

Business analysis and valuation essay sample

[Finance](#)



**ASSIGN
BUSTER**

1. A finance student states, " I don't understand why anyone pays any attention to accounting earnings numbers, given that a ' clean' number like cash from operations is readily available." Do you agree? Why or why not? There are several reasons why we should pay attention to accounting earnings numbers.

First, net income predicts a company's future cash flow better than current cash flow does.

Second, net income is potentially informative when there is information asymmetry between corporate managers and outside investors.

Question 5(a). If management reports truthfully, what economic events are likely to prompt the following accounting changes?

Increase in the estimated life of depreciable assets. Managers may increase the estimated life of depreciable assets when they realize that the assets are likely to last longer than was initially expected.

Decrease in the uncollectibles allowance as a percentage of gross receivables. The firm's change of customer focus may prompt managers to decrease the allowance for uncollectible receivables.

Recognition of revenues at the point of delivery, rather than at the point cash is received. Revenues can be recognized when the customer is expected to pay cash with a reasonable degree of certainty.

Capitalization of a higher proportion of software R&D costs. According to SFAS No. 86, costs incurred on software development after the

establishment of technical feasibility and commercial feasibility are to be capitalized.

Question 5(b). What features of accounting, if any, would make it costly for dishonest managers to make the same changes without any corresponding economic changes?

Third-Party Certification. Public companies are required to get third-party certification (auditor's opinion) on their financial statements. Unless the accounting policy changes are reasonably consistent with underlying economic changes, auditors would not provide clean auditor's opinion.

Reversal Effect. Aggressive accounting choices may inflate net income in the current period but they hurt future net income due to the nature of accrual reversal.

Investors' Lawsuit. If a company disclosed false or misleading financial information and investors incurred a loss by relying on that information, the company may have to pay legal penalties.

Labor Market Discipline. The labor market for managers is likely to penalize individuals who are perceived to be unreliable in their dealings with external parties.