

IFRS Standards Edition

BUSINESS ANALYSIS AND VALUATION

Krishna G. Palepu
Paul M. Healy
Erik Peek

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**Krishna G. Palepu, Paul M. Healy
& Erik Peek**

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Preface

Financial statements are the basis for a wide range of business analyses. Managers use them to monitor and judge their firms' performance relative to competitors, to communicate with external investors, to help judge what financial policies they should pursue, and to evaluate potential new businesses to acquire as part of their investment strategy. Securities analysts use financial statements to rate and value companies they recommend to clients. Bankers use them in deciding whether to extend a loan to a client and to determine the loan's terms. Investment bankers use them as a basis for valuing and analyzing prospective buyouts, mergers, and acquisitions. And consultants use them as a basis for competitive analysis for their clients. Not surprisingly, therefore, there is a strong demand among business students for a course that provides a framework for using financial statement data in a variety of business analysis and valuation contexts. The purpose of this book is to provide such a framework for business students and practitioners. This IFRS Standards edition is the European adaptation of the authoritative US edition – authored by Krishna G. Palepu and Paul M. Healy – that has been used in Accounting and Finance departments in universities around the world. In 2007 we decided to write the first IFRS Standards edition because of the European business environment's unique character and the introduction of mandatory IFRS Standards reporting for public corporations in the European Union. This fifth IFRS Standards edition is a thorough update of the successful fourth edition, incorporating new examples, cases, problems and exercises, and regulatory updates.

This IFRS Standards edition

Particular features of the IFRS Standards edition are the following:

- A large number of examples support the discussion of business analysis and valuation throughout the chapters. The examples are from (mostly European) companies that students will generally be familiar with, such as Audi, BMW, British American Tobacco, BP, Carlsberg, Deutsche Telekom, easyGroup, Hennes and Mauritz, Lufthansa, Renault, Sanofi, Société Générale, and Tesco.
- The chapters dealing with accounting analysis (Chapters 3 and 4) prepare students for the task of analyzing IFRS Standards-based financial statements. All numerical examples of accounting adjustments in Chapter 4 describe adjustments to IFRS Standards-based financial statements. Further, throughout the book we discuss various topics that are particularly relevant to understanding IFRS Standards-based (European) financial reports, such as: the classification of expenses by nature and by function; a principles-based approach versus a rules-based approach to standard setting; the first-time adoption of IFRS Standards; cross-country differences and similarities in external auditing and public enforcement, and cross-country differences in financing structures.
- The terminology that we use throughout the chapters is consistent with the terminology that is used in the IFRS Standards.
- Throughout the chapters, we describe the average performance and growth ratios, the average time-series behavior of these ratios, and average financing policies of a sample of close to 7,800 firms that have been listed on European public exchanges between 1998 and 2017.
- The financial analysis and valuation chapters (Chapters 5-8) focus on firms in the apparel retail sector, primarily Hennes & Mauritz and Inditex. Throughout these chapters, we explicitly differentiate between analyzing and valuing operations and analyzing and valuing non-operating investments. Further, Chapter 8 explicitly discusses implementation differences between equity-based and asset-based valuation approaches.

- Chapter 10 on credit analysis includes a discussion of how credit ratings and default probability estimates can be used in debt valuation. Chapter 11 on M&A analysis includes a discussion on how to perform a purchase price allocation using the tools and techniques from Chapters 5 through 8.
- Data, analyses, problems, and examples have been thoroughly updated in the fifth edition.
- We have updated some of the fourth IFRS Standards edition's cases ('Carrefour SA,' 'Forecasting Earnings and Earnings Growth in the European Oil and Gas Industry,' 'Two European Hotel Groups') and have included eight new cases: 'Akris: Competition in the High-End Fashion Industry,' 'Toshiba: Accounting Fraud,' 'Accounting for the iPhone Upgrade Program,' 'Valuation Multiples in Fast Fashion,' 'Ferrari: The 2015 Initial Public Offering,' 'Tesco: From Troubles to Turnaround,' 'Spotify's Direct Listing IPO,' and 'Valuing Europe's fastest growing company: HelloFresh in 2017.'

Key features

This book differs from other texts in business and financial analysis in a number of important ways. We introduce and develop a framework for business analysis and valuation using financial statement data. We then show how this framework can be applied to a variety of decision contexts.

FRAMEWORK FOR ANALYSIS

We begin the book with a discussion of the role of accounting information and intermediaries in the economy, and how financial analysis can create value in well-functioning markets (Chapter 1). We identify four key components, or steps, of effective financial statement analysis:

- Business strategy analysis
- Accounting analysis
- Financial analysis
- Prospective analysis

The first step, business strategy analysis (Chapter 2), involves developing an understanding of the business and competitive strategy of the firm being analyzed. Incorporating business strategy into financial statement analysis is one of the distinctive features of this book. Traditionally, this step has been ignored by other financial statement analysis books. However, we believe that it is critical to begin financial statement analysis with a company's strategy because it provides an important foundation for the subsequent analysis. The strategy analysis section discusses contemporary tools for analyzing a company's industry, its competitive position and sustainability within an industry, and the company's corporate strategy.

Accounting analysis (Chapters 3 and 4) involves examining how accounting rules and conventions represent a firm's business economics and strategy in its financial statements, and, if necessary, developing adjusted accounting measures of performance. In the accounting analysis section, we do not emphasize accounting rules. Instead we develop general approaches to analyzing assets, liabilities, entities, revenues, and expenses. We believe that such an approach enables students to effectively evaluate a company's accounting choices and accrual estimates, even if students have only a basic knowledge of accounting rules and standards. The material is also designed to allow students to make accounting adjustments rather than merely identify questionable accounting practices.

Financial analysis (Chapter 5) involves analyzing financial ratio and cash flow measures of the operating, financing, and investing performance of a company relative to either key competitors or historical performance. Our distinctive approach focuses on using financial analysis to evaluate the effectiveness of a company's strategy and to make sound financial forecasts.

Finally, under prospective analysis (Chapters 6–8) we show how to develop forecasted financial statements and how to use these to make estimates of a firm's value. Our discussion of valuation includes traditional discounted cash flow models as well as techniques that link value directly to accounting numbers. In discussing accounting-based

valuation models, we integrate the latest academic research with traditional approaches such as earnings and book value multiples that are widely used in practice.

While we cover all four steps of business analysis and valuation in the book, we recognize that the extent of their use depends on the user's decision context. For example, bankers are likely to use business strategy analysis, accounting analysis, financial analysis, and the forecasting portion of prospective analysis. They are less likely to be interested in formally valuing a prospective client.

APPLICATION OF THE FRAMEWORK TO DECISION CONTEXTS

The next section of the book shows how our business analysis and valuation framework can be applied to a variety of decision contexts:

- Securities analysis (Chapter 9)
- Credit analysis and distress prediction (Chapter 10)
- Merger and acquisition analysis (Chapter 11)

For each of these topics we present an overview to provide a foundation for the class discussions. Where possible we discuss relevant institutional details and the results of academic research that are useful in applying the analysis concepts developed earlier in the book. For example, the chapter on credit analysis shows how banks and rating agencies use financial statement data to develop analysis for lending decisions and to rate public debt issues. This chapter also presents academic research on how to determine whether a company is financially distressed.

Using the book

We designed the book so that it is flexible for courses in financial statement analysis for a variety of student audiences – MBA students, Masters in Accounting or Finance students, Executive Program participants, and undergraduates in accounting or finance. Depending upon the audience, the instructor can vary the manner in which the conceptual materials in the chapters, end-of-chapter questions, and case examples are used. To get the most out of the book, students should have completed basic courses in financial accounting, finance, and either business strategy or business economics. The text provides a concise overview of some of these topics, primarily as background for preparing the cases. But it would probably be difficult for students with no prior knowledge in these fields to use the chapters as stand-alone coverage of them.

If the book is used for students with prior working experience or for executives, the instructor can use almost a pure case approach, adding relevant lecture sections as needed. When teaching students with little work experience, a lecture class can be presented first, followed by an appropriate case or other assignment material. It is also possible to use the book primarily for a lecture course and include some of the short or long cases as in-class illustrations of the concepts discussed in the book. Alternatively, lectures can be used as a follow-up to cases to more clearly lay out the conceptual issues raised in the case discussions. This may be appropriate when the book is used in undergraduate capstone courses. In such a context, cases can be used in course projects that can be assigned to student teams.

Companion website

A companion website accompanies this book. This website contains the following valuable material for instructors and students:

- Instructions for how to easily produce standardized financial statements in Excel.
- Spreadsheets containing: (1) the reported and standardized financial statements of Hennes & Mauritz (H&M) and Inditex; (2) calculations of H&M's and Inditex's ratios (presented in Chapter 5); (3) H&M's forecasted

financial statements (presented in Chapter 6); and (4) valuations of H&M's shares (presented in Chapter 8). Using these spreadsheets students can easily replicate the analyses presented in Chapters 5 through 8 and perform “what-if” analyses – i.e., to find out how the reported numbers change as a result of changes to the standardized statements or forecasting assumptions.

- Spreadsheets containing case material.
- Answers to the discussion questions and case instructions (for instructors only).
- A complete set of lecture slides (for instructors only).

Accompanying teaching notes to some of the case studies can be found at www.harvardbusiness.org or www.thecasecentre.org. Lecturers are able to register to access the teaching notes and other relevant information.

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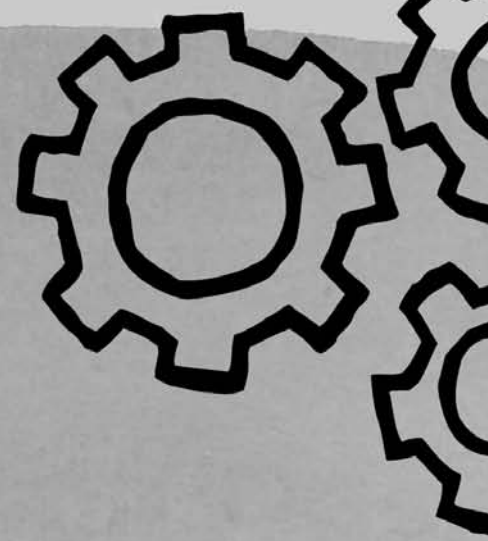
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Framework

PART I

1 A framework for business analysis and valuation using financial statements

1 A framework for business analysis and valuation using financial statements

This chapter outlines a comprehensive framework for financial statement analysis. Because financial statements provide the most widely available data on public corporations' economic activities, investors and other stakeholders rely on financial reports to assess the plans and performance of firms and corporate managers.

A variety of questions can be addressed by business analysis using financial statements, as shown in the following examples:

- **A security analyst may be interested in asking:** “How well is the firm I am following performing? Did the firm meet my performance expectations? If not, why not? What is the value of the firm's stock given my assessment of the firm's current and future performance?”
- **A loan officer may need to ask:** “What is the credit risk involved in lending a certain amount of money to this firm? How well is the firm managing its liquidity and solvency? What is the firm's business risk? What is the additional risk created by the firm's financing and dividend policies?”
- **A management consultant might ask:** “What is the structure of the industry in which the firm is operating? What are the strategies pursued by various players in the industry? What is the relative performance of different firms in the industry?”
- **A corporate manager may ask:** “Is my firm properly valued by investors? Is our investor communication program adequate to facilitate this process?”
- **A corporate manager could ask:** “Is this firm a potential takeover target? How much value can be added if we acquire this firm? How can we finance the acquisition?”
- **An independent auditor would want to ask:** “Are the accounting policies and accrual estimates in this company's financial statements consistent with my understanding of this business and its recent performance? Do these financial reports communicate the current status and significant risks of the business?”

In almost all countries in the world today, **capital markets** play an important role in channeling financial resources from savers to business enterprises that need capital. Financial statement analysis is a valuable activity when managers have complete information on a firm's strategies, and a variety of institutional factors make it unlikely that they fully disclose this information to suppliers of capital. In this setting, outside analysts attempt to create “inside information” from analyzing financial statement data, thereby gaining valuable insights about the firm's current performance and future prospects.

To understand the contribution that financial statement analysis can make, it is important to understand the role of financial reporting in the functioning of capital markets and the institutional forces that shape financial statements. Therefore we present first a brief description of these forces; then we discuss the steps that an analyst must perform to extract information from financial statements and provide valuable forecasts.

The role of financial reporting in capital markets

A critical challenge for any economy is the allocation of savings to investment opportunities. Economies that do this well can exploit new business ideas to spur innovation and create jobs and wealth at a rapid pace. In contrast, economies that manage this process poorly dissipate their wealth and fail to support business opportunities.

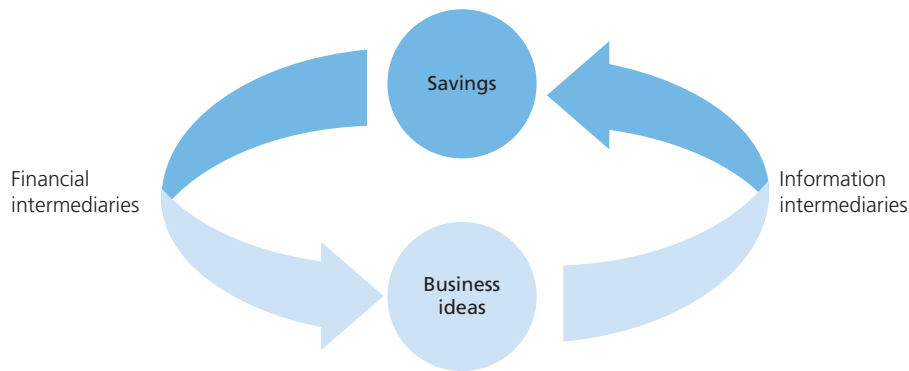
FIGURE 1.1 Capital markets

Figure 1.1 provides a schematic representation of how capital markets typically work. Savings in any economy are widely distributed among households. There are usually many new entrepreneurs and existing companies that would like to attract these savings to fund their business ideas. While both savers and entrepreneurs would like to do business with each other, matching savings to business investment opportunities through the use of capital markets – funding business ideas with the highest prospects first – is complicated for at least three reasons:

- **Information asymmetry between savers and entrepreneurs.** Entrepreneurs typically have better information than savers on the value of business investment opportunities.
- **Potentially conflicting interests – credibility problems.** Communication by entrepreneurs to savers is not completely credible because savers know that entrepreneurs have an incentive to inflate the value of their ideas.
- **Expertise asymmetry.** Savers generally lack the financial sophistication needed to analyze and differentiate between the various business opportunities.

The information and incentive issues lead to what economists call the **lemons problem**, which can potentially break down the functioning of the capital market.¹ It works like this. Consider a situation where half the business ideas are “good” and the other half are “bad.” If investors cannot distinguish between the two types of business ideas, entrepreneurs with “bad” ideas will try to claim that their ideas are as valuable as the “good” ideas. Realizing this possibility, investors value both good and bad ideas at an average level. Unfortunately, this penalizes good ideas, and entrepreneurs with good ideas find the terms on which they can get financing to be unattractive. As these entrepreneurs leave the capital market, the proportion of bad ideas in the market increases. Over time, bad ideas “crowd out” good ideas, and investors lose confidence in this market.

The emergence of intermediaries can prevent such a market breakdown. Intermediaries are like a car mechanic who provides an independent certification of a used car’s quality to help a buyer and seller agree on a price. There are two types of intermediaries in the capital markets. **Financial intermediaries**, such as venture capital firms, banks, collective investment funds, pension funds, and insurance companies, focus on aggregating funds from individual investors and analyzing different investment alternatives to make investment decisions. **Information intermediaries**, such as auditors, financial analysts, credit-rating agencies, and the financial press, focus on providing or assuring information to investors (and to financial intermediaries who represent them) on the quality of various business investment opportunities. Both these types of intermediaries add value by helping investors distinguish “good” investment opportunities from the “bad” ones.

The relative importance of financial intermediaries and information intermediaries varies from country to country for historical reasons. In countries where individual investors traditionally have had strong legal rights to discipline entrepreneurs who invest in “bad” business ideas, such as in the UK, individual investors have

been more inclined to make their own investment decisions. In these countries, the funds that entrepreneurs attract may come from a widely dispersed group of individual investors and be channeled through public stock exchanges. Information intermediaries consequently play an important role in supplying individual investors with the information that they need to distinguish between “good” and “bad” business ideas. In contrast, in countries where individual investors traditionally have had weak legal rights to discipline entrepreneurs, such as in many Continental European countries, individual investors have been more inclined to rely on the help of financial intermediaries. In these countries, financial intermediaries, such as banks, tend to supply most of the funds to entrepreneurs and can get privileged access to entrepreneurs’ private information.

Over the past decade, many countries in Europe have been moving towards a model of strong **legal protection of investors’ rights** to discipline entrepreneurs and well-developed stock exchanges. In this model, financial reporting plays a critical role in the functioning of both the information intermediaries and the financial intermediaries. Information intermediaries add value either by enhancing the credibility of financial reports (as auditors do) or by analyzing the information in the financial statements (as analysts and rating agencies do). Financial intermediaries rely on the information in the financial statements to analyze investment opportunities and supplement this information with other sources of information.

Ideally, the various intermediaries serve as a system of checks and balances to ensure the efficient functioning of the capital markets system. However, this is not always the case as on occasion the intermediaries tend to mutually reinforce rather than counterbalance each other. A number of problems can arise as a result of incentive issues, governance issues within the intermediary organizations themselves, and conflicts of interest, as evidenced by accounting scandals at companies such as Carillion, Olympus, Steinhoff, and Tesco. However, in general this market mechanism functions efficiently, and prices reflect all available information on a particular investment. Despite this overall market efficiency, individual securities may still be temporarily mispriced, thereby justifying the need for financial statement analysis.

In the following section, we discuss key aspects of the financial reporting system design that enable it to play effectively this vital role in the functioning of the capital markets.

From business activities to financial statements

Corporate managers are responsible for acquiring physical and financial resources from the firm’s environment and using them to create value for the firm’s investors. Value is created when the firm earns a return on its investment in excess of the return required by its capital suppliers. Managers formulate business strategies to achieve this goal, and they implement them through business activities. A firm’s business activities are influenced by its economic environment and its business strategy. The economic environment includes the firm’s industry, its input and output markets, and the regulations under which the firm operates. The firm’s business strategy determines how the firm positions itself in its environment to achieve a competitive advantage.

As shown in Figure 1.2, a firm’s **financial statements** summarize the economic consequences of its business activities. The firm’s business activities in any time period are too numerous to be reported individually to outsiders. Further, some of the activities undertaken by the firm are proprietary in nature, and disclosing these activities in detail could be a detriment to the firm’s competitive position. The firm’s accounting system provides a mechanism through which business activities are selected, measured, and aggregated into financial statement data.

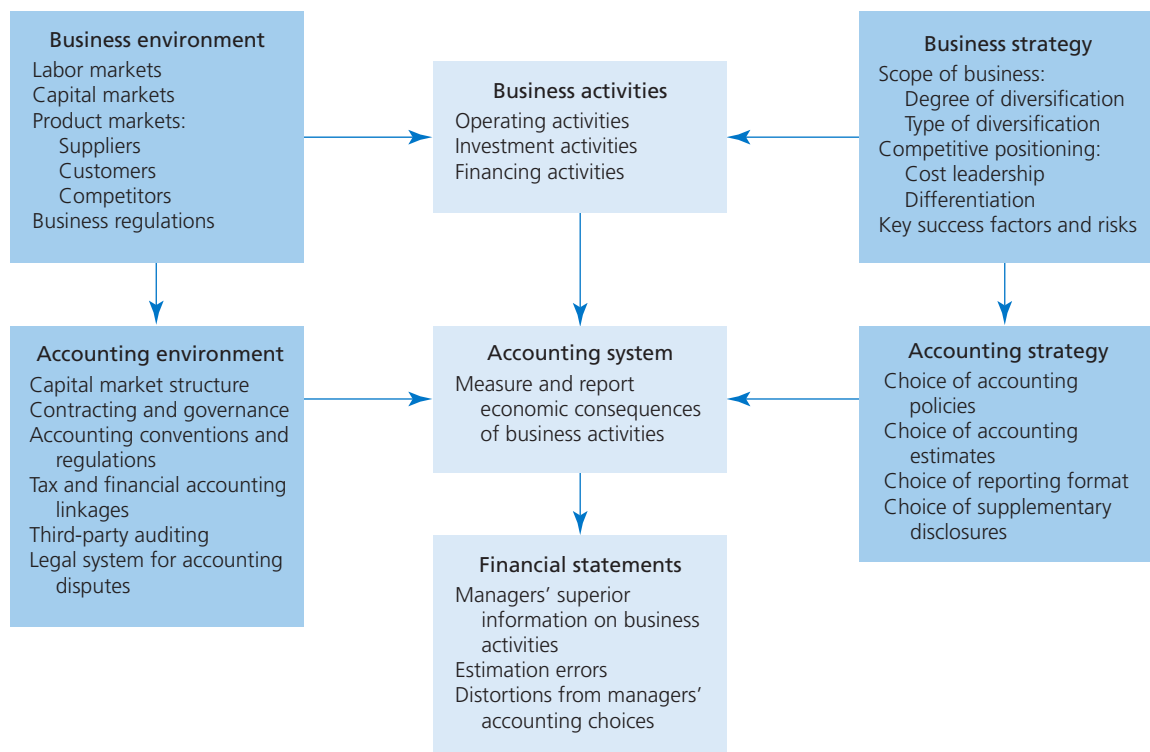
On a periodic basis, firms typically produce five financial reports:

- 1 An income statement that describes the operating performance during a time period.
- 2 A balance sheet that states the firm’s assets and how they are financed.²
- 3 A cash flow statement that summarizes the cash flows of the firm.

- 4 A statement of other comprehensive income that outlines the sources of changes in equity that are (a) not the result of transactions with the owners of the firm and (b) not included in the income statement.³
- 5 A statement of changes in equity that summarizes all sources of changes in equity during the period between two consecutive balance sheets, consisting of (a) total comprehensive income – being the sum of profit or loss [item 1] and other comprehensive income [item 4] – and (b) the financial effects of transactions with the owners of the firm.

These statements are accompanied by notes that provide additional details on the financial statement line items, as well as by management's narrative discussion of the firm's activities, performance, and risks in the Management Commentary section.⁴

FIGURE 1.2 From business activities to financial statements



Influences of the accounting system on information quality

Intermediaries using financial statement data to do business analysis have to be aware that financial reports are influenced both by the firm's business activities and by its accounting system. A key aspect of financial statement analysis therefore involves understanding the influence of the accounting system on the quality of the financial statement data being used in the analysis. The institutional features of accounting systems discussed next determine the extent of that influence.

FEATURE 1: ACCRUAL ACCOUNTING

One of the fundamental features of corporate financial reports is that they are prepared using accrual rather than cash accounting. Unlike cash accounting, **accrual accounting** distinguishes between the recording of costs or benefits associated with economic activities and the actual payment or receipt of cash. Profit or loss is the

primary periodic performance index under accrual accounting. To compute profit or loss, the effects of economic transactions are recorded on the basis of *expected*, not necessarily *actual*, cash receipts and payments. Expected cash receipts from the delivery of products or services are recognized as revenues, and expected cash outflows associated with these revenues are recognized as expenses. Timing differences between the moment of recording costs or benefits and the moment of experiencing cash inflows or outflows result in the recognition of assets and liabilities on the balance sheet.

While many rules and conventions govern a firm's preparation of financial statements, only a few conceptual building blocks form the foundation of accrual accounting. Starting from the balance sheet, the principles that define a firm's **assets**, **liabilities**, and **equity** are as follows:

- **Assets** are economic resources controlled by a firm that (a) have the potential to produce future economic benefits and (b) are measurable with a reasonable degree of certainty. An example of an asset is a firm's inventories that will produce economic benefits once sold and delivered to the firm's customers.
- **Liabilities** are economic obligations of a firm that (a) arise from benefits received in the past, (b) have the potential of being required to be met, and (c) cannot be feasibly avoided by the firm. Examples of liabilities are bonds or bank loans that must be settled in cash or performance obligations that must be settled by providing services to a customer.
- **Equity** is the difference between a firm's assets and its liabilities.

The definitions of assets, liabilities, and equity lead to the fundamental relationship that governs a firm's balance sheet:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

The following definitions are critical to the (comprehensive) income statement, which summarizes a firm's **income** and **expenses**.⁵

- **Income or revenue** consists of economic resources earned (or increases in assets that affect equity) and performance obligations settled (or decreases in liabilities that affect equity) during a time period. Revenue recognition is governed by the realization principle, which proposes that revenues should be recognized when (a) the firm has provided all, or substantially all, the goods or services to be delivered to the customer and (b) the customer has paid cash or is expected to pay cash with a reasonable degree of certainty.
- **Expenses** are economic resources used up (or decreases in assets that affect equity) and economic obligations created (or increases in liabilities that affect equity) during a time period.
- **Profit or loss** is the difference between a firm's income and expenses in a time period. The following fundamental relationship is therefore reflected in a firm's income statement:

$$\text{Profit or loss} = \text{Income} - \text{Expenses}$$

Note from the preceding definitions that the recognition of income and expenses depends on a firm's measurement of its assets and liabilities. A consistent application of the principles that define assets and liabilities implies that associated elements of income and expenses are recognized in the income statement in the same time period – a process that is also referred to as matching of income and expenses. For example, after a firm has sold and delivered goods to a customer, an increase in the asset “trade receivables” combined with a simultaneous decrease in the asset “inventories” lead to the recognition of associated income and expense in the same time period.

Remeasurements of assets or liabilities may also result in the recognition of income or expense items that are not related to the firm's current economic activities. For instance, when a firm holds inventories that have suddenly become obsolete, writing down the value of such assets will cause the recognition of an expense item that is unrelated to the firm's current economic transactions. In sum, expenses are (a) costs directly associated with revenues recognized in the same period (such as the cost of inventory sold), or (b) costs associated with

benefits that are consumed in this time period (such as depreciation on non-current assets used in the period), or (c) resources whose future benefits are not reasonably certain (such as research expenditures or inventory write-downs).

The need for accrual accounting arises from investors' demand for financial reports on a periodic basis. Because firms undertake economic transactions on a continual basis, the arbitrary closing of accounting books at the end of a reporting period leads to a fundamental measurement problem. Because cash accounting does not report the full economic consequence of the transactions undertaken in a given period, accrual accounting is designed to provide more complete information on a firm's periodic performance.

FEATURE 2: ACCOUNTING CONVENTIONS AND STANDARDS

The use of accrual accounting lies at the center of many important complexities in corporate financial reporting. For example, how should revenues be recognized when a firm sells land to customers and also provides customer financing? If revenue is recognized before cash is collected, how should potential defaults be estimated? Are the outlays associated with research and development activities, whose payoffs are uncertain, assets or expenses when incurred? Are contractual commitments under lease arrangements or post-employment plans liabilities? If so, how should they be valued? Because accrual accounting deals with expectations of future cash consequences of current events, it is subjective and relies on a variety of assumptions. Who should be charged with the primary responsibility of making these assumptions? In the current system, a firm's managers are entrusted with the task of making the appropriate estimates and assumptions to prepare the financial statements because they have intimate knowledge of their firm's business.

The accounting discretion granted to managers is potentially valuable because it allows them to reflect inside information in reported financial statements. However, because investors view profits as a measure of managers' performance, managers have incentives to use their accounting discretion to distort reported profits by making biased assumptions. Further, the use of accounting numbers in contracts between the firm and outsiders provides another motivation for manipulation of accounting numbers. Income management distorts financial accounting data, potentially making them less valuable to external users of financial statements. Therefore the delegation of financial reporting decisions to corporate managers has both costs and benefits.

A number of accounting conventions have been implemented to ensure that managers use their accounting flexibility to summarize their knowledge of the firm's business activities, and not to disguise reality for self-serving purposes. For example, in most countries financial statements are prepared using the concept of prudence, where caution is taken to ensure that assets are not recorded at values above their fair values and liabilities are not recorded at values below their fair values. This reduces managers' ability to overstate the value of the net assets that they have acquired or developed.

Accounting standards and rules also limit management's ability to misuse accounting judgment by regulating how particular types of transactions are recorded. For example, accounting standards for leases stipulate how firms are to record contractual arrangements to lease resources. Similarly, post-employment benefit standards describe how firms are to record commitments to provide pensions and other post-employment benefits for employees. These accounting standards, which are designed to convey quantitative information on a firm's performance, are complemented by a set of disclosure principles. The disclosure principles guide the amount and kinds of information that are disclosed and require a firm to provide qualitative information related to assumptions, policies, and uncertainties that underlie the quantitative data presented.

More than 100 countries have delegated the task of setting accounting standards to the International Accounting Standards Board (IASB). For example:

- Since 2005 European Union (EU) companies that have their shares traded on a public exchange must prepare their consolidated financial statements in accordance with International Financial Reporting Standards (IFRS Standards) as promulgated by the IASB and endorsed by the EU. Most EU countries, however, also have their own national accounting standard-setting bodies. These bodies may, for example,

set accounting standards for private companies and for single entity financial statements of public companies or comment on the IASB's drafts of new or modified standards.⁶

- UK-based public companies must continue to prepare IFRS Standards-based consolidated financial statements, even after the United Kingdom's exit from the EU.
- Since 2005 and 2007, respectively, Australian and New Zealand public companies must comply with locally adopted IFRS Standards, labelled A-IFRS Standards and NZ-IFRS Standards. These sets of standards include all IFRS Standards requirements as well as some additional disclosure requirements.
- South African public companies have prepared financial statements that comply with IFRS Standards, as published by the IASB, since 2005.
- Some other large economies with stock exchanges that require (most) publicly listed companies to prepare IFRS Standards-compliant financial statements are Brazil (since 2010), Canada (2011), Korea (2011), Mexico (2012), and Russia (2012).

In the United States, the Securities and Exchange Commission (SEC) has the legal authority to set accounting standards. Since 1973 the SEC has relied on the Financial Accounting Standards Board (FASB), a private sector accounting body, to undertake this task.

Uniform accounting standards attempt to reduce managers' ability to record similar economic transactions in dissimilar ways either over time or across firms. Thus the standards create a uniform accounting language, improve the comparability of financial statements, and increase the credibility of financial statements by limiting a firm's ability to distort them. Increased uniformity from accounting standards, however, comes at the expense of reduced flexibility for managers to reflect genuine business differences in a firm's accounting decisions. Rigid accounting standards work best for economic transactions whose accounting treatment is not predicated on managers' proprietary information. However, when there is significant business judgment involved in assessing a transaction's economic consequences (such as in determining the economic benefits of product development), rigid standards (such as requiring the immediate expensing of product development outlays) are likely to be dysfunctional for some companies because the standards prevent managers from using their superior business knowledge to determine how best to report the economics of key business events. Further, if accounting standards are too rigid, they may induce managers to expend economic resources to restructure business transactions to achieve a desired accounting result or forego transactions that may be difficult to report on.

FEATURE 3: MANAGERS' REPORTING STRATEGY

Because the mechanisms that limit managers' ability to distort accounting data add noise, it is not optimal to use accounting regulation to eliminate managerial flexibility completely. Therefore real-world accounting systems leave considerable room for managers to influence financial statement data. A firm's **reporting strategy** – that is, the manner in which managers use their accounting discretion – has an important influence on the firm's financial statements.

Corporate managers can choose accounting and disclosure policies that make it more or less difficult for external users of financial reports to understand the true economic picture of their businesses. Accounting rules often provide a broad set of alternatives from which managers can choose. Further, managers are entrusted with making a range of estimates in implementing these accounting policies. Accounting regulations usually prescribe minimum disclosure requirements, but they do not restrict managers from *voluntarily* providing additional disclosures.

A superior disclosure strategy will enable managers to communicate the underlying business reality to outside investors. One important constraint on a firm's disclosure strategy is the competitive dynamics in product markets. Disclosure of proprietary information about business strategies and their expected economic consequences may hurt the firm's competitive position. Subject to this constraint, managers can use financial statements to provide information useful to investors in assessing their firm's true economic performance.

Managers can also use financial reporting strategies to manipulate investors' perceptions. Using the discretion granted to them, managers can make it difficult for investors to identify poor performance on a timely

basis. For example, managers can choose accounting policies and estimates to provide an optimistic assessment of the firm's true performance. They can also make it costly for investors to understand the true performance by controlling the extent of information that is disclosed voluntarily.

The extent to which financial statements are informative about the underlying business reality varies across firms and across time for a given firm. This variation in accounting quality provides both an important opportunity and a challenge in doing business analysis. The process through which analysts can separate noise from information in financial statements, and gain valuable business insights from financial statement analysis, is discussed in the following section.

FEATURE 4: AUDITING, LEGAL LIABILITY, AND PUBLIC ENFORCEMENT

Auditing

Broadly defined as a verification of the integrity of the reported financial statements by someone other than the preparer, **auditing** ensures that managers use accounting rules and conventions consistently over time and that their accounting estimates are reasonable. Therefore auditing improves the quality of accounting data. In Europe, the United States, and most other countries, all listed companies are required to have their financial statements audited by an independent public accountant. The standards and procedures to be followed by independent auditors are set by various institutions. By means of the Revised Statutory Audit Directive and Regulation, the EU has set minimum standards for public audits that are performed on companies from its member countries. These standards prescribe, for example, that the external auditor does not provide any nonaudit services to the audited company that may compromise his independence and place a cap on nonaudit service fees. To maintain independence, the auditor also must not audit the same company for more than ten consecutive years. Further, in most European countries, audits must be carried out in accordance with the International Standards on Auditing (ISA), as promulgated by the International Auditing and Assurance Standards Board (IAASB).

In the United States, independent auditors must follow Generally Accepted Auditing Standards (GAAS), a set of standards comparable to the ISA. All US public accounting firms are also required to register with the Public Company Accounting Oversight Board (PCAOB), a regulatory body that has the power to inspect and investigate audit work, and if needed discipline auditors. Like the Statutory Audit Directive and Regulation in the EU, the US Sarbanes–Oxley Act specifies the relationship between a company and its external auditor, for example, requiring auditors to report to, and be overseen by, a company's audit committee rather than its management.

While auditors issue an opinion on published financial statements, it is important to remember that the primary responsibility for the statements still rests with corporate managers. Auditing improves the quality and credibility of accounting data by limiting a firm's ability to distort financial statements to suit its own purposes. However, as audit failures at companies such as Carillion, Olympus, Steinhoff, and Tesco show, auditing is imperfect. Audits cannot review all of a firm's transactions. They can also fail because of lapses in quality or because of lapses in judgment by auditors who fail to challenge management for fear of losing future business.

Third-party auditing may also reduce the quality of financial reporting because it constrains the kind of accounting rules and conventions that evolve over time. For example, the IASB considers the views of auditors – in addition to other interest groups – in the process of setting IFRS Standards. To illustrate, about one-quarter of the IASB board members have a background as practicing auditor. Further, the IASB is advised by the IFRS Standards Advisory Council, which contains several practicing auditors. Finally, the IASB invites auditors to comment on its policies and proposed standards. Auditors are likely to argue against accounting standards that produce numbers that are difficult to audit, sometimes also if the proposed rules produce relevant information for investors.

Legal liability

The legal environment in which accounting disputes between managers, auditors, and investors are adjudicated can also have a significant effect on the quality of reported numbers. The threat of lawsuits and resulting penalties have the beneficial effect of improving the accuracy of disclosure. In the EU, the Transparency Directive requires that every member state has established a statutory civil liability regime for misstatements