Financial Reporting

Why are reformulated financial statements necessary to discover operating profitability?

Most of the operational decisions of an organization are based on their financial statements like income statement, cash flow and balance sheet. All these statements provide the information about company’s finance and by analyzing these statements financial performance of the organization can be measured. In order to more accurately depict various aspects of the business several items of these stamens are reorganized. Before doing so the finical statements are changed for a particular time period that is called reformulation. The analysis of financial statements of an organization is based on three stages first is reformulating reported financial statements, then the second is analysis and adjustments of measurement errors and last is financial ratio analysis on the basis of adjusted and reformulated financial statements. The financial performance of the organization is based on reformulated financial statements.

In order to discover the operating profitability of an organization formulated financial statements are necessary because reformulating can help highlight recent changes in the income statement that led to extra income or a lower income than previously reported. In most of the cases it is connected with shareholder changes. For example if there is any change in shareholder equity or company made the dividend distribution it is must for the business to reformulate its income statement and show the actual profitability for that period. In order to distinguish profitability that earned from operating and financial activity reformulated income statement is necessary (Nissim and Penman, 2003).

Permanent income is the discounted expected flow of income smoothed out and it always differ from measured income. On the other hand transitory earnings result from transactions that are not likely to occur again in the foreseeable future or expected to make a different impact on earnings in future (Sepe and Spiceland, 2008).

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Explain the concept of residual earnings and discuss its drivers.

There are several methods that can be used for valuing the common stock in order to determine the value of the firm. In order to determine the equity change of a firm the key calculation is residual income of the firm. This measures the return to shareholders above the required return on capital. The residual income can be defined as income earned by capital invested in a firm’s assets that take into account the opportunity cost of the capital.

Currently there are seven concepts of residual income measurement. The common universal formula is used by all of them assuming that residual income is the fiscal variation among cost of the capital and return on capital invested in a firm’s assets. Yet several asset valuation methods are employed by various concepts along with different conventions of return on capital estimation. It is a performance measurement of an organization and can also be used to evaluate investment alternatives. The basics concept of residual income dates back in the late 1880s. The residual income is also called Economic Value Added.

The below formula can be used to calculate the residual income:

If the amount of residual income is positive it indicates that company is gaining wealth but if the figures is negative than means the company is consuming capital.

Basically residual earning is the rate of return in equity which expressed as a dollar excess return on equity. It has two key drivers one is ROCE (Return on Capital Employed) and book value. So residual earning always changes according to changes in ROCE and book value. If the forecasted ROCE is equals to require return then residual earning will be zero (Yehuda, 2003).

A) Managerial incentives underlying earnings management.

An organization provides special benefits to their employee for achieving specific goals. The most common form managerial incentive is bonus or increment in salary. The link between compensation and earning management has been highlighted my several researches. The earning management can also be a tool to increase compensation of corporate manager along with increasing the job security with expense of shareholders as it is a useful tool to prepare financial statements before the period of public securities offerings, to increase regulatory benefits, to reduce regulatory costs or to avoid violating lending contracts. There are several techniques of earning management such as channel stuffing and cookie jar accounting. These techniques are used to fulfill the short term objectives of the organization but it ultimately leads to loss (Murphy, 2000).

It is a well documented fact of corporate behavior that in order to manage their reported earnings accounting rules are exploited by firms that is called earnings management. It has been stated by agency theory that an undiversified CEO has a reason to accept less risk compared to diversified shareholders if his compensation is majorly based on to the firm’s performance. By using this context it can be sated that earning management is the method that is designed with aim to avoid the unwanted consequences of risk on managerial wealth (Larkin, 2008).

One of the commonly used techniques of earning management is channel stuffing where firm push huge amount of stock into their distribution channels to fulfill the short term objectives. The basic objective of doing so can be managerial bonus. As the bonus amount of managers are based predetermined target of sales and in order to achieve this target such earning management techniques are used by managers. So basically it is the Managerial incentives that motivate the earning management.

B) Five “accounting red flags” that may affect financial reporting quality.

Most of the business decisions are based on the financial statements of the organization. Along with business decision investors and other stakeholders also assess the financial statements of the firm to take effective decisions. If the performance of the organization is not good in a particular time period then they sue several techniques to improve the figures in short time period. In such cases they use the techniques of earning management and other. These accounting techniques can improve the business performance for short term but company may have to survive in long-run (Stubben, 2009). Such techniques or frauds harm the quality of financial statements. The financial reporting quality may be affected by the flowing accounting red flags:

Abnormal Inventory Growth as Compared to Sales Growth: It can be predicted by increasing inventory that the obsolete products are increasing or inventory management is poor. It can be detected by reviewing the falling inventory turnover ratio.

Aggressive Revenue Collection:

Recognizing the revenue too soon is the most common earnings manipulation technique. It is must for the company to reveal it in the footnotes along with this it is significant to recognize when revenue recognition should takes place.

LIFO Liquidations:

the profits of a LIFO firm are increased by decreasing COGS when it sells more stock than it produces during a period of increasing price. This situation can be sustained for a long time as the firm will run out of inventory. A good indicator of this is a declining LIFO reserve (Steenburg and Chapman, 2008).

Fraud triangle component:

The fraudulent financial reporting can be forced by incentives or pressures such as pressure to meet earnings expectations of analysts'.