

## INTERNATIONAL ACCOUNTING ANALYSIS

**B. B. Khalilov**

*Asia international university*

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### Abstract

This article provides information on international accounting. Also, international accounting is analyzed and relevant conclusions and suggestions are made.

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The purpose of accounting analysis is to assess the extent to which a firm's reported results reflect economic reality. The analyst needs to evaluate the firm's accounting policies and estimates, and assess the nature and extent of a firm's accounting flexibility. The latter refers to management's discretion in choosing which accounting policies and estimates to apply to a particular accounting event. To reach reliable conclusions, the analyst must adjust reported accounting amounts to remove distortions caused by the use of accounting methods the analyst deems inappropriate. Examples might include marking trading assets to market and not recording the gains or losses in income but in an allowance account, prematurely recognizing revenues, or reversing estimated liability accruals to smooth earnings. Corporate managers are allowed to make many accounting-related judgments because they know the most about their firm's operations and financial condition. Flexibility in financial reporting is important because it allows managers to use accounting measurements that best reflect the company's particular operating circumstances. However, managers have incentives to distort operating reality by using their accounting discretion to distort reported profits. One reason is that reported earnings are often used to evaluate their managerial performance.

Two major issues confront those doing accounting analysis in an international setting. The first is cross-country variation in accounting measurement quality, disclosure quality, and audit quality; the second concerns the difficulty in obtaining information needed to conduct accounting analysis. Cross-country variation in quality of accounting measurement, disclosure, and auditing is dramatic. National characteristics that cause this variation include required and generally accepted practices, monitoring and enforcement, and extent of managerial discretion in financial reporting. Consider accounting practices in Germany. German financial accounting is closely aligned with tax reporting. Creditor protection is a second goal of financial reporting. As a result, financial reports are prepared with a creditor focus rather than an investor focus. The resulting conservative reporting bias may generate accounting amounts that do not reflect actual operating performance. German managers have great discretion in their use of reserves and in implementing many accounting policies. Even where specific procedures are mandated, monitoring and enforcement of compliance with reporting requirements is far short of what investors can expect in the United States. Disclosure quality and the level of audit assurances must also be closely scrutinized when analyzing a German company's financial statements. Footnote disclosure of accounting policies is quite limited in some German annual reports. Identifying

the components of large financial statement items (such as reserve accounts) can be difficult. Auditing issues are so important that we discuss international auditing in a separate section of this chapter. Financial reporting in China provides a second example of how accounting measurement, disclosure, and audit quality can vary dramatically from accounting practices in Anglo-American countries. Although China is implementing major accounting reform as part of its transition from a planned economy to a controlled market economy, until recently it did not have financial reporting and external auditing in forms that would be familiar to Westerners. Private investors and creditors were virtually nonexistent for three decades after the People's Republic was founded in 1948, and The Accounting Law, which sets forth accounting and reporting requirements, was adopted only in 1985. Accounting Standards for Business Enterprises, which specifies that such basic accounting practices as double-entry bookkeeping and the accrual basis should be used, became effective in 1993. The auditing profession is also very new in China. Also, the German auditing environment is dramatically different from countries such as the United Kingdom and the United States. Auditor independence rules in Germany are much less comprehensive and intricate than in the United Kingdom and the United States, and German managers might consider it inappropriate for auditors to question their oral statements. German auditors are also more hesitant to accept responsibility for detecting irregularities than their U.K. or U.S. counterparts. External auditors play a key role in ensuring that accounting standards are followed. Legal systems provide enforcement mechanisms for ensuring that auditors remain as independent as practicable. However, audit environments are not uniform around the world. For example, while auditor litigation is relatively common in the United States, they have been rare in Germany. Especially when analyzing companies in emerging market countries, the analyst should meet often with management to evaluate their financial reporting incentives and accounting policies. Many companies in emerging market countries are closely held, and managers may not have strong incentives for full and credible disclosure. Accounting policies in some countries may be similar or identical to IAS (or other widely accepted standards), but managers often have great discretion in how those policies are applied.

The goal of financial analysis is to evaluate a firm's current and past performance, and to judge whether its performance can be sustained. Ratio analysis and cash flow analysis are important tools in financial analysis. Ratio analysis involves comparison of ratios between the firm and other firms in the same industry, comparison of a firm's ratios across years or other fiscal periods, and/or comparison of ratios to some absolute benchmark. It provides insights on the comparative and relative significance of financial statement items and can help evaluate the effectiveness of managements' operating, investing, financing and earnings retention policies. Cash flow analysis focuses on the cash flow statement, which provides information about a firm's cash inflows and outflows, classified among operating, investing, and financing activities, and disclosures about periodic noncash investing and financing activities. Analysts can use cash flow analysis to address many questions about the firm's performance and management. For example, has the firm generated positive cash flows from operations? How have cash flow components changed across time in relation to changes in income statement components, sales, and cost of sales in particular? What have been the cash flow consequences of management decisions about financial policy, dividend policy, and investment? When used in conjunction with the income statement, cash flow information also informs analysts about the validity of the going concern assumption, a firm's liquidity and management's use of measurement options to manage earnings. Two issues must be addressed in analyzing ratios in an international setting. First, do cross-country differences in accounting principles cause significant variation in financial statement amounts of companies from different countries? Second, how do differences in local culture and economic and competitive conditions affect the interpretation of accounting measures and financial ratios, even if accounting measurements from different countries are restated to achieve "accounting comparability"? Extensive evidence reveals substantial cross-country differences in profitability, leverage, and other financial statement ratios and amounts that result from both accounting and nonaccounting factors. (The next section discusses cross-country differences in two valuation ratios, the price-to-earnings and price-

to-book ratios.) In one study, sales revenue, net income, and leverage (total debt/shareholders' equity) was compared among firms domiciled in France, Germany, Japan, the United Kingdom, and the United States. The five 80-firm country samples were matched according to size (market value of equity), with all firms belonging to the manufacturing industry group (SIC codes 20 through 39). All three financial measures varied substantially among the country samples. For example, median net income was much greater in the United Kingdom and the United States than in Germany and Japan. Variation in net income was partially explained by accounting principle differences because financial reporting is generally less conservative in the United Kingdom and the United States than in Germany and Japan. Nonaccounting factors also affected reported net income. For example, the creditor focus in France, Germany, and Japan accounted for lower net income than in the United States and the United Kingdom as there is less pressure on managers in those countries to report steadily increasing net income. In the foregoing study, Frost found median leverage in the United Kingdom and the United States to be lower than in Germany and Japan. This is partially attributed to the fact that conservative accounting in Germany and Japan results in lower reported shareholders' equity than in the United Kingdom and the United States. Higher leverage in Germany, Japan, and France is also attributed to higher debt in capital structures, reflecting the heavy dependence on bank financing in those countries. How large are the differences in financial statement items caused by differences among national accounting principles? Hundreds of non-U.S. companies listed on U.S. stock exchanges give footnote reconciliation disclosures that provide evidence on this question, at least in the context of differences between U.S. GAAP-based and non-U.S. GAAP-based accounting amounts. An earlier survey of financial statement reconciliations by foreign registrants prepared by the U.S. SEC is informative. Approximately one-half of the 528 non-U.S. registrants surveyed disclosed material differences between net income as reported in their financial statements and U.S. GAAP-based net income. The five types of financial statement differences disclosed by the largest number of registrants were (in descending order):

- 1) depreciation and amortization,
- 2) deferred or capitalized costs,
- 3) deferred taxes,
- 4) pensions,
- 5) Foreign currency translation.

The study also shows that more than two-thirds of the registrants that disclosed material differences in net income reported that income under U.S. GAAP was lower than under non-U.S. GAAP. Nearly half of them reported income differences greater than 25 percent. Twenty-five of the 87 registrants that reported that income under U.S. GAAP was greater than under non-U.S. GAAP reported differences greater than 25 percent. Similar results were found for reconciliations of shareholders' equity. Overall, the evidence in the SEC study shows that financial statement differences under U.S. versus non-U.S. GAAP are highly material for many companies. Evidence from SEC registrants' reconciliation disclosures therefore indicates that GAAP differences can cause significant variation in financial statement numbers. The analyst will often choose to make financial statements more comparable by making accounting principle adjustments to the financial statements being analyzed. As discussed earlier, cash flow analysis provides insights about a company's cash flows and management. Highly detailed cash flow statements are required under U.S. GAAP, U.K. GAAP, IFRS, and accounting standards in a growing number of other countries. Cash flow-related measures are especially useful in international analysis because they are less affected by accounting principle differences than are earningsbased measures. When cash flow statements are not presented, it is often difficult to compute cash flows from operations and other cash flow measures by adjusting accrual-based earnings. Many companies simply do not disclose the information needed to make the adjustments. As one example, German balance sheets often contain surprisingly large reserve accounts that reflect many different

types of accrual. Few (if any) details are presented that might allow the financial statement user to assess the implications for operating, investment, and financing cash flows.

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