<u>ACCT7106 – Session #8</u>: Accounting / Earnings Quality

<u>PART 1 – Background</u>

overarching objective:

to conduct the fundamental **purpose of estimating the 'intrinsic value' of a firm's**

➙ requires an understanding of the firm's

➡ need to accumulate a 'tool kit' as the basis for developing the *pro forma Financial Statements*

$\Rightarrow$ ***projected*** $\left\{ \begin{array}{c} \text{Balance Sheet (B/S)} \\ \text{Income Statement (I/S)} \\ \text{Statement of Cash Flows (SCF)} \end{array} \right\}$ over the forecast horizon

➡ core inputs ➞ x g

Sessions #3 ➞ #10

Sessions #1 ➞ #3; #12 – #13

STEP 1
Understanding the past

1. **Information collection**
2. **Understanding the business**
3. **Accounting analysis**
4. **Financial ratio analysis**
5. **Cash flow analysis**

STEP 2
Forecasting the future

1. **Structured forecasting**

STEP 3
Valuation

1. **Cost of capital**
2. **Valuation models – *AE, FCF, D***
3. **Valuation ratios**
4. **Complications**
   a. **Negative values**
   b. **Value creation and destruction**

Figure 1.1 Lundholm & Sloan, *Framework for Equity Valuation*

Sessions #10 ➞ #12

external environment

- economic prospects
- macroeconomic factors
- socio-cultural forces
- political / regulatory

Analysis of Financial Statements

- understanding current F/S ✓
- re-formulating the F/S ✓
- accounting quality ** Session #8
- ratio analysis Sessions #9 & #10

- analysts' reports
- management forecasts
- financial press
- ???

Industry dynamics

➔ Porter's five forces

(suppliers, buyers, new entrants, substitutes, rivalry)

- Financial Statements – AASB 101:
  - Balance Sheet
  - Income Statement *and/or* Statement of Comprehensive Income
  - Statement of Changes in Equity
  - Statement of Cash Flows
  - Notes to the financial statements

- building blocks → definitio

- accounting principles → AASB / IFRS rules ounting decisions/choices

- recognition (item to F/S) *versus* disclosure (n

- 'accountability' & 'stewardship'
  - ***'accountability'*** → preservation by management of the resources entrusted to them
  - ***'stewardship'*** → efficient use by management of resources entrusted to them (earning a return)

'articulation' → Financial Statements constitute an ***'integrated system'***

beginning stock → *flows* → *ending stock*

Beginning Balance Sheet

Cash

\+ Other assets

= Total Assets

– Liabilities

= Shareholders' Equity (BV_{t-1})

Cash Flow Statement

Cash from operations

\+ Cash from investing

\+ Cash from financing

= Net change in cash

Statement of Changes in S/E

\+ Net Income & O

= Net Change in S/E

Income Statement

Revenue

– Expenses

= Net Income (NPAT)

Ending Balance Sheet

Cash

\+ Other assets

= Total Assets

– Liabilities

= Shareholders' Equity (BV_t)

Reformulation

- **Objectives:**

  - separate **operating** activities from **financing** activities
    - *Operations*: buying and selling goods and services
    - *Financing*: the company’s use of debt and equity to finance its operations, as well as the company’s investment in financial assets

    Why? industrial companie [illegible] ir operations, not from their financial activities

  - alter several accounting classifications

  - for the Income Statement, separate revenues and expenses based on their *driver* (sales volume or other), and whether they are recurring or non-recurring

  - for Statement of Cash Flows, separate operating from financing activities; determine free cash flows → operations-related cash flows split by operating versus investing; and separate equity and debt financing cash flows

PART 2 – Accounting Quality & Earnings Management

- **Definition:** ***earnings management***

  ⇒ *choices by management to influence earnings in a <u>systematic direction</u>*

  → strategic (intentional) choice

- **Conceptual foundation** – co d earnings serve as:

  1. a measure of the past and ility of a firm

  2. a principal variable in valuing a firm's c

- **Definition:** ***earnings quality***

  *a firm's **reported earnings** number is said to be of **high quality** if it accurately and reliably measures current economic value-added and is a good predictor of economic value likely to be added in the future*

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- reasons why the link between reported earnings and economic value-added may not be “clean”:

1. the “*sustainability*” issue

→ inclusion of non-recurring items in reported income

2. the “*earnings measureme*

→ inadequacy of acco ly and reliably measure economic value-add

3. the “*earnings management*” issue

→ the opportunity (and incentive) for management to manage the level or trend of reported earnings to its advantage

➢ The decision to manage earnings:

- reasons cited as to ***why*** management might wish to manage earnings include:
  - share price; compensation; job security; reduce perceived risk by smoothing
- reasons cited as to ***why*** management may decide ***not*** to manage earnings include:
  - earnings and cash flow ultimately coincide; capital markets penalise firms

➢ Mechanisms available to m

- ***accounting-based***: selection and/or applica unting principles within GAAP

  e.g., choice of depreciation method (straight-line *versus* accelerated)
  estimating the useful life & salvage value for non-current assets

- ***'real activities' management*** ➔ **business strategy / operations**

  e.g., timing of discretionary expenditures (R&D, advertising, maintenance)
  timing of acquisitions & disposals (gain/loss)

- **Constraints on management behaviour (*relating to accounting-based EM*):**
  - securities **regulators** and stock exchange requirements and monitoring
  - **independent audit** of the financial statements
  - **financial analysts** typically have a sense of the reporting "personalities" of various firms
  - the **frequency, timeliness, and quality of management's communications** serve as signals of the forthrightness of od of earnings being managed
  - since **earnings and cash flows must ultim e**, earnings can not be managed "forever"

⇒ analysts (and investors) must understand the GAAP that adapt to earnings management so that they can separate economic value-added from "cosmetic" (i.e., earnings managed) value-added

❖ ***Healy and Wahlen***

Healy and Wahlen, 1999. "A review of the earnings management literature and its implications for standard setting", *Accounting Horizons*, 13(4), 365-383

- a central question for standard setters and regulators is to decide ***how much judgment*** to allow management to exercise in financial reporting

- ideally, financial reporting helps the best-performing firms to distinguish themselves from poor performers, and facilitates efficient resource allocation and stewardship

⇒ accounting standards add valu statements to effectively portray differences in firms' economic p a timely and credible manner

⇒ ***if*** accounting policy choice and implement employed to signal firm quality

i.e., managers can then use their knowledge about the business and its opportunities to select reporting methods, estimates, and disclosures that match the firms' business economics, potentially increasing the value of accounting as a form of communication

however, because auditing is imperfect, management's use of judgment also creates the opportunities for "earnings management"

*** Dep^{n} Policy for Delta and Pan Am (1988) ***

excerpt from 'Notes to Financial Statements'

Delta All of the company's flight equipment is being depreciated on a straight-line basis to residual value (10% of cost) over a 15-year period from dates placed in service.

Pan Am Operating property ... ed to estimated residual value (15% of cost) on a straight-lin ... the estimated useful lives of the equipment, typically 25 years

Are these policy choices: ***defensible (e.g., auditor)?***

rational / reasonable?

informative?

hypothetical illustration

- 1 January, 2010, each firm purchases a new Boeing 777 aircraft at a cost of $100 million
- each company sells the aircraft for $35 million on December 31, 2019

Based on this assumed information and each company's stated depreciation policy:

Calculations:	**Delta**	**Pan Am**
Original cost		100,000,000
Residual value (10% / 15		(15,000,000)
Amount to depreciate	90,	85,000,000
Estimated life	15	25 years
Depreciation (2010 – 2019)	**6,000,000**	**3,400,000**
Net Book Value (31/12/19)	40,000,000	66,000,000
Sales proceeds (31/12/19)	35,000,000	35,000,000

Are these policy choices:

defensible (e.g., auditor)? ***rational?*** ***informative?***

operating statistics	Delta	Pan Am
Operating inc (loss)	497,054	(84,183)
Net income (loss)		(118,254)
Accounting choice	shorter life lower residual (10%)	longer life (25 years) higher residual (15%)
currently affordable? signal of future profitability?	**higher dep^n charge**	**lower dep^n charge**

⇒ ongoing debate – ‘rules-based’ *versus* ‘principles-based’

rules-based

- ⇨ accounting standards prescribe in detail exactly how to account for various items and situations without providing discretion
  - → more limited scope for earnings management type behaviour *BUT* also limited opportunity for management to use accounting policy choice as a means of communication

principles-based

- ⇨ accounting standards provide guidance on how various items and situations should be accounted for, but also provide flexibility for management to exercise judgement within the spirit of the guidance
  - → more opportunity for management to use accounting policy choice as a means of communication *BUT* also increased scope for earnings management type behaviour

→ **debate about trade-offs between costs and benefits of allowing discretion**

PART 3 – Academic Evidence

Graham, J., C. Harvey, and S. Rajgopal, 2005. "The economic implications of corporate financial reporting", *Journal of Accounting and Economics*, 40, 3-73

- ***<u>Graham, Harvey, Rajgopal</u>***

- survey CFOs of both public and private companies

- focus on the factors that drive ... ng accounting numbers

- basic questions:
  - do managers care about earnings benchmarks or earnings trends?
  - if so, which benchmarks are perceived to be important?
  - what factors motivate firms to exercise discretion, and even sacrifice economic value, to manage reported earnings?

1. *earnings vs. cash flow* – CFOs believe that earnings and not cash flows, are the key metric

2. *earnings benchmarks* – CFOs treat 'same quarter last year EPS' and consensus analyst forecast as the most important benchmarks – hitting benchmarks builds credibility and enhances share price

3. *why focus on benchmarks – benefits and consequences*

benefits – credibility with capital markets, reputation of management, portrays stability

consequences – uncertainty, possibility of unknown problems, time required to explain

4. *actions taken to meet benchmarks* – CFOs express a strong preference towards real activities manipulation over GAAP management – while au ng policies, they cannot readily challenge real economic actions to t to assure stakeholders that there is no accounting-based earnings man

5. *voluntary disclosure*: benefits – reputation for tra urate reporting; reduce information risk

constraints – setting a precedent; revealing proprietary information

⇒ willing to sacrifice economic value to meet earnings targets; also a clear tension between short-term and long-term objectives of the firm

→ sacrifice of value perceived to be the lesser of two evils (relative to short-term turmoil in debt and equity markets)

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why voluntarily disclose?

constraints on voluntary disclosure?

bad news vs good news? – no real evidence of an asymmetry in terms of the timing of the disclosure of good and bad news – argued that both need to be disclosed to build credibility with the market; better that news come from the firm rather than from outside sources

❖ ***Burgstahler and Dichev***

Burgstahler, D. and I. Dichev, 1997. "Earnings management to avoid earnings decreases and losses", *Journal of Accounting and Economics*, 24, 99-126

- do managers manage earnings to avoid reporting earnings decreases and losses?

- **conclusions:**

  - approximately 8% - 12% of fir arnings decreases exercise discretion to r

  - approximately 30% - 44% of firms with slightly -managed earnings exercise discretion to report positive earnings

figure 1: histogram of scaled earnings changes with an irregularity near zero

⇨ consistent with earnings management to avoid decreases

figure 3: histogram of scaled earnings with an irregularity near zero

⇨ consistent with earnings management to avoid losses

❖ ***Roychowdhury***

Roychowdhury, S., 2006. "Earnings management through real activities manipulation", *Journal of Accounting and Economics*, 42(3), 335-370

- the management of operational activities – to avoid losses

  "real activities manipulation – management actions that deviate from normal business practices, undertaken with the primary objective of meeting certain earnings thresholds"

- focus on three specific manipulation methods:

  - sales manipulation (increased redit terms)
  - reduction of discretionary exp aintenance)

  - overproduction (to report low

- focus on "***suspect firm-years***" → net inco t of zero

- *findings:* abnormal CFO unusually low for suspect firm-years

  abnormal discretionary expenditures unusually low for suspect firm-years

  abnormal production costs (% of sales) unusually high for suspect firm-years

⇒ documents evidence consistent with real activities manipulation around earnings thresholds commonly discussed in the literature, in particular, the zero threshold

Dichev, I.. J. Graham, C. Harvey & S. Rajgopal, 2013. Earnings quality: Evidence from the field. *Journal of Accounting and Economics*, *56*(2-3), 1-33

❖ ***Dichev, Graham, Harvey, Rajgopal***

➢ survey of 169 CFOs of public companies and in-depth interviews of 12 CFOs and two standard setter

1. believe earnings management is quite common (T10 – 18.3% of earnings are managed)

2. believe that when EM occurs, – almost 10% of earnings figure)

3. greatest incentives – to influence stock price; pr earnings benchmarks; to influence compensation

4. common 'red flags' – disconnect between earnings and cash flow; deviations from industry norms; consistently meet or beat earnings targets; large/frequent one-time items; significant accruals and changes in accruals

Table 10
Survey responses to the question: from your impressions of companies in general, in any given year, what percentage of companies use discretion within GAAP to report earnings which misrepresent the economic performance of the business?

Public ($N=163$)								Private ($N=194$)
Mean	Median	Std. dev.	Min	Max	% Greater than 0	% Greater than 15	H_0: Mean$=0$	Mean
18.43	15.00	17.24	0	100	99.37	40.47	***	30.37***

Table 13

Table 14

PART 4 – Methodological Issue - Detection / Measurement of EM

there are a number of methodological "challenges" or issues associated with the detection of earnings management (irrespective of whether undertaken cosmetically through the financial statements or alternatively through real operating decisions)

Why? management has a strong incentive to hide the earnings management

Approaches to detection

Academic studies → large sample ⇒ statistical power

Regulatory (enforcement) / Investing **→ 'case study' ⇒ "red flag required"**

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The 3 basic questions that frame the notion of "*power to detect*" are the following:

1. Where is it most "profitable" to look?

- under what set of circumstances is earnings management activity most likely to occur?
- which firms are the most suspicious (in the most suspicious circumstances)?
- what are management's incentives? (earnings targets? contractual obligations? compensation?)

i.e., small positive earnings; small earnings increases; earnings volatility (smooth earnings)

2. What should be examined?

→ what should the search focus on? what 'le[illegible]ement most likely to utilize to accomplish the earnings management?

i.e., accounting (accruals); real activities

3. How should the investigation be conducted? → technique(s)?

****** our focus – accounting statements (especially Income Statement) → *accruals* ******

⇒ Basic Steps in the Analysis of Accounting Quality

1. Identify key accounting policies e.g., revenue recognition; depreciation policies for airlines

2. Assess accounting flexibility e.g., expected default on bank loans

3. Evaluate accounting strategy
   - compare with industry practise
   - analyse managers' incentives
   - examine changes in accounting policies
   - assess accounting policies and estimate
   - investigate unusual transactions

4. Evaluate disclosure quality i.e., sufficient and clea

5. Identify potential red flags see Penman Table 18.1, Figure 18.2 (reproduced below)
   - accruals and cash flows
   - financing activities
   - financial market pressure

6. Undo accounting distortions

***Why* accruals as the 'lever'?**

recall – from the 'reformulation' process (Session #6, slide 53)

$$\text{OI (after tax)} = \triangle\text{NOA} \pm \text{FCF}$$

✓ FCF is difficult to manipulate – it involves relatively few assumptions/estimates; cash flow is generally easier to audit/verify

✓ $\triangle$NOA involves accruals and ates

→ usually where earning place

→ if accrual-based earnings manag ing place, it should be reflected in abnormal changes in NOA (i.e. *mal growth*)

→ '*diagnostics*' to discriminate between growth-related changes and EM

notes: accruals affect both earnings and NOA

accruals 'reverse' over time → a company cannot inflate its earnings forever using accruals (accrual-based earnings management is like 'borrowing earnings from the future')

To illustrate - return to the data underlying the Delta / Pan Am example

- residual value estimate – 10% versus 15%
- useful life estimate – 15 years versus 25 years
- ***assume***

  XYZ Airlines Ltd purchased a new Boeing 787 for $200 million on 31/12/20; XYZ's tax rate is 30%; accounting requires an impairment charge at the end of 2025

Year	Depreciation (10%, 15 years)	Deprecia (15%, 25 y		Difference in NOA	Difference in S/E
2021	12,000,000	6,800,000	3,640	5,200,000	3,640,000
2022	12,000,000	6,800,000	3,640,000	10,400,000	7,280,000
2023	12,000,000	6,800,000	3,640,000	15,600,000	10,920,000
2024	12,000,000	6,800,000	3,640,000	20,800,000	14,560,000
2025	12,000,000	6,800,000	3,640,000	26,000,000	18,200,000
Impairment charge to return to appropriate balance (based on 10% & 15 years)					
2025	Impairment charge = 26,000,000		−18,200,000	0	0

Further illustration - provision for doubtful debts

- $100,000 in credit sales in Year 1; collected in Year 2; no sales in Year 2
- ‘true’ expected bad debt = 10% company understates the amount as 5% (i.e., EM)
- ‘true’ bad debt realised in second year when customers do not pay

Year	Correct Accounting		With Earnings Management	
	NOA (A/R – provision)	[illegible] (sal[illegible]	NOA [illegible] provision)	OI (component) (sales – bad debt exp)
1	90,000 (= 100 – 10)	90,000 (= 100 – 10)	[illegible] = 100 – 5)	95,000 (= 100 – 5)
2	0	0	0	-5,000

⇒ OI overstated in Year 1 (due to EM); understated in Year 2 (due to reversal of EM)

NOA overstated in Year 1 (due to EM)

OI over the 2-year period is the same ($90,000)

PART 5 – Diagnostic Approach to Detecting Earnings Management

Returning to the relation

$$OI \text{ (after tax)} = \triangle NOA \pm FCF$$

recall $\triangle NOA = \triangle OA - \triangle OL$

⇨ earnings can be A and/or by decreasing OL

Overview – Penman: Table 18.1 602)

focus – management (manipulation) of acc orts for the purposes of increasing income

- summary of how specific Balance Sheet items can be managed to increase income
- accounts most likely manipulated across different industry sectors
- summary of situations when manipulation is more likely
- diagnostic template to facilitate detection of operating income manipulation

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Sensitive areas prone to manipulation –

Situations where manipulation is more likely –

- Financial reports are used for other purposes, like tax reporting and union negotiations.
- Accounting adjustments in the last quarter of the year.

e 18.2 – Diagnostics to Detect Manipulation of Operating Income

tigate the quality of sales revenue
tigate the quality of core expenses
tigate unusual items

note – much of the investigation will involve ratios (value of one account(s) relative to value of another account(s))

Step #1

Step #2

Step #3

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PART 6 – Worked Example

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Reformulated Balance Sheet (*assuming* 'operating cash' = $28 million each year)

	1984	1985	1986	1987	1988
OA					
Operating cash	28	28	28	28	28
Acc receivable	8,551	11,719	14,402	27,801	51,076
Inventory	11,109	6,325	9,762	19,577	39,135
Other	1,124	2,250	2,592	2,561	5,496
PPE (net)	17,219		3	14,788	21,548
Total	**38,031**	[illegible]	**[illegible]7**	**64,755**	**117,283**
OL					
Acc payable	3,082	4,724	7,344	15,072	13,288
Accrued liab	3,800	3,091	3,127	5,468	4,710
Taxes payable	2,349	1,145	1,554	2,619	3,782
Deferred tax liability	0	118	685	1,254	1,881
Total	**9,231**	**9,078**	**12,710**	**24,413**	**23,661**
NOA	**28,800**	**28,426**	**30,457**	**40,342**	**93,622**

‘Diagnostics’

	1984	1985	1986	1987	1988
NOA	**28,800**	**28,426**	**30,457**	**40,342**	**93,622**
△NOA	- - -	-374	2,031	9,885	53,280
% △NOA	- - -	-1.30%	7.14%	32.46%	132.07%
Sales			76,144	128,234	181,123
△Sales			8,490	52,090	52,889
% △Sales			[illegible].55%	68.41%	41.24%
Asset turnover (ATO) = Sales / NOA		2.380	2.500	3.179	1.935
‘normal’ ATO = ave 1985 – 1987 = 2.6862					
‘normal’ △NOA = △Sales / ‘normal’ ATO				19,391.40	19,668.84

‘Diagnostics’

	1984	1985	1986	1987	1988
NOA	**28,800**	**28,426**	**30,457**	**40,342**	**93,622**
△NOA	- - -	-374	2,031	9,885	53,280
% △NOA	- - -	-1.30%	7.14%	32.46%	132.07%
Sales			76,144	128,234	181,123
△Sales			8,490	52,090	52,889
% △Sales			[illegible].55%	68.41%	41.24%
Asset turnover (ATO) = Sales / NOA		2.380	2.500	3.179	1.935
‘normal’ ATO = ave 1985 – 1987 = 2.6862					
‘normal’ △NOA = △Sales / ‘normal’ ATO				19,391.40	19,668.84

In sum:

- ✓ while sales growth is similar in 1987 and 1988, NOA increased dramatically in 1988, but not in 1987

- ✓ actual change in NOA is much larger than normal change in NOA in 1988

→ suggests that accru ment *might* be a problem

Next step: are there patterns within any of the ccounts that suggestive of earnings management (EM) behaviour?

‘Diagnostics’ (cont)

	1985	1986	1987	1988
A/R Turnover = Sales / A/R	5.773	5.287	4.613	3.546
Inventory Turnover = Sales / Inventory	10.696	7.800	6.550	4.628
pp&e Turnover = Sales / pp&e		4.648	8.671	8.406
A/P Turnover = Sales/Accounts receivable		10.368	8.508	13.631
Accrued Liab Turnover = Accrued Liab	21.887	24.350	23.452	38.455

The increase in NOA in 1988 is mainly due to:

- large increase in Accounts Receivable (decrease in receivables turnover)
  - Is provision for doubtful debts understated?
  - Have adequate provisions been made for sales returns?
- large increase in Inventory (decrease in inventories turnover)
  - Is the company struggling to sell its inventory?
  - Is inventory overvalued? Sh

- sudden build-up in ‘Other assets’
- decrease in Accounts Payable: why would it decrease, despite increasing sales?
- decrease in Accrued Liabilities: why would it decrease, despite increasing sales?

These appear to be suspicious changes that are consistent with earnings management (EM)

⇒ any change in NOA that is different than what you might expect should be investigated

✓ it could be 'okay' (defensible / normal)

- extra investment in long-term OAs, such as pp&e or intangibles
- normal growth in short-term OAs, such as A/R and Inventory because of sales growth
- normal decline in OLs due to changes in operating model or better efficiency
- acquisition of another business

✓ it could be a 'problem' (the r ent activity)

- aggressive accrual estimates, resulting in overstat d NOA
- look for unusual build-up in accrual accounts, such as A/R, inventory, etc.

*** **the identification of statements materially affected by earnings management activity is critical when deciding whether to rely on the reported financial statements as a basis for developing forecasts of the firm's future financial performance (i.e., its pro forma financial statements)**

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PART 7 – Fair Value

To re-iterate,

"Earnings management occurs when managers use **judgment in financial reporting** and in structuring transactions to alter financial reports to either **mislead** some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." (Healy & Wahlen, 1999)

- most earnings management is anagement (e.g., CEO, CFO)
- *why* do managers (e.g. CEO, CFO) engage in e agement? – two basic drivers (Healy and Wahlen):

Valuation: an attempt to mislead investors (shareholders) into believing that the company is performing better, or is less risky, than it would appear without the earnings management in hopes of achieving a higher share price

Contracting: an attempt to manipulate a contractual outcome that depends on accounting numbers, most typically compensation contracting (incentive bonuses based on accounting figures) and debt contracting (covenants based on accounting numbers)

Major types of earnings management:

- **Manipulation of accrual estimates**, e.g., underestimate Provision for Doubtful Debts; underestimate Provision for Warranty Expenses
- **Manipulation of accounting policies**, e.g., changing depreciation method to one that involves a lower expense; changing from cost to fair value method for an asset that has increased in value
- **Manipulation of fair value estimates**, e.g., overestimating fair value of an investment

- **Changing the timing of transactions**, e.g., delaying spending on R&D or advertising until the next year

- **Transaction structuring**: c gement that usually exploit loopholes in accounting rules by entering specially designed tra

Earnings management activity is restricted by:

- external auditor (note – only provide ‘reasonable assurance’)
- internal auditor (but can be pressured)
- regulation and regulators (including fines, shareholder lawsuits, and imprisonment)
- board of directors oversight (governance)

Finally, the possibility of manipulating fair value (FV) estimates:

- under AASB / IFRS, there are two measurement methods – historical cost & fair value
- historical cost is typically viewed as more reliable but less relevant
  - with 'historical cost', the two accounting quality concerns are depreciation and impairment
- 'fair value' defined under AASB 13 as "the price that would be received to sell an asset or paid to transfer a liability in a een market participants at the measurement date"
  - the reliability of a 'fair value' measure depends pri it is determined
  - the estimate (and thereby its integrity) will also aff I (depending on whether the change in FV is recorded in the I/S or in OCI)

- AASB 13 (IFRS 13) defines three levels of fair value from most to least reliable:
  - “Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.”
  - “Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.” (i.e., “quoted prices for similar assets or liabilities in acti

  - “Level 3 inputs are unobservable inputs fo r liability” (i.e., internal estimates)

**clearly, Level 3 fair values are to ones that should be viewed with the greatest scepticism

Illustration – Harvey Norman's financial assets and liabilities (Levels 1 and 2)

Illustration (cont) – Harvey Norman's property holdings

Net Property Revaluation Adjustments

The investment property portfolio in Australia and properties held in joint venture entities are subject to a semi-annual review to fair market value. At each reporting period, one-sixth of the investment property portfolio is independently valued with the remaining five-sixths reviewed for fair value by Directors. The entire portfolio is independently valued every three years.

→ Harvey Norman's property holdings are measured at 'fair value' and recognised through profit and loss under AASB 140 Investment Property

key concern ≡ *what* is the quality of these fair value estimates? As revealed through Note 15, the revaluations are 'Level 3' ➝ internal estimates

Assignment Project Exam Help

https://eduassistpro.github.io/

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Ernst & Young's audit report included the following Key Audit Matter:

key concern ≡ *what* is the quality of these fair value estimates?

- they are all Level 3 fair values → fair values are based on internal estimates, rather than observable market prices

- Harvey Norman does use an independent valuation expert (unnamed?) to check the valuations.

  - the independent valu each property at least once every three years.

  - the auditor (EY) has also randomly ch ns and discusses the issue as a key audit matter

Interpretation of the reliability of these estimates is ultimately a matter of judgement !!

PART 8 – Summary: Sessions #1 → #6

overarching objective:

to conduct fundamental value for the purpose of estimating the 'intrinsic value' of a firm's common shares

→ requires an understanding of the firm's 'value drivers'

➡ need to accumulate a 'tool kit' as the basis for developing the *pro forma Financial Statement*

STEP 1
Understanding the past

1. Information collection
2. Understanding the business
3. Accounting analysis
4. Financial ratio analysis
5. Cash flow analysis

□

STEP 2
Forecasting the future

1. Structured forecasting
2. Income Statement forecasts
3. Balance sheet forecasts
4. Cash flow forecasts

□

STEP 3
Valuation

1. Cost of capital
2. Valuation models – *AE, FCF, D*
3. Valuation ratios
4. Complications
   a. Negative values
   b. Value creation and destruction

external environment

- economic prospects
- macroeconomic factors
- socio-cultural forces
- political / regulatory

Industry dynamics
→ Porter's five forces
(suppliers, buyers, new entrants, substitutes, rivalry)

Analysis of Financial Statements

- understanding current F/S ✓
- re-formulating the F/S ✓
- accounting quality ✓
- ratio analysis ** Sessions #9 & #10

- analysts' reports
- management forecasts
- financial press
- ???