

READING

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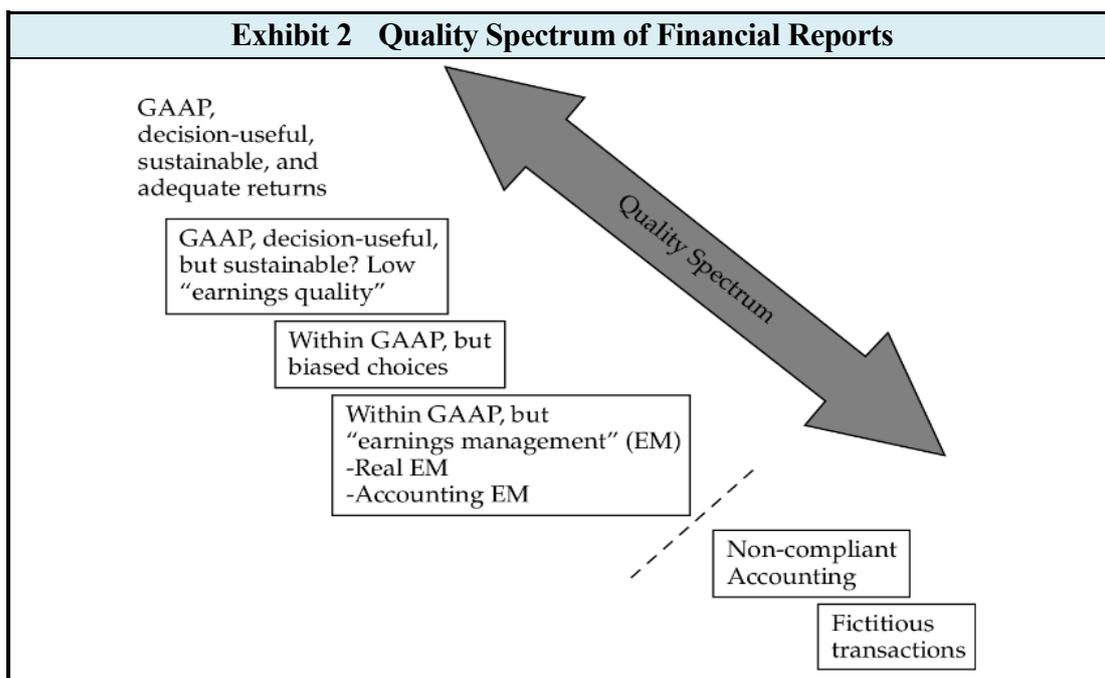
FINANCIAL REPORTING QUALITY

- a. distinguish between financial reporting quality and quality of reported results (including quality of earnings, cash flow, and balance sheet items);
- b. describe a spectrum for assessing financial reporting quality;

- Financial reporting quality, which pertains to the quality of information in financial reports, including disclosures in notes.
 - High-quality reporting provides decision-useful information, which is relevant and faithfully represents the economic reality of the company's activities during the reporting period as well as the company's financial condition at the end of the period.
- A separate but interrelated attribute of quality is quality of reported results or earnings quality, which pertains to the earnings and cash generated by the company's actual economic activities and the resulting financial condition.
 - 'earning quality'라는 표현은 실무에서 earning 만이 아니라, cash flow, 그리고 B/S 등의 품질을 나타내는 넓은 의미로 사용된다.
 - 'High-quality earning'은 미래에도 지속 가능할 수 있는 기업활동의 결과이며, 기업투자에 대한 충분한 수익률(WACC를 초과하는 ROIC)을 제공한다.
 - 'earning quality'에 대한 평가는 일정수준의 'financial reporting quality'가 주어졌을 때 가능하기 때문에 두 개념은 상호 관련되어 있다.

Exhibit 1 Relationships between Financial Reporting Quality and Earnings Quality		
Financial Reporting Quality		
Low		
High		
Earnings (Results) Quality	High	LOW financial reporting quality impedes assessment of earnings quality and impedes valuation.
	Low	HIGH financial reporting quality enables assessment. HIGH earnings quality increases company value.
		HIGH financial reporting quality enables assessment. LOW earnings quality decreases company value.

- Earnings (results) quality can range from high and sustainable to low and unsustainable.
 - > Providers of resources prefer high and sustainable earnings.



c. distinguish between conservative and aggressive accounting;

□ **Conservatism in Accounting Standards**

- 보수주의는 일반적으로는 신중하고 바람직한 접근으로 받아들여지지만, 재무정보가 지녀야 할 중립성(neutral : 상향 혹은 하향의 어떤 방향으로도 치우치지 않는 바람직한 특성)과 충돌되기도 한다.
- Despite efforts to support neutrality in financial reporting, however, many conservatively biased standards remain.
 - These standards result in downward-biased pictures of earnings and financial position within financial reports.
 - Without care, this biased portrayal can result in biased estimates of future prospects developed using financial reports.
 - 즉, 경제적 실질상으로는 현재 기간에 발생한 이익을 특정한 미래기간으로 이연시키는 회계의 보수주의는, 때때로 외부정보이용자의 경제적 의사결정자를 위한 재무제표의 목적적합성(relevance)을 훼손하게 된다.
- 보수주의로 위장해서 편향된 접근을 하는 대표적인 예가 소위 "big bath"관행이다.
 - restructuring expenses
 - impairment losses
 - cookie jar reserve accounting

d. describe motivations that might cause management to issue financial reports that are not high quality;

e. describe conditions that are conducive to issuing low-quality, or even fraudulent, financial reports;

□ **Motivations**

- 경영진들은 시장점유율을 잃거나 경쟁기업 보다 수익성이 낮아지는 등의 poor performance를 감추기(mask) 위해 저품질의 재무보고를 하고자 하는 동기가 있을 수 있다.
- Even when there is no need to mask poor performance, managers frequently have incentives to meet or beat market expectations as reflected in analysts' forecasts and/or management's own forecasts.
- Career concerns and incentive compensation may motivate accounting choices.

Level 1 Final Review

□ Conditions Conducive to Issuing Low-Quality Financial Reports

- Typically, three conditions exist when low-quality financial reports are issued: opportunity, motivation, and rationalization.
 - **Opportunity** can be the result of internal conditions, such as poor internal controls or an ineffective board of directors, or external conditions, such as accounting standards that provide scope for divergent choices or minimal consequences for an inappropriate choice.
 - **Motivation** can result from pressure to meet some criteria for personal reasons, such as a bonus, or corporate reasons, such as concern about financing in the future.
 - **Rationalization** is important because if an individual is concerned about a choice, he or she needs to be able to justify it to him- or herself.

f. describe mechanisms that discipline financial reporting quality and the potential limitations of those mechanisms;

- 기업의 성과와 재무상태에 내포된 risk에 대한 보상을 요구하는 '시장의 힘'이야말로 재무보고의 고품질을 유지하게 하는 원동력이다.

□ Market Regulatory Authorities(IOSCO or SEC)

- Typical features of a regulatory regime that most directly affect financial reporting quality include the following:
 - Registration requirements : 상장기업등록 제출자료요구
 - Disclosure requirements : 상장기업에 대한 공시자료요구
 - Auditing requirements : 독립된 회계법인에 의한 회계감사요구
 - Management commentaries : 미국상장기업이 제출하는 MD&A와 같이 회사의 전반적 영업상황 및 불확실성, 위험 등에 대한 경영진의 언급
 - Responsibility statements : 제출되는 재무제표 등의 정확성에 대한 경영진의 책임요구
 - Regulatory review of filings : 제출된 자료에 대한 규제기관의 검토
 - Enforcement mechanisms : 처벌 및 벌금부과, 면허박탈, 상장취소 등

In summary, market regulatory authorities play a central role in encouraging high-quality financial reporting.

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□ Auditors

- 외부감사제도와 감사의견 등에 대해서는 FR&A 첫 번째 리딩에서 상세하게 다루었으므로 이를 참고하기를 바랍니다!
- Although audit opinions provide discipline for financial reporting quality, inherent limitations exist.

□ Private Contracting

- Aspects of private contracts, such as loan agreements or investment contracts, can serve as mechanisms to discipline financial reporting quality.

- g. describe presentation choices, including non-GAAP measures, that could be used to influence an analyst's opinion;
- h. describe accounting methods (choices and estimates) that could be used to manage earnings, cash flow, and balance sheet items;

□ Accounting Choices and Estimates

- 회계의 선택이 항상 복잡한 회계기준문제를 내포하는 것은 아니며, 제품의 선적기준(FOB shipping point 혹은 FOB destination)과 같은 간단한 선택문제도 수익인식에 큰 영향을 미칠 수 있다.
 - 무르익지 않은 수익을 조기에 앞당겨 인식하고자 하는 경영자는 가급적 FOB shipping point로 선적조건을 정하고자 할 것이다. (inventory의 경제적 실질과 관계없이)
 - 반면, 계속해서 좋은 성과를 기록하고 있는 기업이 당해 연도 성과가 너무 좋게 나올 경우, 다음 연도에 대한 시장기대가 과잉될 것을 우려하여 FOB destination으로 정하고자 할 수도 있다.
- 발생주의 회계(accrual accounting)에 내포된 다양한 선택적 재량(discretion)

- i. describe accounting warning signs and methods for detecting manipulation of information in financial reports.

Pay attention to revenue

- **회사의 수익인식정책에 대한 회계정책주석사항을 검토할 것**
 - Consider whether the policies make it easier to prematurely recognize revenue, such as recognizing revenue immediately upon shipment of goods, or if the company uses bill-and-hold arrangements whereby a sale is recognized before goods are actually shipped to the customer.
 - Barter transactions may exist, which can be difficult to value properly.
- **Look at revenue relationships**
 - 기업의 수익성장이 주요 경쟁기업이나 산업, 혹은 경제전반의 상황에 비추어서 너무 좋다면, 성과의 이유를 꼼꼼히 확인할 필요가 있다.
 - 수년간에 걸친 'revenue'와 'account receivable'의 관계를 살펴볼 필요가 있다.
 - ① 총수익 대비 매출채권의 비중이 증가하고 있다면, 'channel-stuffing' 심지어는 가공의 수익인식도 의심해 볼 수 있다.
 - ② An increase in DSO or decrease in receivables turnover could suggest that some revenues are recorded prematurely or are even fictitious, or that the allowance for doubtful accounts is insufficient.

Pay attention to signals from inventories

- **Look at inventory relationships**
 - 매출의 성장 없이 재고자산의 성장이 비교대상 보다 크다면, 이는 단순히 재고관리의 실패 혹은 진부화가 원인일 수 있다.

Pay attention to capitalization policies and deferred costs

Pay attention to the relationship of cash flow and net income

- **Construct a time series of cash generated by operations divided by net income**
 - 이 비율이 지속적으로 1 미만이거나 계속해서 하락세를 나타낸다면, 발생액 비중이 높아서 이익의 품질이 나쁘다고 할 수 있다.

□ Other potential warnings signs

- Depreciation methods and useful lives
- Fourth-quarter surprises
- Presence of related-party transactions
- Non-operating income or one-time sales included in revenue
- Classification of expenses as “non-recurring”
 - 영업성과를 보다 매력적으로 나타내기 위해 "특별항목"을 구별하여 제시하는 경향이 있음. 반복적으로 "특별항목"이 나타날 경우, 투자자는 이를 무시하고 장기적 관점에서 순이익만을 바탕으로 성과를 평가할 필요가 있다.

핵심문제체크

1. To properly assess a company's past performance, an analyst requires:
 - A. high earnings quality.
 - B. high financial reporting quality.
 - C. both high earnings quality and high financial reporting quality.
2. Low quality earnings most likely reflect:
 - A. low-quality financial reporting.
 - B. company activities which are unsustainable.
 - C. information that does not faithfully represent company activities.
3. Financial reports of the lowest level of quality reflect:
 - A. fictitious events.
 - B. biased accounting choices.
 - C. accounting that is non-compliant with GAAP.
4. If a particular accounting choice is considered aggressive in nature, then the financial performance for the current period would most likely:
 - A. be neutral.
 - B. exhibit an upward bias.
 - C. exhibit a downward bias.
5. Which of the following is most likely to reflect conservative accounting choices?
 - A. Decreased reported earnings in later periods
 - B. Increased reported earnings in the current period
 - C. Increased debt reported on the balance sheet at the end of the current period
6. Which of the following statements most likely describes a situation that would motivate a manager to issue low-quality financial reports?
 - A. The manager's compensation is tied to stock price performance.
 - B. The manager has increased the market share of products significantly.
 - C. The manager has brought the company's profitability to a level higher than competitors.

Level 1 Final Review

7. A company is experiencing a period of strong financial performance. In order to increase the likelihood of exceeding analysts' earnings forecasts in the next reporting period, the company would most likely undertake accounting choices that:
 - A. inflate reported revenue in the current period.
 - B. delay expense recognition in the current period.
 - C. accelerate expense recognition in the current period.

8. Which of the following best describes an opportunity for management to issue low-quality financial reports?
 - A. Ineffective board of directors
 - B. Pressure to achieve some performance level
 - C. Corporate concerns about financing in the future

9. An audit opinion of a company's financial reports is most likely intended to:
 - A. detect fraud.
 - B. reveal misstatements.
 - C. assure that financial information is presented fairly.

10. Which of the following is an indication that a company may be recognizing revenue prematurely? Relative to its competitors, the company's:
 - A. asset turnover is decreasing.
 - B. receivables turnover is increasing.
 - C. days sales outstanding is increasing.

11. Private contracts, such as bank loan agreements, are most likely to provide an effective disciplinary mechanism to insure high financial reporting quality because:
 - A. loan covenants require the firm to meet specific financial ratios in order to renew the loan.
 - B. loan covenants may allow the lender to recover all or part of their investment if certain financial conditions are triggered.
 - C. lenders monitor managers and pay close attention to the firm's financial reports.

12. Which of the following is the best example of conservative accounting?
 - A. Choosing to depreciate new equipment over the shortest estimate of its useful life.
 - B. Reducing the allowance for bad debt expense below the experienced loss rate.
 - C. Deferring R&D expenses to a subsequent year.

SOLUTIONS

1. B
Financial reporting quality pertains to the quality of the information contained in financial reports. If financial reporting quality is low, the information provided is not useful to assess the company's performance. Financial reporting quality is distinguishable from earnings quality, which pertains to the earnings and cash generated by the company's actual economic activities and the resulting financial condition.
2. B
Earnings quality pertains to the earnings and cash generated by the company's actual economic activities and the resulting financial condition. Low-quality earnings are likely not sustainable over time because the company does not expect to generate the same level of earnings in the future or because earnings will not generate sufficient return on investment to sustain the company in the future. Earnings that are not sustainable decrease company value. Earnings quality is distinguishable from financial reporting quality, which pertains to the quality of the information contained in financial reports.
3. A
Financial reports span a quality continuum from high to low based on decision-usefulness and earnings quality (see Exhibit 2 of the reading). The lowest-quality reports portray fictitious events, which may misrepresent the company's performance and/or obscure fraudulent misappropriation of the company's assets.
4. B
Aggressive accounting choices aim to enhance the company's reported performance by inflating the amount of revenues, earnings, and/or operating cash flow reported in the period. Consequently, the financial performance for the current period would most likely exhibit an upward bias.
5. C
Accounting choices are considered conservative if they decrease the company's reported performance and financial position in the current period. Conservative choices may increase the amount of debt reported on the balance sheet. Conservative accounting choices may decrease the amount of revenues, earnings, and/or operating cash flow reported in the current period and increase those amounts in later periods.

Level 1 Final Review

6. A
Managers often have incentives to meet or beat market expectations, particularly if management compensation is linked to increases in stock prices or to reported earnings.
7. C
In a period of strong financial performance, managers may pursue accounting choices that increase the probability of exceeding next period's earnings forecasts. By accelerating expense recognition or delaying revenue recognition, managers may increase earnings in the next period and increase the likelihood of exceeding next period's earnings targets.
8. A
Opportunities to issue low quality financial reports include internal conditions such as an ineffective board of directors and external conditions such as accounting standards that provide scope for divergent choices. Pressure to achieve some performance level and corporate concerns about financing in the future are examples of motivations to issue low-quality financial reports. Typically, three conditions exist when low-quality financial reports are issued: opportunity, motivation, and rationalization.
9. C
An audit is intended to provide assurance that the company's financial reports are presented fairly, thus providing discipline regarding financial reporting quality. Regulatory agencies usually require that the financial statements of publicly traded companies be audited by an independent auditor to provide assurance that the financial statements conform to accounting standards. Privately held companies may also choose to obtain audit opinions either voluntarily or because an outside party requires it. An audit is not typically intended to detect fraud. An audit is based on sampling and it is possible that the sample might not reveal misstatements.
10. C
If a company's days sales outstanding (DSO) is increasing relative to competitors, this may be a signal that revenues are being recorded prematurely or are even fictitious. There are numerous analytical procedures that can be performed to provide evidence of manipulation of information in financial reporting. These warning signs are often linked to bias associated with revenue recognition and expense recognition policies.
11. C.
The monitoring role of lenders is most likely to insure high-quality financial reports because the lenders inspect financial reports carefully to be sure they are not manipulated.

Level 1 Final Review

12. A.

Depreciating equipment over the shortest estimated period of its useful life is a conservative accounting choice that reduces earnings in the early years and increases them in the future, creating a positive trajectory.

REVIEW PROBLEMS

1. The following data are available on a company:

Metric	Company
Stock price per share	\$60.75
Comprehensive income per share	\$4.15
Other comprehensive income (millions)	\$87.60
Common shares outstanding (millions)	46.506

On a net income basis, the company's P/E ratio is closest to:

- A. 10.1.
 - B. 14.6.
 - C. 26.8.
2. The following data are available on a company:

Metric (\$ thousands)	Company
Interest expense & payments	1,000
Income tax expense	1,100
Net income	3,400
Lease payments	500

The company's fixed charge coverage ratio is closest to:

- A. 2.27.
 - B. 4.00.
 - C. 5.50.
3. Under the IFRS Conceptual Framework for Financial Reporting, which of the following is least likely considered a fundamental qualitative characteristic that makes financial information useful?
- A. Relevance
 - B. Comparability
 - C. Faithful representation

Level 1 Final Review

4. Under IFRS, which of the following is most commonly classified as a noncurrent liability?
- A. Warranties
 - B. Notes payable
 - C. Deferred tax liability

5. The following financial data are available for a company:

Metric	2011 (€ thousands)	2010 (€ thousands)
Cost of goods sold	600	400
Inventory	500	600
Accounts payable	200	400
Accounts receivable	400	900

Cash paid to suppliers (€ thousands) in 2011 is closest to:

- A. 300.
 - B. 700.
 - C. 900.
6. The following financial statement data are available for a company:

Metric	(£ thousands)
Net income	500
Depreciation	150
Cash flow from operations	600
Free cash flow to the firm	300
Beginning total assets	4,000
Ending total assets	6,000
Book value	3,000

The company's cash return on assets ratio is closest to:

- A. 10%.
 - B. 12%.
 - C. 13%.
7. For which of the following inventory valuation methods is the gross profit margin least likely to be the same under both a perpetual inventory system and a periodic inventory system?
- A. FIFO
 - B. LIFO
 - C. Specific identification

Level 1 Final Review

8. Under U.S. GAAP, which of the following is least likely a disclosure concerning inventory?
- A. The amount of inventories recognized as an expense during the period
 - B. The carrying amounts of inventories carried at fair value less costs to sell
 - C. The circumstances or events that led to the reversal of any write-down of inventories
9. Due to significant changes in the marketplace, the demand for a company's product has fallen and is not expected to recover to previous levels. The following information is related to the patent under which the product is produced:

Item Description	\$ (thousands)
Carrying value amount	36,000
Undiscounted expected future cash flows	38,000
Present value of expected future cash flows	32,000
Fair value if sold	34,000
Costs to sell	4,000

Which of the following statements is most accurate? The patent is impaired under:

- A. IFRS only.
 - B. U.S. GAAP only.
 - C. both IFRS and U.S. GAAP.
10. The following information is available about a company for its 2011 fiscal year:

Accounting profit (earnings before taxes)	\$250,000
Taxable income	\$215,000
Tax rate	30%
Income taxes paid in 2011	\$61,200
Deferred tax liability, 1 January 2011	\$82,400
Deferred tax liability, 31 December 2011	\$90,650

The income tax expense reported on the 2011 statement of earnings is closest to:

- A. \$64,500.
 - B. \$72,750.
 - C. \$83,250.
11. 문제는 계속됩니다 !

REVIEW SOLUTIONS

1. C.

Comprehensive earnings = Comprehensive income per share × Common shares outstanding.	$\$4.15 \times 46.506$	\$193
Net income = Comprehensive earnings – Other comprehensive income (OCI).	$\$193 - \87.60	\$105.40
Net income per share (EPS) = Net income / Common shares outstanding.	$\$105.40 / 46.506$	\$2.27
P/E = Stock Price / EPS.	$\$60.75 / \2.27	26.76

2. B.

First, EBIT must be calculated, then the fixed charge coverage ratio.

		Company
EBIT = Net income + Interest expense + Income tax expense.		3,400 + 1,000 + 1,100 = 5,500.
Fixed charge coverage ratio =	$\frac{EBIT + Lease\ payments}{Interest\ payments + Lease\ payments}$	$\frac{5,500 + 500}{1,000 + 500} = 6,000$
		1,500
Fixed charge coverage ratio		4.00

3. B.

Comparability is not a fundamental qualitative characteristic but rather one of the four characteristics that enhance the usefulness of relevant and faithfully represented financial information.

4. C.

A deferred tax liability is a noncurrent liability that results from temporary differences between a company's income as reported for tax purposes and income as reported for financial statement purposes. Though temporary, deferred tax liabilities are defined as the amounts of income taxes payable in future periods with respect to taxable temporary differences; under IFRS, they are always classified as noncurrent.

5. B.

The calculation is as follows:

	(€ thousands)
COGS	600
Less decrease in inventory (500-600)	<u>-100</u>
Purchases from suppliers	500
Plus decrease in A/P (200-400)	<u>200</u>
Cash paid to suppliers	700

Level 1 Final Review

6. B.

Cash return on assets = CFO / Average total assets.	
$\frac{600}{\frac{1}{2} \times (6,000 + 4,000)}$	= 12.0%.

7. B.

The periodic and perpetual systems result in the same inventory and cost-of-goods-sold values (and hence, gross profit margin) using both FIFO and specific identification valuation methods but not necessarily using LIFO.

8. C.

U.S. GAAP does not permit the reversal of prior-year write-downs; therefore, there are no disclosures related to reversals.

9. A.

Under IFRS, First you must determine the recoverable amount that is the higher of:

- Value in use, which is the present value of the future cash flows: \$32,000.
- Fair value less costs to sell: \$34,000 – 4,000 = \$30,000.

The recoverable amount (\$32,000) is lower than the carrying value (\$36,000).

Therefore, the asset is impaired and should be written down to that amount.

Under U.S.GAAP, to assess impairment the carrying value (\$36,000) is compared with the undiscounted expected future cash flows (\$38,000).

In this case, the carrying value is lower, so the patent is not impaired.

10. B.

Income tax expense equals income tax payable (the tax rate times the taxable income) plus the increase in the deferred tax liabilities.

$$(0.30 \times 215,000) + (90,650 - 82,400) = 64,500 + 8,250 = 72,750.$$

11. SOLUTION도 계속됩니다!