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Limitations of financial reporting

Finance: Processes of financial management

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LIMITATIONS OF FINANCIAL REPORTING

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Normalised earnings

This means earnings are adjusted ('normalised') to remove unusual items that affect profit.

For example: a business sells a major asset. This could be a major source of revenue...but on a one-off basis.

Investors **SHOULD NOT** expect this kind of revenue to regularly occur.

Why do we normalise earnings?

- To make comparisons between time periods and businesses easier.
- To give a more accurate picture of a business's revenue.

Normalised earnings

So what's the limitation?

The limitation is that businesses DO NOT normalise their earnings.

Therefore: investors cannot get an accurate picture of the financial statements...and they make poor decisions as a result.

Capitalising expenses

Here, a business records an expense as an ASSET on the Balance Sheet (capitalises it), rather than recording it as an EXPENSE on the Income Statement.

For example: a business conducts Research and Development (R&D) into developing a new product. The business classifies this spending as an ASSET rather than an EXPENSE.

So what's the limitation?

- If we classify an EXPENSE as an ASSET, then the business will understate expenses.
- It will overstate the profits and assets of the business.
- So: the business may appear 'better' than it actually is

Capitalising expenses

Can you offer an example?

Drip Co. **capitalises** development costs for new properties such as taxes and legal fees (recorded as an asset under BUILDINGS and depreciated over the life of the asset -- 40 years)

This will overstate profits (as it understates expenses)

But it’s legal.

VALUING ASSETS

This is about how a business estimates the value of its assets when recording them on the balance sheet.

“Does the value of assets on the balance sheet reflect their true value?”

So what’s the limitation?

A business uses a method that overstates the value of its assets to present a better impression of business performance.

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Valuing Assets: Issues

1. Historical vs market value

A business may record its assets at the original purchase cost (HISTORICAL VALUE). This is the simplest method.

However...the asset may have appreciated or depreciated. As a result, businesses can record the current value of the asset (MARKET VALUE).

The choice of method may artificially boost the value of the asset on the balance sheet.

2. Intangible assets are very difficult to value

These include goodwill, trademarks and patents and brand names.

Sometimes they are NOT included on the balance sheet because they are too difficult to value.

If they are included: how are they valued? Is their value overstated?

Timing issues

A business may adjust when it records revenue inflows or expense outflows in its financial statements.

So what’s the limitation?

A business can change the timing to overstate or understate profits for a particular time period.

This could present an inaccurate picture of the business.

Timing issues: examples

A business delays recording revenue. This reduces its income for the time period, which could reduce its tax liability in that time period (and overstates profit).

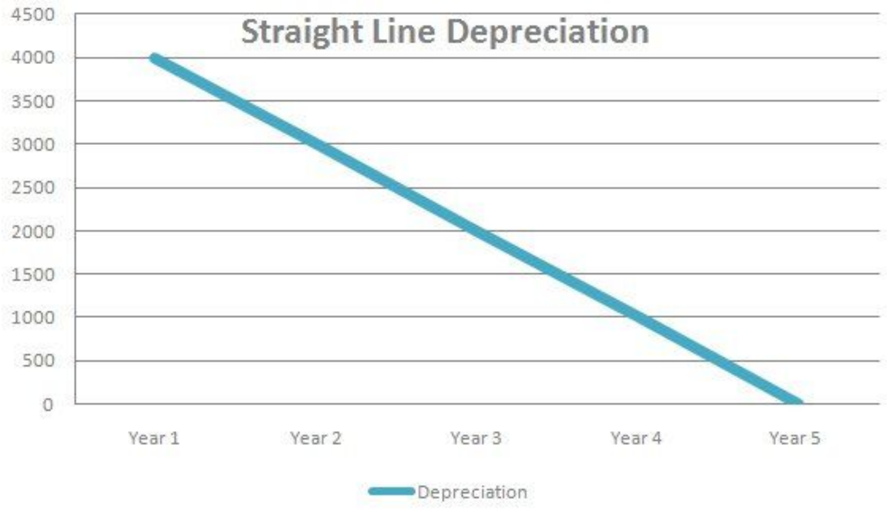
A business could also bring forward its expenses (prepays expenses for future time periods). This will reduces its income for the time period, which could reduce its tax liability in that time period (and overstates profit).

Further Example of timing issues?

Drip Co. records its depreciation for property on a straight line basis.

This means they record the same amount of depreciation each year.

However..this may not reflect the economic reality. Some assets depreciate more quickly in the early years (they quickly lose a lot of their value).



Source: businessaccounting basics.co.uk

Debt repayments

The gearing (debt-to-equity) ratio can be used to determine whether businesses can successfully meet their long-term financial commitments.

So what's the limitation?

It may be difficult to determine the business's insolvency risk because the financial reports do not disclose key info about debt repayments.

This could information such as:

- How long the business has had or has been trying to recover the debt
- The capacity of the business to actually repay the debts owed
- How capable the business is of recovering debts, including through the use of collection agencies
- When the debts are actually due

Notes to the Financial Statements

Businesses include 'Notes to the Financial Statements'. These provide information on how financial transactions were recorded, including timing issues, as well as further details about the financial statements.

So what's the limitation?

These financial statements are often very long and complex.

This can make them challenging for investors to understand.

As a result, they may not be able to form an accurate picture of the business.