# محاضرة (10)

- **Factors Affecting Statutory Financial Reports**

**العوامل المؤثرة في التقارير المالية النظامية**

Statutory financial reports are prepared according to the set of generally accepted accounting principles (GAAP). A regulatory hierarchy that includes the Securities and Exchange Commission, the American Institute of Certified Public Accountants, and the Financial Accounting Standards Board promulgates these principles. GAAP is also influenced in some industries by specialized industry practices. Managers prepare the statutory financial reports. Thus, the reports are subject to manipulation based on incentives of managers to present the company in its best light.

**يتم إعداد التقارير المالية القانونية وفقًا لمجموعة المبادئ المحاسبية المقبولة عمومًا (GAAP). وينص الهيكل التنظيمي لكل من هيئة الأوراق المالية والبورصة (SEC) ، والمعهد الأمريكي للمحاسبين القانونيين المعتمدين (AICPA) ، ومجلس معايير المحاسبة المالية ( FASB )على العمل بهذه المبادئ. كذلك تتأثر المبادئ المحاسبية المقبولة عمومًا(GAAP) في بعض الصناعات بممارسات صناعية متخصصة. يقوم المديرون بإعداد التقارير المالية القانونية. وبالتالي ، فإن التقارير تخضع للتلاعب استنادًا إلى حوافز المديرين على تقديم الشركة في أفضل حالاتها.**

There are many of external and internal factors effected on financial analysis, we can briefly mention some of them as follow:

**هناك العديد من العوامل الخارجية والداخلية التي تؤثر على التحليل المالي ، يمكننا أن نذكر باختصار بعضا منها وكما يأتي.**

i. **Enterprise Ownership** **المالكين وإدارة المنشاة**

1. Managers have the main responsibility for ensuring fair and accurate financial reporting by a company.
2. Managers have discretion in financial reporting in most cases. This discretion may result from either of two sources. First, managers often have a choice between alternative generally accepted rules in accounting for certain transactions. Second, managers often have to make estimates of uncertain future outcomes. Each of these managerial judgments creates managerial discretion.
3. Monitoring and control mechanisms include SEC oversight, internal and external auditor review, corporate governance such as Board of Director

subcommittees assembled to oversee the audit and financial reporting, and the omnipresent threat of litigation.

4. Managers have several potential incentives to manage earnings.
    **a.** First, managers that earn bonus payments as a function of reported earnings may manage earnings to maximize their bonus.
    **b.** Second, if the company is subject to debt contract constraints (debt covenants) such as minimum net income, minimum working capital, minimum net worth, or maximum debt levels then the manager might have incentive to manage earnings to minimize the probability that the company will violate any of the debt covenant constraints.
    **c.** Third, the company might choose to manage earnings because of potential stock price implications.
    **d.** Forth, coming merger or security offering, or plans to sell stock or exercise options. Managers also smooth income to lower market perceptions of risk and to decrease the cost of capital
5. There are several popular earnings management strategies:
    a. First, managers often adhere to a strategy of increasing income where latitude exists. The motivation is to portray the success of the company more favorably.
    b. Second, managers might take a big bath. This strategy involves taking all discretionary losses in the current period.
    c. Third, managers might follow a strategy of income smoothing in which slightly higher than usual earnings are reduced in line with the trend of earnings and slightly lower than usual earnings are increased in line with the trend of earnings.
6. Earnings management is the “purposeful intervention by management in the earnings determination process, usually to satisfy selfish objectives”.
7. There are powerful incentives at work, which motivate companies and their employees to engage in income smoothing.

**ii. Finance and capital markets** **الأسواق المالية والتمويل**

1. The Securities and Exchange Commission SEC serves as an advocate for investors. As such, the SEC requires registrant companies to file periodic standard reports. These reports allow the SEC to oversee the financial

reporting activities of the company and allow the SEC to make key financial information available to all investors.

**تعمل هيئة الأوراق المالية والبورصة (SEC) كجهة داعمة للمستثمرين. فعلى سبيل المثال ، تطلب لجنة الأوراق المالية (SEC) من شركات المسجلة في السوق إعداد تقارير دورية معيارية . تسمح هذه التقارير لـ (SEC) بالإشراف على أنشطة التقارير المالية للشركة والسماح لـ (SEC ) بإتاحة المعلومات المالية الرئيسية لجميع المستثمرين.**

2. Financial intermediaries (analysts) play an important role in capital markets. They are an active and sophisticated group of users that provide useful information to market participants.
3. Market approach: As the name implies, this approach directly or indirectly uses prices from actual market transactions. Sometimes, market prices may need to be transformed in some manner in determining fair value.

### iii. Accounting Profession المهنة المحاسبية

The accounting profession currently establishes accounting standards. The Financial Accounting Standards Board is currently the primary rule making body. The SEC and the AICPA oversee the activities of the FASB. The FASB proposes rules by first issuing a discussion memorandum.

**تقوم مهنة المحاسبة حالياً بوضع معايير المحاسبة. و حاليا مجلس معايير المحاسبة المالية هو هيئة صنع القواعد الأولية. يشرف هيئة الأوراق المالية والبورصة (SEC) والمعهد الأمريكي للمحاسبين القانونيين المعتمدين (AICPA) على أنشطة مجلس معايير المحاسبة المالية. ويقترح مجلس معايير المحاسبة المالية( FASB ) القواعد من خلال إصدار مذكرة مناقشة لأول مرة.**

### iv. Economic growth and development نمو وتطور الاقتصاد

1. The two basic income concepts are economic income and permanent income. Economic income is typically determined as cash flow during the period plus the change in the present value of expected future cash flows, typically represented by the change in the fair value of the business's net assets. Permanent income (also called sustainable income or recurring income) is the stable average income that a business is expected to earn over its life, given the current state of its business conditions. Economic income measures change in shareholder value and is useful in evaluating the total shareholder.
2. Economic income measures the net change in shareholder value during a period.
3. Accounting income is the excess of revenues and gains over expenses and losses measured using accrual accounting.

4. Economic income is a measure of the change in shareholder value over a period of time. Permanent income is the normal, recurring amount of income that a company is able to earn each period. Accounting income has aspects of both.
5. The permanent component of accounting income is the portion of total earnings that is expected to persist indefinitely (recur). Revenues and cost of goods sold components are largely permanent income components.
6. Value irrelevant income components have no economic content and, as the name suggests, have no effect on the value of the company.
7. Core income refers to a current period's recognized income from which all transitory components have been removed.
8. Some of the major adjustments to net income for determining economic income are including various unrealized gains and losses that are included in other comprehensive income, such as unrealized gains/losses on marketable securities or net pension assets.
9. Following are some of the circumstances that can point to areas of high audit risk:
    a. Growth industry or company with need for continuing earnings growth to justify high market price or to facilitate acquisitions.
    b. Company in difficult financial condition requiring financing urgently and frequently.
    c. Company with high market visibility issuing frequent progress reports and earnings estimates.
    d. Management dominated mostly by one or a few strong-willed individuals.
    e. Personal financial difficulties of members of management.
    f. Deteriorating operating performance.
    g. Excessively complex capital structure.
    h. Management which has displayed a propensity for earnings manipulation. Problem industry displaying weaknesses, in such areas as receivable collection, inventories, contract cost overruns, dependence on few products, etc.
    i. Dealings with insiders on related parties or stockholder lawsuits.
    j. Turnover of key officers, legal counsel or auditors.

## v. Inflation التضخم

Historical cost model generates more reliable accounting information, since all numbers are based on actual transaction, i.e. the exact price paid by the company at acquisition; Fair value model is more relevant, as it reflects market participant (e.g., investor) assumptions about the present value of expected future cash inflows or outflows arising from an asset or a liability.

## vi. Legal system النظام القانوني

1. To manipulate the financial reports is limited by several monitoring and enforcement mechanisms including the SEC, internal and external auditors, corporate governance, and the possibility of litigation against the company and/or the managers.
2. Statutory financial reports are not the only source of information about a company that is available to interested parties outside of the organization. Other sources include forecasts and recommendations of information intermediaries (analysts), general economic information, general information about the company's industry, and news about the company. Also, management will often provide voluntary disclosure of information that is not required by GAAP or other regulatory mandate.

1. **التلاعب في التقارير المالية محدود من خلال العديد من آليات المراقبة والتنفيذ بما في ذلك لجنة الأوراق المالية والبورصات والمراجعين الداخليين والخارجيين وحوكمة الشركات وإمكانية المقاضاة ضد الشركة و / أو المديرين.**
2. **التقارير المالية القانونية ليست هي المصدر الوحيد للمعلومات حول شركة متاحة للأطراف المهتمة خارج المنظمة. تتضمن المصادر الأخرى تنبؤات وتوصيات وسطاء المعلومات (المحللين) ، والمعلومات الاقتصادية العامة ، والمعلومات العامة حول صناعة الشركة ، والأخبار عن الشركة. كما ستقوم الإدارة في الغالب بتوفير الإفصاح التطوعي عن المعلومات التي لا تتطلبها المبادئ المحاسبية المقبولة عموماً أو أي اختصاصات تنظيمية أخرى.**

## vii. Accounting regulation النظام المحاسبي المطبق

1. Earnings announcements provide summary information about the company's performance and financial position during the quarter and/or year just ended.

The earnings announcement contains much less detail than the financial statements, which are only released after they are prepared and audited.

**توفر إعلانات الأرباح معلومات موجزة عن أداء الشركة ومركزها المالي خلال الربع و / أو العام المنتهي. يحتوي إعلان الأرباح على تفاصيل أقل بكثير من القوائم المالية ، والتي يتم إصدارها فقط بعد إعدادها ومراجعتها.**

2. Under the historical cost model, asset and liability values are determined on the basis of prices obtained from actual transactions that have occurred in the past. Under the fair value accounting model, asset and liability values are determined on the basis of their fair values (typically market prices) on the measurement date (i.e., approximately the date of the financial statements).
3. In accounting, conservatism states that when choosing between two solutions, the one that will be least likely to overstate assets and income should be selected. The two main advantages of conservatism are that:
    a. it naturally offsets the optimistic bias on the part of management to report higher income or higher net assets; and
    b. it is important for credit analysis and debt contracting because creditors prefer financial statements that highlight downside risk.
4. The two types of conservatism are unconditional and conditional conservatism. Unconditional conservatism understates assets (or income) regardless of the economic situation.
5. Finance and accounting researchers have established that accounting information is indeed relevant for decision making. For example, researchers have shown that accounting earnings explain much (50% - 70%) of the fluctuation in stock price changes.
6. Financial statement information has several limitations.
    - First, financial statements are released well after the end of the quarter and/or fiscal year. Thus, they are not entirely timely.
    - Second, they are only released on a quarterly basis. Investors often have a need for information more often than just on a quarterly basis. Thus, financial statements are limited by the relative infrequency of their release.
    - Third, financial statements have little forward-looking information. Investors must use the largely backward looking financial statements to generate their own beliefs about the future.

- Fourth, financial statements are prepared using rules that are promulgated with a relevance and reliability trade-off. The need for reliability causes the relevance of the information to be, in certain instances, compromised.
- Fifth, the usefulness of financial statement information may also be limited by the bias of the managers that prepare the statements. For example, managers in certain instances may have incentives to overstate or understate earnings, assets, liabilities, and/or equity.

7. Short-term accruals arise because of the timing differences between income and cash flows.
8. Cash flow measures of performance almost always suffer from the timing and matching problems that accrual accounting was developed to mitigate.
9. Cash flows are highly reliable because the receipt or payment of cash measures the cash flows. Accounting net income is less reliable than cash flows because calculating net income often requires estimations of future outcomes.
10. Income (also referred to as earnings or profit) summarizes, in financial terms, the net effects of a business's operations during a given time period. Economic income differs from cash flow because it includes not only current cash flows but also changes in the present value of future cash flows. Similarly, accounting income considers not only current cash flow but also future cash flow implications of current transactions.
11. Preparers of financial statements must make certain estimates of uncertain outcomes and make judgments about other uncertainties.
12. Accounting analysis is the process of evaluating the extent to which a company's accounting numbers reflect economic reality.
13. Accounting analysis involves several interrelated processes and tasks. First, the analyst must evaluate the quality of the financial information. Second, the analyst must adjust the financial information based on the findings in the evaluation of the quality of the financial information.
14. Accounting distortions are deviations of reported information in financial statements from the underlying business reality. These distortions arise from accounting policy choices, errors in estimation, the trade-off between relevance and reliability, and the latitude in application.

15. Earnings management may take many forms. Listed here are some forms to which the analyst should be particularly alert:
    a. Changing accounting methods or assumptions with the objective of improving or modifying reported results.
    b. Misstatements, by various methods, of inventories as a means of redistributing income among the years.
    c. The offsetting of extraordinary credits by identical or nearly identical extraordinary charges as a means of removing an unusual or sudden injection of income that may interfere with the display of a growing earnings trend.
16. The "quality" of earnings of an enterprise is a measure of the degree of care and unbiased judgment with which they are determined, the extent to which all important and necessary costs have been provided for and the variability which industry conditions subject these earnings to. Analysts must assess the quality of earnings in order to render them comparable to those of other enterprises. The quality of earnings depends, among other factors, on:
17. The degree of conservatism with which the estimates of present and future conditions are arrived at. That is, the degree of risk that real estimates or assumptions may prove over-optimistic or downright unwarranted and misleading.
18. Management's discretion in applying GAAP. This requires the analysis of discretionary and future directed costs.
19. The relation between earnings and business risk. The stability and the growth trend of earnings as well as the predictability of factors that may influence their future levels.

**viii. Accounting and Standards Principles** **المبادئ والمعايير المحاسبية**

1. Contemporary generally accepted accounting principles (GAAP) is the set of rules and guidelines of financial accounting that are currently mandated as the acceptable rules and guidelines for preparing financial reports for the external users of financial information.
2. Timing and matching problems make short-term performance measurement difficult and often less meaningful.

3. Accrual accounting calls for recognizing revenue when the revenue is both earned and realizable. Revenues are earned when the company delivers the products or services. Revenues are realized when cash is received.
4. Accrual accounting requires that the economic efforts required to generate revenues be matched against the related revenues.
5. Accrual accounting is a superior measure of performance and financial position relative to cash flows. The factors that give rise to this superiority are the more appropriate timing of revenue recognition and the more precise matching of costs against these revenues.
6. Accrual-accounting based income measures repeatedly out-perform cash flow-based measures such as operating cash flow or free cash flow at explaining changes in stock price.
7. Accounting principles can, in certain cases, create differences between financial statement information and economic reality.
8. Under the historical cost model, asset and liability values are determined on the basis of prices obtained from actual transactions that have occurred in the past. Under the fair value accounting model, asset and liability values are determined on the basis of their fair values (typically market prices) on the measurement date (i.e., approximately the date of the financial statements).
9. The fair value accounting periodically updates asset/liability values even in the absence of explicit transactions.
10. Under historical cost accounting, income is the accountants estimate of what an enterprise has “earned” during a period. Under fair value accounting, income is merely the residual amount that measures the net change in the fair values of assets and liabilities.
11. Formally, SFAS 157 defines fair value as exchange price, that is, the price that would be received from selling an asset (or paid to transfer a liability) in an orderly transaction between market participants on the measurement date.
12. Financial assets/liabilities are easier to fair value. This is because they are more homogenous and usually have liquid markets with traded quotes.
13. Some of the issues that the analyst needs to consider when evaluating fair value accounting are:
    a. balance sheet and not income statement is the most important statement under fair value accounting;

    b. income under fair value accounting measures change in net assets, it is not a measure of profitability and cannot be used for directly valuing an enterprise;
    c. use of fair value assumptions.

14. Different persons use accrual accounting information and cash flow information to varying degrees in their valuation models. Accrual accounting information is often used in valuation models based on price to earnings multiples, market to book multiples, and abnormal accounting earnings-based valuation models. Cash flow information is used in such models as discounted dividend and discounted cash flow models.
15. Accounting concepts and standards are subject to individual judgments and incentives in the promulgation process. Accounting regulation is proposed by accounting regulators and then commented upon by the financial reporting community.
16. Auditing standards are broad generalizations that come in three sets:
    a. General standards define the personal qualities required of the independent CPA.
    b. Standards of fieldwork cover the actual execution of the audit and cover the planning of the work, evaluation of the client's system of internal control, and the quality and sufficiency of the evidence obtained.
    c. Reporting standards govern the preparation and presentation of the auditor's report.
17. Auditing procedures are tests applied to a company's accounts to develop evidence to support or refute the hypothesis that the reported numbers are prepared according to generally accepted accounting principles and are fairly presented.
18. The auditor's opinion deals with:
    a. The fairness of presentation of the financial statements,
    b. Their conformity with generally accepted accounting principles, and
    c. Disclosure when a material change in accounting principles has occurred.

19. Auditing is based on a sampling approach to the data under audit. Statistical sampling, while lending itself to many applications in theory, is more limited in actual practice.
20. The auditor maintains that s/he expresses an opinion on management's statements. Auditors are very insistent on this point and attach considerable importance to it. It means that, normally, the auditor did not prepare the financial statements nor did the auditor choose the accounting principles embodied in them.

### ix. Other Factors عوامل أخرى

**There are many factors that affect regular financial reporting: legal requirements, specialized accounting standards, tax laws and the financial structure of companies.** Some of these variables can be controlled, while others cannot be controlled, resulting in a difference in the calculation of profits. For example, DAFSA, a financial analysis firm, uses the following method to calculate profits:

s.m = 1- (d.m- d.r) ÷ [d.m]

This means that:

sm = indicator of measurement behavior

dm = Adjusted earnings

dr = disclosed earnings

| |
|---|
| **Measurement behavior= (Adjusted earnings - disclosed earnings) ÷ Adjusted earnings** |

The measure of profit pessimistic when the indicator (s.m> 0.95), and can be a measure neutral when the indictor (1 ≤ s.m ≤ 0.95) and be optimistic when the indictor (s.m> 1.05).

- **عوامل أخرى**

هنالك العديد من العوامل التي تؤثر في التقارير المالية النظامية وهي المتطلبات القانونية ، والمقاييس المحاسبية التخصصية ، وقوانين الضرائب والهيكل المالي للشركات. يمكن التحكم في بعض هذه المتغيرات ، في حين لا يمكن التحكم في البعض الآخر ، مما يؤدي إلى التباين في احتساب الأرباح. فعلى سبيل المثال تستخدم شركة (DAFSA) ، وهي مؤسسة تعنى بالتحاليل المالية الطريقة التالية لاحتساب الأرباح :-

| |
|---|
| **س م = 1 – (د م – د ر) ÷ [ د م ]** |

حيث أن :-

س م = سلوك المقاييس (indicator of measurement behavior).

د م = الأرباح المعدلة (adjusted earnings).

د ر = الأرباح المنشورة أو المعلنة (disclosed earnings).

أي أن :-

$$\text{سلوك المقاييس} = 1 - \frac{(\text{الأرباح المعدلة} - \text{الأرباح المنشورة})}{\text{الأرباح المعدلة}}$$

يكون مقياس الربح متشائم (pessimistic) حينما يكون المؤشر (س. م < 0,95)، ويمكن أن يكون المقياس محايد (neutral) حينما يكون المؤشر (1 ≤ س م ≤ 0.95) ويكون متفائل (optimistic) حينـــــــما يكــــــون المؤشر (س م > 1.05).

**Example**

An Egyptian company operating in Iraq announced that annual profits, which amounted to (5,000,000) Egyptian pounds during 2019, has provided financial statements to the tax authorities by the Egyptian re-preparation of financial statements and adjusted in accordance with the laws in in Egypt.

Required: calculate the behavior of the scale, assuming the following: -

(1) adjusted earnings (6,000,000) pounds.

(2) adjusted earnings (4,000,000) pounds.

**1 - The first assumption**

S m = 1- (6,000,000 – 5,000,000) ÷ 6,000,000 = 1 - 0.16 = 0,84

S m = 0.84 which is less than (0.95) any (pessimistic).

**2 - The second assumption**

S M = 1 - (4,000,000 – 5,000,000) ÷ 4,000,000 = 1 - (1,000) / 4,000

S m = 1 - (- 0.25) = 1 + 0.25 = 1.25

S M = 1.25, that is more than of 1,05 (optimistic)

**مثال**

أعلنت إحدى الشركات المصرية العاملة في العراق أرباحها السنوية التي بلغت (5000000) جنيه مصري خلال عام 2019م، وقد قدمت القوائم المالية إلى السلطات الضريبية المصرية التي قامت بإعادة إعداد القوائم المالية وتعديلها بما يتفق مع القوانين في مصر.

المطلوب: احتساب سلوك المقياس بافتراض الآتي :- (1) الأرباح المعدلة (60000000) جنيه (2) الأرباح المعدلة (4000000) جنيه.

1- الافتراض الأول

س م = 1– [(6000000 – 5000000) ÷ 6000000 ]= 1 – 0,16 = 0,84

س م = 0,84 وهو اقل من (0,95) أي (متشائم).

2- الافتراض الثاني

س م = 1– [(4000000 – 5000000) ÷ 4000000] = 1 ـ (1000000)/4000000

س م = 1ـ (- 0,25) = 1+ 0,25 = 1,25

س م = 1,25 وهو اكبر من 1,05 (متفائل)