

Reporting Quality

- **GAAP Compliant**
 - Adhere to GAAP in the jurisdiction in which it operates
 - GAAP provides choices of methods, estimates, and specific treatment
 - Compliance with GAAP does not necessarily result in financial reporting of highest quality
- **High Quality (Decision Useful)**
 - **Relevance**
 - information is useful to make decisions. Relevant must be **material**.
 - **Faithful**
 - **Completeness**
 - **Neutrality**
 - Absence of errors

Earning Quality

- **Earning Sustainability**
 - Sustainable: high profits from increased efficiency or market share
 - Non-sustainable: exchange rate or appreciated assets
- **Important**
 - **Level** of earning and **adequate** high enough return on invested capital
 - Sustainability of reported cash flow
 - Values on the balance sheet
 - Inadequate accruals for liabilities and overstatement of asset values can decrease quality

Spectrum Levels (Compliance * Reporting quality * Earning quality)

- Compliant; decision useful; **high** (sustainable and adequate)
- Compliant; decision useful; **low** (not sustainable or not adequate)
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- Compliant; low; low; **biased** reporting choices and estimation
- Compliant; low; low; **actively** managed to increase/decrease or **smooth** earnings
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- Not Compliant; even numbers are **actual**
- Not Compliant; numbers are **fictitious** or **fraudulent**

Accounting Bias

- **Biased Accounting**
 - **Conservative** accounting
 - **decrease** earning and financial positions
 - **Aggressive** accounting
 - **increase** earning and improve financial positions
 - may decrease future earning
- **Earning Smoothing**
 - Adjustment of **accrued liabilities**.
 - Conservative – **deferral** of reported **earnings (cookie jar)**:
 - High return -> liability upward
 - Later on, adjust liability downward to increase earning

- **GAAP Conservatism**
 - Higher standard of verification for **revenue** and profit than for expenses and accrual liabilities
 - Research costs are **expensed** when occurred, and the associated revenue is not recognized until some future period.
 - Accruals for **legal liabilities** are recorded when a future payment becomes **probable**, while the standard for recognizing accrued asset value is **stricter**.
 - GAAP, **write downs** of inventory are required when future values are **likely** impaired, but reversal is not allowed until the inventory is actually **sold**.
- **GAAP Conservatism Benefits**
 - Reduce the probability of future litigation from misled users
 - Protect interest who have less complete information.

Aggressive and Conservative Accounting

Item	Aggressive	Conservative
Cost	Capitalizing	Expensing
Depreciation Method	Straight-line	Accelerated
Depreciation useful lives	Longer	Shorter
Depreciation Salvage values	Higher	Lower
Recognition of impairments	Delayed	Early
Accrual of bad debt reserves	Less	More
Valuation allowances on DTA	Smaller	Larger

Low Reporting Quality - Motivation - Aggressive Accounting

- Meet or exceed a **benchmark** for EPS
 - Earnings greater than
 - Guidance offered by **management**
 - Consensus analyst **expectation**
 - Those of the same period in the prior year
- **Career** oriented
 - Enhance reputation, improve future career opportunities
- **Incentive** compensation (bonuses)
 - Depend on stock returns
- Gain **credibility** with equity investors or improve the way viewed by its customers and suppliers
- Avoid violating debt **covenants** for highly leveraged and unprofitable
 - Meet specific financial ratio in loan covenant
 - Avoid financial triggers in loan covenant
- Note
 - personal **pressures** or corporate pressures
 - When earnings exceed benchmark, may use **conservative** accounting to allow earnings to be show in the future, increasing its chance to exceed again

Low Reporting Quality - Opportunities & Rationalization

- **Opportunities**
 - Weak **internal controls** (i.e., Nonindependent audit committee)

- BOD provides inadequate **oversight**
- Standards provides a **more** acceptable treatments or inconsequential **penalties** in case of fraud
- Cutbacks in the enforcement branch of financial regulators
- **Rationalization**
 - Less-than-ethical action, a **psychological** process to **justify** their actions.

Reporting Quality - Discipline Mechanisms

- **Regulators**
 - US: securities and exchange commission (SEC)
 - UK: financial conduct authority (FCA)
 - International organization of securities commissions (IOSCO)
 - EU: European securities and markets authority (ESMA)
- **Securities**
 - **Registration** for issuance of new securities
 - **Disclosure**
 - **Independent** audit of financial reports
 - Statement of financial condition (management commentary) by management
 - **Signed** statement by person responsible for the preparation
 - **Review** process for newly securities
 - US only: Management must include assessment of effectiveness of internal control
- **Enforcement Actions**
 - Fines, suspension in issuance and trading, public disclosure
 - Pursue criminal prosecution
- **Audit**
 - Clean opinion is not a **guarantee** of **fraud**.
 - Offer **reasonable** assurance reports are fairly reported
- **Private Contracts**
 - Counterparties will inspect financial reports carefully

Non-GAAP Measures

- **Goal**
 - Control the evaluation metric and reduce focus on GAAP measures
- **Non-GAAP**
 - Display the most **comparable** GAAP measure with equal prominence
 - Explain why the non-GAAP measure is **useful**
 - **Reconcile** different between them
 - Disclose the other **purpose**
 - **Include** any items that are **likely** to **recur** in the future, even those treated as nonrecurring, unusual, or infrequent in the financial statements
- **Non-IFRS**
 - Define and explain the **relevance**
 - **Reconcile** different between them

Accounting Manipulation

- **Revenue Recognition**

- **Timing**
 - **Free-on-board (FOB)** at the shipping (earlier) points or destination (later)
- **Accelerating** (increase current revenue)
 - Offer discounts to increase orders
 - ship to distributors without receiving order
- **Channel stuffing**
 - overload a channel with more goods than normal
 - Overstatement of revenue, underestimate inventory
 - High ratio of accounts receivable to revenue
 - **Days of sales outstanding** increase
- **Delaying** (reduce current and increase expected in next period)
 - Delay recognition to the next period
 - Delay customer shipments
- **Bill-and-hold**
 - Customers buy goods, receives an invoice, but keep the goods at their location for a period of time.
 - Increase revenue of goods still in the inventory
- **Credit Loss Estimation**
 - Uncollectable Bad debt reserve
 - Reduce Accounts receivable
 - Warranty expense: as percentage of sales
- **Valuation Allowance**
 - Reduce DTA
- **Depreciation Methods and Estimates**
 - Straight-line vs accelerated
 - Useful life and salvage value
- **Amortization and Impairment**
 - Goodwill
- **Inventory Method**
 - FIFO, LIFO, weighted average
- **Related-Party Transactions**
 - Shift profits private company
- **Capitalization**
 - Affect income and cashflow
- **Other cash flow effects**
 - Classification
 - Stretching payable: delay payment
 - Capitalizing interest expense
 - IFRS
 - Interest and dividend paid: CFO or CFF
 - Interest and dividend received: CFO or CFI

Warning Signal & Earning Manipulation Detection

- **General**
 - Evaluate warning signals **cohesive** not isolation
 - Comparing a company's methods and policies to those of its **peers**

- **Revenue Recognition**
 - Bill-and-hold
 - Barter transaction
 - Growth out of line with peer companies
- **Inventories**
 - Turnover ratio decline
 - LIFO liquidation
 - sell **older**, lower-cost layers of inventory to generate earnings without supporting cash flow in order to produce specific earnings benefits.
- **Capitalization policies**
- **Revenue and Cash flow**
 - Operating cash flow / net income is lower
- **Other**
 - Depreciation method, estimations
 - High Related party transactions
 - Nonrecurring items appear regularly
 - Minimal disclosure
 - Emphasize non-GAAP measures

Financial Statement Analysis: Applications

- **Strategy**
 - **Product differentiation:** more on R&D and advertising
- **Forecast Earning**
 - Shorter horizon
 - Top down: GDP growth -> industry growth -> market share
 - Simple forecast
 - Historical average or trend-adjusted measure (margin)
 - Complex forecast
 - Each item on IS and BS can be estimated (growth related to revenue)
 - Multi-period forecast
 - A single estimate of sales growth at some expected to continue indefinitely
- **Forecast Cash flow**
 - Future sources and use of cash
 - Non-cash working capital / sales remains constant
 - First-pass model
 - A need for cash in the future, project necessary borrowing
 - Interest expense adjusted based on debt
- **Credit Quality of Debt Investment**
 - Cs: character, collateral, capacity
- **Credit Rating Factors Categories**
 - **Scale and Diversification**
 - Large companies (more **purchasing** power with suppliers)
 - A wider variety of product lines and geographic diversification
 - **Operational Efficiency**

- Operating ROA, margins, EBITDA, cost structure
- **Margin Stability**
 - Stable -> higher rating
- **Leverage**
 - Ratios of operating earnings, EBITDA
 - Free cash flow to interest expense
 - Total debt
 - Operating cash flow less dividends
 - High EBITDA/Average assets and the lowest Debt/EBITDA -> better
- **Screening Equity Investment**
 - **Criteria**
 - Multiple criteria are used
 - **Screen**
 - Likely to include/exclude many or all firms in particular **industries**
 - **Value or Growth stocks (low value)**
 - Value: low **P/E** and low **P/BV**
 - Backtesting
 - Test criteria on historical data
 - Bias: survivorship, data-mining, look-ahead
- **Comparison Difference**
 - **Accounting method Difference**
 - Subject to the same standard or due to local accounting standard
 - Make comparisons problematic
 - **GAAP and IFRS Difference**
 - Inventory cost flow, securities, exchange rate
- **Comparison Adjustment**
 - **Investment in Securities**
 - Classification: held-for-trading, held-to-maturity, available-for-sale
 - **Unrealized gains & losses**
 - income statement: held-for-trading
 - Balance sheet: held-for-trading and available-for-sale
 - IFRS: available-for-sale debt securities, result from **exchange rate** are recorded in income statement. GAAP does not.
 - **Inventory Accounting Differences**
 - LIFO reverse
 - Depreciation methods and estimates
 - Upward evaluation
 - Average ages, useful life
 - **Off-Balance-Sheet Financing**
 - Debt ratio: include both financing and operating lease
 - **Present value** of lease under operating lease
 - Ratio of PV / sum of future payment
 - Discount rate, IRR
 - **Goodwill**
 - Purchase
 - Tangible asset -> fair value at acquisition date
 - Identifiable intangible: acquisition cost

- Goodwill -> balance sheet
- Adjustment
 - Remove goodwill from asset (P/B)
 - Reverse goodwill impairment, increase NI
- **Other intangible assets**
 - Reduce intangible asset value by the cumulative amount of upward revaluation
 - Price to **tangible** book value: remove goodwill and intangible asset from equity
 - Pre-post acquisition lack comparability