Mind the GAAP

– an insider's guide to successful investments

Aidan Clifford examines the accounting standards used in various jurisdictions, and the different views they can give of a company's financial health.

Annual financial statements are the most valuable source of information on a company, yet most investors never even look at them. Ignoring them is a big mistake, but investors need to be aware that different accounting rules apply in different jurisdictions and within one set of rules in particular there are a number of options.

There are three main sets of rules used in the preparation of financial statements for most companies. UK Generally Accepted Accounting Principles (UK GAAP), International Financial Reporting Standards (IFRS) and US GAAP. The application of different GAAPs can produce completely different results.

compare and contrast

Some companies will go to great lengths to assist investors in comparing themselves with their competitors. Recent examples show that one Irish company effectively produced two sets of accounts, one set of figures were titled 'audited' and compliant with IFRS rules, and a second set where they designed their own accounting rules. The main difference between the application of the two sets of rules is in the treatment of brands. IFRS requires that the value of purchased intangible assets (like brand names) are stated at their purchase cost while internally generated or self-grown brands are valued at nil.

The company had a lot of internally-developed and very valuable brand names; however, under IFRS these were valued at nil. In the second set of accounts they were shown at their market value. The company's main competitor purchased all of their brands and showed them as assets in their balance sheet. The additional information allowed better comparison between the two companies. The treatment of intangible assets is the reason why David Beckham was on Real Madrid's balance sheet as an asset but was never on Manchester United's balance sheet. Real Madrid purchased him and Manchester United brought him up through their junior ranks.

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the property game

The value of buildings is another area to watch out for. Under UK GAAP you may revalue a building to its market value based on an 'existing use' basis or you may leave it at its purchase cost. Under IFRS you also have a choice, but if you revalue, you value the building at its best alternative use if that is higher than 'existing use'. For example, a football stadium will be revalued as a football stadium under UK GAAP and potentially as development land under IFRS. Some football clubs could be insolvent under UK GAAP but switch to IFRS and they might be worth millions. Under US GAAP you are not allowed to revalue property at all.

So which GAAP gives us the best answer? IFRS is at least comparable and is used and understood all over the world. However, in the case of accounting for pensions, IFRS gives eight different options, whereas UK GAAP has only one prescribed treatment. For investment properties, IFRS has two options and UK GAAP again has just one.

reading the small print

Whilst it is difficult to extract the hard information from 130-odd pages of an average set of financial statements, it can be done. The trick is to treat the financial statements as if they were a murder mystery and read the last page first, where you will usually find a GAAP reconciliation. As for the information at the front of the annual report, while many chairman's and director's reports contain insightful commentary on the performance of the company, it would be safe to say that there will be a certain gloss put on the performance, and the writer is not exactly neutral.

Some investors make investment decisions based on broker or newspaper reports rather than hard information, yet every company produces very detailed and enlightening financial statements that, as an investor, you should never ignore. For long-term value, investors should treat financial statements as a primary source of information. ■

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