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FINANCE AND INFORMATION MANAGEMENT/ INFORMATION TECHONOLOGY

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ACCOUNTING ANALYSIS (CHAPTER 3)

ACCOUNTING ANALYSIS

- **Accounting analysis** is a crucial aspect of financial analysis that involves **evaluating and interpreting** a company's **financial statements** to assess its **financial performance**, health, and potential for investment.
- It provides valuable insights into the company's financial position, profitability, cash flow, and overall efficiency in utilizing resources.
- The core components of a account analysis include:
    - Financial statement analysis which involves analyzing a company's **income statement, balance sheet, and cash flow** statement to determine how well the company is managing its resources.

OBJECTIVES

- **Assessing Financial Performance -** Accounting analysis aims to evaluate how well a company has performed financially over a specific period. It involves analyzing key financial metrics and ratios to assess profitability, efficiency, and liquidity.
- **Understanding Financial Health -** By examining financial statements, analysts can gain insights into the company's financial health, including its ability to meet short-term and long-term obligations, manage debt levels, and generate sustainable cash flows.
- **Identifying Strengths and Weaknesses -** Accounting analysis helps identify the strengths and weaknesses of a company's financial position and operations. It enables stakeholders to pinpoint areas of improvement and develop strategies to enhance performance and mitigate risks.
- **Supporting Decision Making -** Accounting analysis provides valuable information to support decision-making processes, such as investment decisions, lending decisions, strategic planning, and performance evaluation.

Key Concepts in Accounting Analysis

- **Financial Statements -** Understanding the structure, components, and interrelationships among financial statements is essential for conducting accounting analysis. The three main financial statements include the balance sheet, income statement, and cash flow statement.
- **Accounting Principles and Standards -** Familiarity with generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) is crucial for interpreting financial statements accurately and consistently.
- **Financial Ratios and Metrics -** Financial ratios and metrics serve as quantitative tools to assess various aspects of a company's financial performance and position. Commonly used ratios include liquidity ratios, profitability ratios, leverage ratios, and efficiency ratios.
- **Trend Analysis -** Examining trends and patterns in financial data over multiple periods helps identify changes and developments in the company's financial performance and position. Trend analysis provides insights into the company's historical performance and future prospects.

ACCRUAL ACCOUNTING AND ACCOUNTING QUALITY

- Financial reports are prepared using accrual accounting instead of cash accounting.
- The main difference between **accrual** and **cash basis** accounting lies in the timing of when revenue and expenses are recognized.
- The cash method provides an immediate recognition of revenue and expenses, while the accrual method focuses on anticipated revenue and expenses.
- Accrual accounting **records revenue and expenses** when **transactions occur** but before money is **received or dispensed**. Cash basis accounting **records revenue and expenses** when cash related to those transactions actually is **received or dispensed.**

ACCRUAL ACCOUNTING AND ACCOUNTING QUALITY

- 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.

- Mitigating effects of legal liability, auditing, public enforcement.

- Three potential sources of noise and bias in accounting data include:
    1. Noise from accounting rules
    2. Forecast errors
    3. Manager's accounting choices

NOISE IN ACCOUNTING RULES

- Accounting rules introduce noise and bias because it is often difficult to restrict management discretion without reducing the information content of accounting data.
- Accounting noise may make a firm look better by showing many one-time-only sales or worse by showing one-time-only expenses.
- Most of the time, accounting noise is incidental, but some firms abuse the GAAP to manipulate earnings in order to make themselves look healthy when they are not.

FORECAST ERRORS

- In statistics, a forecast error is the difference between the actual or real and the predicted or forecast value of a time series or any other phenomenon of interest.
- Forecast errors introduce noise because managers cannot predict future consequences of current transactions perfectly.
- The extent of errors in managers' accounting forecasts depends on a variety of factors, including the complexity of the business transactions, the predictability of the firm's environment, and unforeseen economy-wide changes.

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

MANAGER'S ACCOUNTING CHOICES

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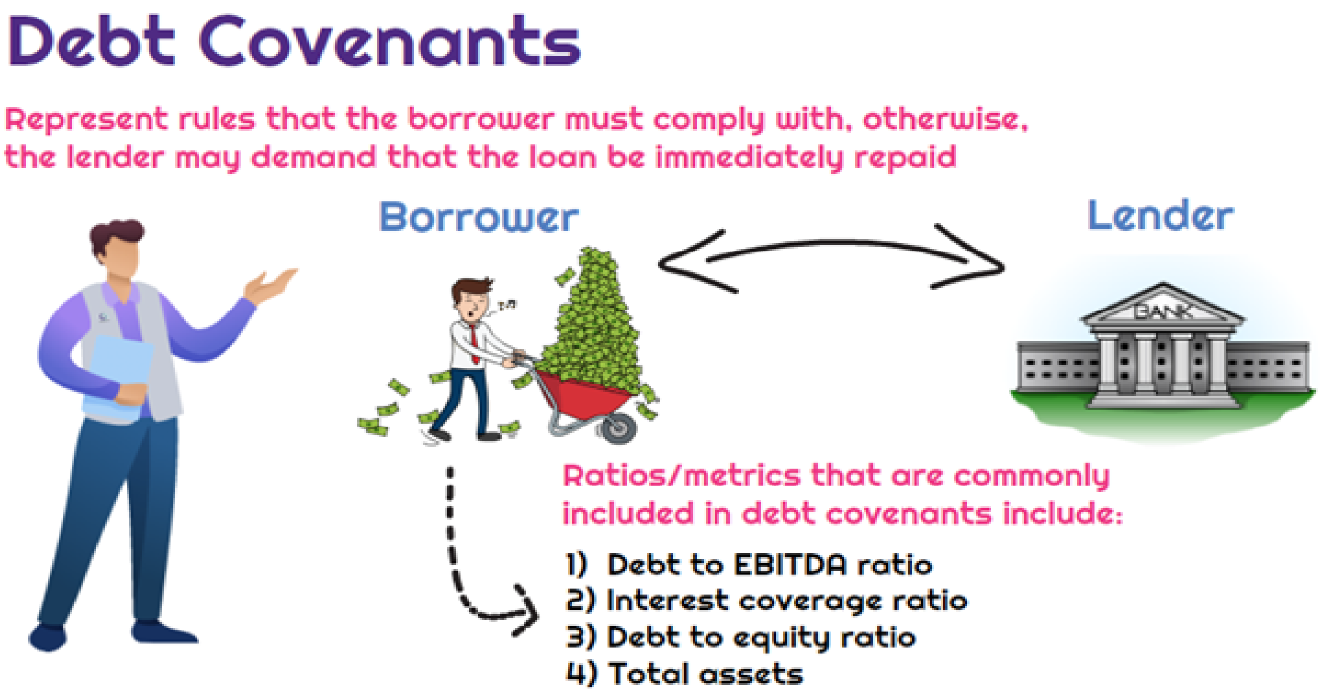

MANAGER'S ACCOUNTING CHOICES

- **Compensation contracts -** is used by an employer to record a negotiated change in wage or earning potential for an employee.
- **Contests for corporate control**
- **Tax considerations -** South Africa has a residence-based tax system, which means residents are, subject to certain exclusions, taxed on their worldwide income, irrespective of where their income was earned. By contrast, non-residents are taxed on their income from a South African source.
- **Regulatory considerations -** is an organization's adherence to laws, regulations, guidelines and specifications relevant to its business processes.

MANAGER'S ACCOUNTING CHOICES

- **Capital market and stakeholder considerations -** Capital-market stakeholders are groups that affect the availability or cost of capital shareholders, venture capitalists, banks, and other financial intermediaries. Product-market stakeholders include parties with whom the firm shares its industry, including suppliers and customers.
- **Competitive considerations -** Are often an unescapable aspect of strategy and, as a result, strategic evaluation.

STEPS IN PERFORMING ACCOUNTING ANALYSIS

- Gathering Financial Data. Collecting and organizing relevant financial data from the company's financial statements, annual reports, regulatory filings, and other sources.
- Analyzing Financial Statements. Reviewing and analyzing the company's financial statements to assess its financial performance, position, and trends.
- Calculating Financial Ratios. Calculating key financial ratios and metrics to evaluate liquidity, profitability, solvency, efficiency, and other aspects of the company's financial performance.
- Interpreting Results. Interpreting the results of accounting analysis by comparing financial ratios to industry benchmarks, historical trends, and competitors' performance.
- Drawing Conclusions and Making Recommendations.: Drawing conclusions based on accounting analysis findings and making recommendations for improving financial performance, mitigating risks, and achieving strategic objectives.

POTENTIAL RED FLAGS IN FINANCIAL STATEMENT

– More issues that warrant gathering more information:

- Unexpected large asset write-offs
- Large year-end adjustments
- Qualified audit opinions or auditor changes
- Related-party transactions

CONCLUDING COMMENTS

- Accounting analysis is an essential step in analyzing corporate financial reports.

- A methodology consisting of five steps in analyzing accounting data was presented in this chapter.

THANK YOU