Finance: accounting

ASSIGN BUSTER

Q One of the basic principles of financial decision making is to undertake an analysis of the cash flows of the firm because net earnings is not considered as an effective method of assessing the process of value creation.

Accounting profit is subjective in nature due to the accrual principle.

Different accounting policies can provide different estimates of earnings therefore accounting profit is not only an arbitrary figure but also subjective in nature. Accounting income can also be misleading because of the fact that it can distort the figures like Earnings per share (EPS) due to its subjectivity.

A distorted EPS can lead to faulty decisions by the investors investment required to produce earnings growth is ignored in measures like EPS.

Accounting rate of return which is calculated by dividing the accounting income earned with the total capital employed because it fails to take into account the time value of money. Earnings growth can destroy value if the actual rate of return is less than the required rate of return. It is also of great importance that income volatility can lead to higher required rate of returns because higher income is subject to higher risk therefore would be requiring higher discount rates.

Further, information which is of value to the shareholders does not include accounting earnings but figures like total shareholder return, market - value - added, economic profit etc. Total shareholder returns measure the total income over the equity invested by the shareholders. Shareholders, before making investment decisions tend to compare shareholder return with the required rate of returns to make their decisions. Similarly, economic profit which is the difference between the revenue and opportunity cost foregone by the investors is another important item of financial information which is used by the investors in assessing the value generation of firms. Economic

value added or EVA is another important indicator of value generation which investors take into account to make investment decisions. Accounting does not calculate economic profit or EVA or other value added measures and rather calculate accounting profit which is misleading measure to calculate and measure value. (Kleiman, 2007).

Q#2

Researching by institutional investors on financial markets obligation generally does not generate the above average returns due to various reasons. Researching the financial markets obligations by institutional investors increases their overall transaction cost because costs incurred on researching the same finally adds up to reduce the return on the investment made. Further, the higher transaction costs increase the overall volatility of the financial markets. Higher volatility results into the low rate of returns despite the efforts on researching the obligations of financial markets. (Hau, 2002).

It is also important to understand that this research is conducted with an aim of getting the information which may help institutional investors to gain insight into the predictability of the financial markets as well as individual assets so that they can maximize their returns on the investments made into the financial markets. However, analysing the same fact against the efficient market hypothesis criteria, we need to understand the basic assumptions of Efficient Market Hypothesis (EMH). The basic assumption of EMH that the information in efficient markets is distributed in such a way that price determined through the forces of supply and demand is always equal to the intrinsic value of that security. (Stanford, 2008). This assumption therefore gives rise to the fact that smart investors cannot outsmart others because

same information is available to all therefore the probability of earning high average returns is zero or very low therefore the fact that institutional investors despite researching the obligations of financial markets do not earn above average rate of returns is consistent with efficient market hypothesis.

References

1. Kleiman, Robert T (2007), Economic Profit [Online]. Available at : http://www. referenceforbusiness. com/encyclopedia/Eco-Ent/Economic-Profit. html [accessed: August 15, 2008]

2. Hau, Harald (2002), The role of Transaction costs for financial volatility- evidence from the Paris Bourse [Online]. Available at: http://www. cepr. org/press/DP3651. htm [accessed: August 15, 2008]

3. Stanford, Richard A (2008), The Efficient Markets Hypothesis, [Online]. Available at: http://www. e-m-h. org/Stan. htm [accessed: August 15, 2008]