stock market ultimately sees through earnings management. In most cases, earnings management is eventually uncovered and the stock price responds negatively to evidence that firms have inflated prior earnings through misleading accounting.

SUMMARY

In summary, accounting analysis is an important step in the process of analyzing corporate financial reports. The purpose of accounting analysis is to evaluate the degree to which a firm's accounting captures its underlying business reality. Sound accounting analysis improves the reliability of conclusions from financial analysis, the next step in financial statement analysis.

There are six principal steps in accounting analysis. The analyst begins by identifying the key accounting policies and estimates given the firm's industry and its business strategy. The second step is to evaluate the degree of flexibility available to managers given the accounting rules and conventions. Next, the analyst evaluates how managers exercise their accounting flexibility and the likely motivations behind managers' accounting strategy. The fourth step involves assessing the depth and quality of a firm's disclosures. The analyst should next identify any red flags, indicating a need for further investigation. The final step in accounting analysis is to restate accounting numbers to remove any noise and bias introduced by the accounting rules and management decisions.

The next chapter discusses how to implement these concepts and shows how to make some of the most common types of adjustments.

DISCUSSION QUESTIONS

1. A finance student states, "I don't understand why anyone pays any attention to accounting earnings numbers, given that a 'clean' number like cash from operations is readily available." Do you agree? Why or why not?
2. Fred argues, "The standards that I like most are the ones that eliminate all management discretion in reporting—that way I get uniform numbers across all companies and don't have to worry about doing accounting analysis." Do you agree? Why or why not?
3. Bill Simon says, "We should get rid of the FASB and SEC since free market forces will make sure that companies report reliable information." Do you agree? Why or why not?
4. Many firms recognize revenues at the point of shipment. This provides an incentive to accelerate revenues by shipping goods at the end of the quarter. Consider two companies, one of which ships its product evenly throughout the quarter, and the second, which ships all its products in the last two weeks of the quarter. Each company's customers pay 30 days after receiving shipment. Using accounting ratios, how can you distinguish these companies?
5. a. If management reports truthfully, what economic events are likely to prompt the following accounting changes?
      - Increase in the estimated life of depreciable assets
      - Decrease in the uncollectible allowance as a percentage of gross receivables
      - Recognition of revenues at the point of delivery rather than at the point cash is received
      - Capitalization of a higher proportion of software R&D costs

   b. What features of accounting, if any, would make it costly for dishonest managers to make the same changes without any corresponding economic changes?

6. The conservatism principle arises because of concerns about management's incentives to overstate the firm's performance. Joe Banks argues, "We could get rid of conservatism and make accounting numbers more useful if we delegated financial reporting to independent auditors rather than to corporate managers." Do you agree? Why or why not?
7. A fund manager states, "I refuse to buy any company that makes a voluntary accounting change, since it's certainly a case of management trying to hide bad news." Can you think of any alternative interpretation?
8. Fair value accounting attempts to make financial information more relevant to financial statement users, at the risk of greater subjectivity. What factors would you examine to evaluate the reliability of fair valued assets?

NOTES

1. Accounting analysis is sometimes also called "quality of earnings analysis." We prefer to use the term *accounting analysis* since we are discussing a broader concept than merely a firm's earnings quality.
2. These definitions paraphrase those of the Financial Accounting Standards Board (FASB), Statement of Financial Accounting Concepts No. 6, "Elements of Financial Statements" (1985). Our intent is to present the definitions at a conceptual, not technical, level. For a more complete discussion of these and related concepts, see the FASB's Statements of Financial Accounting Concepts (http://www.fasb.org).
3. SEC rules state that these criteria are satisfied when (i) there is persuasive evidence that an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the selling price is fixed or determinable, and (iv) collectibility is reasonably assured (see SAB 104).
4. Strictly speaking, the comprehensive net income of a firm also includes gains and losses from increases and decreases in equity from non-operating activities or extraordinary items.
5. Background information on the history of U.S. GAAP / IFRS convergence from Financial Accounting Standards Board, "International Convergence of Accounting Standards—A Brief History," Financial Accounting Standards Board website, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156304264, accessed February 2011.
6. IFRS Foundation website, http://www.ifrs.org/Home.htm, accessed January 2011.
7. *Who We Are and What We Do*, the IASB and IFRS Foundation brochure, January 2011, http://www.ifrs.org/NR/rdonlyres/9D0DE08C-C584-46EB-B36E-C4B9A8CB6A02/0/WhoWeAreJanuary2011English.pdf, accessed February 2011.
8. "FACTBOX-Auditor lawsuits in wake of credit crisis," January 21, 2011, Reuters, http://www.reuters.com/assets/print?aid=USN2122314420110121, accessed February 2011.
9. "Judge OKs $125 mln New Century lawsuit settlement," August 11, 2010, Reuters, http://www.reuters.com/article/2010/08/11/newcentury-settlement-idUSN1018298820100811, accessed February 2011.
10. Thus, although accrual accounting is theoretically superior to cash accounting in measuring a firm's periodic performance, the distortions it introduces can make accounting data less valuable to users. If these distortions are large enough, current cash flows may measure a firm's periodic performance better than accounting profits. The relative usefulness of cash flows and accounting profits in measuring performance, therefore, varies from firm to firm. For empirical evidence on this issue, see