Financial Accounting as Lingua Franca

Idea In Short

Financial accounting is the language of business and consultants who lack fluency will embarrass themselves. Master the basics of accrual accounting, historical costs and the manipulation tactics companies use to smooth earnings. Know the rules to spot when they are bent.

The Language of Business

Financial accounting is the language of business. No question about it. It is how investors, managers, creditors, suppliers and regulators keep track of the score. Without it, even the most basic questions like how much profit you made would require hours of meetings, persuasion and probably significant disagreement.

It would be like talking without using verbs. It would work eventually, but painfully. Accounting provides the structure that lets business conversations happen efficiently and with shared meaning. 1

You Have to Know the Basics

Consultants without a strong understanding of the vocabulary, frameworks and principles are certain to embarrass themselves in front of the client. If you do not immediately know what A equals L plus E stands for in accounting, which is assets equal liabilities plus equity, you need to do some remedial studying.

As an exercise, read the Economist business section and stop whenever you do not understand something related to a financial statement. Look it up. This practice builds fluency faster than any textbook because it ties vocabulary to real-world context.

It Seems Perfect, but It Is Not

On the surface, accounting seems like a monolith of precision, rules and conservatism. It feels hallowed, balanced and almost scientific. The financial statements tick-tie with each other, articulating perfectly. Financial statements are permanent and accessible, all online and ready for reading.

The Generally Accepted Accounting Principles [GAAP] and International Financial Reporting Standards [IFRS] guidelines tell us what we can and cannot do. Nobody wants to go to jail. This makes accounting seem more immutable than it is. Savvy consultants know that financial statements are the basics, but far from the whole story.

The Good: Accrual Accounting

Cash accounting is brutish. It counts how much cash you spent or have at the end of the quarter and stops there. Simple, but misleading. It tells you nothing about when value was actually created or consumed.

Accrual accounting attempts to fix this by dividing revenue or expense and matching it to the right time period. The easiest example is depreciation on equipment. If you run a printing shop and pay 700,000 dollars for machinery, your accountant will stop you from writing that off as a one-time expense. Since the equipment will likely be used for seven years, you deduct one-seventh of the value, or 100,000 dollars, per year as an expense. Better, but not perfect.

There are a dozen types of accrual accounts that fall into prepaid and accrued expenses and income. You can see this splitting, pulling-in and pushing-out of expenses throughout the balance sheet. The matching principle is the goal, but judgment enters at every step. 2

The Good: Historical Costs

Accounting is conservative by nature, so it forces companies to value things at their acquisition cost. This understates assets that have appreciated, like a corporate headquarters building in Manhattan purchased 30 years ago. It can also overstate assets that have lost value, such as the question of whether MySpace was really worth 580 million dollars when Rupert Murdoch bought it.

This is why some investors lobby McDonald's to spin off the real estate of their locations

into a real estate investment trust. The goal is to unleash the historical cost value trapped in the shares. Historical cost provides objectivity but sacrifices relevance, especially for assets whose market value has diverged sharply from book value.

The Bad: One-Time Events

As with any analysis, you want to look at things in steady-state to see the trend, extrapolate a forecast or estimate the future. Making assumptions on spikes and blips in profitability would be foolish. Keep an eye out for large non-recurring expenses or gains, anything that does not occur during the ordinary course of business.

Yahoo recorded a huge bump in earnings because of a 9 billion dollar windfall from the initial public offering of Alibaba. That is not normal. The graph showed low, low, low, low, then crazy high. Not normal. Strip out one-time items to see the underlying business trajectory.

The Bad: Management Discussion and Analysis

The Management Discussion and Analysis (MD&A) is where management brings up the most salient points: revenues, costs, financing and competition. Of the hundreds of pages in a 10-K filing, these are the 10 pages you always read.

Inside this narrative, you can often find hidden details the company needs to disclose but does not want to brag about. Changes in depreciation schedule, changes in accounting treatment and other tidbits can add up to a dramatically different picture of the financials than the headline numbers suggest.

The Ugly: Earnings Management

Public markets are ruthlessly competitive, and analysts continually pressure companies to beat increasing expectations. Executives work collectively to meet quarterly numbers, sometimes through overly aggressive interpretation of accounting rules.

Several techniques, more or less legal, include loose revenue recognition for sales that are not exactly finished. Companies may keep inadequate accruals for expenses, not saving enough to pay for the cost. Cookie-jar reserves let a company accrue extra expenses when

times are good, then reduce reserves to smooth earnings when results are down.

Big-bath one-time charges are another tactic. Companies dump all their losses and questionable practices into one large non-recurring loss, taking out all the garbage at once. Analysts are trained to overlook one-time events, which can hide structural problems elsewhere.

Channel stuffing is perhaps the most infamous. Companies push extra product to distributors to inflate sales short-term. The Securities and Exchange Commission has litigated several companies for this practice. Al Dunlap of Sunbeam was one of the most famous offenders, using cookie-jar reserves, improper bill-and-hold sales and channel stuffing to create the illusion of a turnaround. 3

The Consultant's Responsibility

The list of accounting improprieties can go on and on, but the idea is clear. Companies steal revenue from future periods or create cookie jars of savings to use at a different time, all to smooth earnings. Financial accounting is a series of rules, and any good mobster will tell you rules were meant to be broken.

As a consultant, be aware of the good, the bad and the ugly. We do not break rules, and we do not help clients break rules. That said, we need to know how people would do it so we can be on the lookout. Understanding the manipulation tactics is not complicity. It is professional competence.

The consultants who serve clients best are those who can read financial statements fluently, spot the irregularities and ask the right questions. Fluency in the language of business is not optional. It is the price of admission to the executive conversation.

- 1Corporate Finance Institute: GAAP
- 2Oracle NetSuite: Generally Accepted Accounting Principles Guide
- 3SEC: Sunbeam Corporation Enforcement Action

Summary

Financial accounting is essential but imperfect. Consultants must understand accrual methods, historical cost limitations and the aggressive tactics executives use to smooth earnings. Know the good, the bad and the ugly to serve clients well and avoid costly surprises.