How accounting rules give companies control over the bottom line

Financial reports always look certain and objective. After all, they’re filled with cold hard numbers, right?

But accounting rules give reporting companies a lot of leeway in how they report certain numbers, such as depreciation, allowances for future taxes and inventory valuation and the effect isn’t small.

“The magnitude of the typical misrepresentation is quite material — about 10 cents on every dollar,” say four U.S. professors who surveyed 375 chief financial officers about this issue. Their study, published in the most recent issue of Financial Analysts Journal, also found that the CFOs believe 20 per cent of companies in any given year intentionally fudge the numbers, albeit legally.

This isn’t always a bad thing, but it is something all investors should understand, particularly those following an investment strategy that connects a company’s stock price with its earnings performance.

“The problem with accounting is more in how it’s understood by a less sophisticated user who might not understand what it really means,” said Aaron Wright, a charted professional accountant at Collins Barrow in Halifax.

Six accounting tricks of the trade

Accounting rules give a reporting company a lot of discretion in how to report depreciation, inventory valuation and other items. Here are some examples of how companies have used this discretion:

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Canadian Natural Resources Ltd. last August reported a second-quarter loss by taking an upfront $579-million “deferred income tax charge” to account for a hike in the provincial corporate income tax rate to 12 per cent from 10 per cent. This particular charge was prudent given that the company will have to
Discretion over some items is needed to recognize that sometimes their precise value isn’t available when companies prepare their financial reports. It’s better to fill the gap with an estimate than to ignore the item completely.

Sophisticated investors and market analysts are well aware of the issue. That’s why you’ll see stock analysts focus not on a company’s bottom line profit, but on its EBITDA — earnings or profit before subtracting tax, interest, depreciation and amortization.

Consider that tax number, for example. A company will never really know what its actual tax liability is for a given quarter or year until it has submitted its tax return and received an assessment back from the tax collector.

To the healthy skeptic, however, discretion opens the door to abuse. Look at those cases where a company has run afoul of regulators or been targeted in a class-action lawsuit, and you’ll probably see that the problem boils down to allegations that the company took advantage of the rules.

In 2011, a professor at Washington University in St. Louis studied the financial results of 20,000 U.S. companies and found evidence that number fludging has been rising over recent decades.

“You have to give managers some discretion and some leeway for judgment so they can convey what’s really relevant about the company,” said Dan Thornton, who holds the Chartered Professional Accountants of Ontario Professorship at Queen’s University in Kingston, Ont.

“But when you give them that discretion, leeway and judgment, you open up the possibility that there will always be a few bad apples who will abuse the privilege and try to manipulate things for their own personal benefit.”

Experts are convinced that in the vast majority of cases, companies and accountants get it right. There may be differences of opinion on whether a company used the right accounting technique in a given situation, but those working with clean hands should have grounds to justify their decisions.

“You’ve got to recognize that it’s human judgment,” said Errol Soriano, a managing director at Campbell Valuation Partners Ltd. in Toronto. “It can run from doing the best you can but coming to a different number, to trying to manipulate your result by being very aggressive in your interpretation of the rules. That’s the spectrum.”

Accounting rules are rooted in something called the matching principle. Managers who prepare financial reports are supposed to match the revenue the company receives with any related expenses, which is not as easy as it seems.

“Sometimes when you’re preparing statements for a given period, you’re trying to give recognition to costs that you don’t have concrete numbers for yet,” Wright said. “You need to make your best estimate of what that cost is expected to come in at, because maybe you’ve recognized revenue in this period and you just haven’t yet recognized all the related costs.”

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As a result, two issues arise.

The first is that the company might not know the precise value of some figures until long after the reporting period is over. For example, if a company has taken a big upfront payment for a multi-year contract, it needs to decide how much of that payment it can apply to the reporting periods.

“Revenue does not always equal cash,” Soriano said. “People can assume revenue means the company is doing well, but if it's all stuck in receivables and you're selling to people on shaky ground, you should be making allowances for that.”

The second issue is that there are some numbers the company will just never know with precision because they’re simply impossible to know.

For example, plants, buildings and equipment might wear out over time, but it’s practically impossible to determine exactly how to record that loss of value as an expense within a given time frame. All accountants can do is make their best guess.

But no matter how a company decides to fill in the numbers, it must back up its decision with some careful reasoning. The decision cannot be arbitrary.

“There’s supposed to be justification for these things,” Wright said. “There has to be some merit to those choices.”

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