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Vern Krishna looks at the Accounting process that tends to confound people who are not familiar with the "art" of numbers, and the "experts" confuse the confounded. The entire process is entirely understandable. Canada adopted International Financial Reporting Standards ("IFRS") for public companies commencing January 1, 2011, which makes understanding accounting even more complex and the notes to financial statements more important.

Parsing the new accounting landscape

Date: September 20, 2012

Vern Krishna

IFRS ups the ante for number-crunching

Accounting tends to confound people, including some lawyers, who are not familiar with the "art" of numbers, and the "experts" confuse the confounded.

The entire process is entirely understandable. Canada adopted International Financial Reporting Standards (IFRS) for public companies commencing Jan. 1, 2011, which makes understanding accounting even more complex and the notes to financial statements more important. Investors should read the notes carefully. That is where the skeletons are usually buried.

Stock prices respond to corporate earnings and corporate earnings are the end-product of the accounting system that measures and reports the bottom line profit. Meanwhile, security analysts set up earnings estimates as targets that create market expectations among investors. Reported earnings that do not meet market expectations cause volatile short-term reactions in corporate stock prices.

There is nothing wrong or illegal in that process. Accountants report on financial results using generally accepted accounting principles (GAAP) according to domestic and international reporting standards and regulatory rules. The important point is that GAAPs are flexible and, therefore, bottom line profits or earnings are not always what they may appear to be.

By "earnings," we mean the increase in the net wealth of a business enterprise. Earnings benefit the owners of the business—the investors. The mechanical process of measuring earnings is really quite simple: deduct expenses from revenues. If the answer is positive, the business has a profit, or net income. GAAP and securities rules require all publicly traded corporations to report their bottom line profits. Thus, in theory, net income produced by applying GAAP should be the standard by which we can evaluate and compare a company's performance over time and make inter-company comparisons.

GAAP requires a company to include all of its revenue that it earns in a year and deduct all expenses that it incurs to earn the revenue. But companies also publish other numbers—"pro forma" profits—that shift the focus away from a net income to other numbers. For example, a company may report its EBITDA—earnings before interests, taxes, depreciation and amortization. EBITDA is a measure of operating results, but it can be potentially misleading. To be sure, a company can increase its earnings if it ignores the costs of financing operations—interests, taxes (the government's compulsory take),

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depreciation and amortization (allocation of costs previously expended).

But how meaningful is the residual number? Consider an enterprise with a 55 per cent debt ratio, depreciable capital assets equal to 4 per cent of total assets, and a tax bill equal to 35 per cent of its earnings. How meaningful is the EBITDA number if we ignore interest, depreciation, amortization and taxes?

Pro-forma earnings often exclude “non-recurring” charges—writedowns, restructuring charges and the like. The theory is that “non-recurring” charges distort regular or recurring net income. Hence, one should ignore non-recurring charges to deter mine the stability of a normal operation. In practice, some companies have regular “non-recur ring” charges.

A restructuring charge is the cost that a company bears when it reorganizes its business. For example, a company may exit a market, change its product mix or close a physical plant. The company may estimate the total cost of present and future charges that the restructuring will trigger. In some cases, the company may report the total restructuring charges in one lump sum in the current year in order to write down its current profit even though the restructuring will occur over several years. There is nothing imp rope r about this, but the charge will depress current earnings and inflate future earnings.

Companies can also establish reserves to cover restructuring charges. A reserve is an estimate of future events and costs. If the company overestimates its reserves in the current year, it can always reduce the reserves in a future period in order to increase future profit. Thus, a company can use its reserve accounting to smooth out profit or juggle profits between accounting years. The danger is that a company can use reserve reversals in future years when earnings are declining in order to give the impression that net earnings are actually increasing.

Writedowns can distort accounting profits between a company’s accounting years.

Some signals to watch out for

Companies can grow their earnings by increasing sales and controlling costs. A company can also grow its earnings by acquiring other companies and enhancing consolidated earnings. Both methods are entirely strategically appropriate. The danger with the second method, however is that the acquirer company may dilute its stock price.

Many companies use their high stock prices during market bubbles to acquire companies by issuing their own stock and taking on a lot of debt. Both of these methods make sense if the acquired company produces earnings and synergies to more than offset the dilution in the acquirer’s stock price and the additional interest expense on new debt.

When an acquiring company pays a large premium to acquire another company, the share capital of the acquirer is diluted or its debt enlarged substantially. If the increased and combined earnings of the acquirer and the acquired company do not materialize, there will be downward pressure on the acquirer’s stock prices. We saw these difficulties with companies such as Tyco and Lucent during the technology boom (and bust) in 2000.

Depreciation

Depreciation involves allocating the cost of capital assets—plant, machinery, equipment and buildings—over the useful life of the assets. For example, if a company acquires a building for $100 million and estimates its useful life to be 40 years, it will allocate $2.5 million per year as an expense against revenues. The estimate of 40 years is just that, an estimate. The company can increase its annual profit by estimating the useful life of the building to be 60 years instead of 40. At 60 years, the annual depreciation charge drops to $1.67 million and profits increase by $800,000.

Most companies have some flexibility in determining the amount that they will allocate to their depreciable capital assets. In large manufacturing enterprises that use a lot of capital equipment, the opportunity for estimate management is quite considerable.

In analyzing financial statements, it is important to bear in mind that accounting is as much art as it is science based on principles. Canada’s adoption of IFRS moves us from rules-based accounting to a principles-based system that involves estimates and professional judgment—neither of which are exact sciences.

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