- Expenses that have already been paid for are included in this calculation.

TYPES OF ADJUSTMENTS

Accrued Revenues - Accrued revenue is the amount of money earned in one accounting period that isn't counted until a subsequent period.

Accrued Expenses - After getting a handle on how accumulated income works, adjusting incurred expenses should be a breeze. They are the costs you incurred in one time period but paid for in another.

Deferred Revenues - Deferred income occurs when a customer pays you in advance. It's essential to report the income in the month you provide the service and incur the prepaid costs, even if you're being paid now.

TYPES OF ADJUSTMENTS

Prepaid Expenses - Similar to delayed income, prepaid expenses may be used in the future. Instead of deducting the cost over the period it pertains to, and you make a one-time payment in this situation.

Depreciation Expenses - Depreciation is the practice of writing off the cost of an item over a more extended period than the asset's useful life. This is generally done for expensive acquisitions like machinery, automobiles, and structures. You will see a change to the overall cumulative depreciation amount on your balance sheet after any **accounting Period** in which depreciation occurred. Depreciation is an ongoing cost that will be shown as an expenditure each time it is paid.

ASSET DISTORTIONS

- The term 'accounting distortions' refers to any kind of deviation and divergence between information reported by financial statements and the reality of the business (Gandevani, 2010).
- Assets are defined as resources with probable future benefits.
- Accounting distortions are not necessarily a deliberate attempt by management to misrepresent the true operating picture of the company. They may occur because of the accounting process in which the true economic profit of a business is not visible (Catalano, 2006).

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 of assets fall below their book values
  - Fair value estimates are accurate

ASSET DISTORTIONS: OWNERSHIP AND CONTROL

- Some types of transactions make it difficult to assess the ownership of an asset.
  - Mechanical rules help to establish economic ownership with noise or induce managers to structure transactions
  - Principles-based rules increase managers' reporting discretion
  - Consequently, IFRS may not capture subtleties associated with ownership or control over certain assets

ASSET DISTORTIONS: ECONOMIC BENEFITS AND FAIR VALUES

- IFRS requires the immediate expensing of some resource outflows that may have future economic benefits, such as research expenditures.

- 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:
  - Understated depreciation/amortization of non-current assets
  - Delayed write-downs of current or non-current assets
  - Understatement of allowances
  - Accelerated recognition of revenues

OVERSTATED ASSETS

- There may be incentives for earnings to be under-reported, resulting in understated assets:
  - Leased assets or key intangible assets off balance sheet
  - Overstated allowances
  - Discounted receivables off balance sheet

- Conservatism in IFRS may also result in understated assets.

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 non-current 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 contingent claims 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.

CONCLUDING COMMENTS

- 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 of assets fall below their book values
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