INSTITUTIONAL INVESTORS, ACCOUNTING INFORMATION AND THE ASB

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ACCOUNTING INFORMATION AND THE ASB

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FOREWORD

I still smile at the memory of a charming lady resident who lived in a home for the active elderly and appeared in a promotional film for the national charity that sponsored it. She was telling of her hobby of making scrapbooks for children to read in the local library.

‘But where do you get the scrapbooks from?’ asked the interviewer ‘it must be very expensive to provide so many’.

‘Oh no,’ she replied ‘all my friends have shares and they get the most wonderful annual reports printed on very good quality paper, but my dear they never read them and so I get a lot of scrap books’.

Those of us whose careers have involved one aspect or another of the business of annual reporting will, I think, recognise that we are all too insufficiently aware of how the results of our work are actually used. That is why the Research Committee of The Institute of Chartered Accountants of Scotland is delighted to publish this excellent report based on the detailed and rigorous study by Richard Barker.

Accountants will be challenged by its findings. On the one hand much has been done since the Accounting Standards Board (ASB) was established little more than ten years ago. Yet by asking some fundamental questions about what a significant sector of the users of accounts are really looking for, this study identifies some widespread misunderstandings and some significant opportunities to accelerate the development of financial reporting. Some of the ideas it generates such as enhanced and structured OFR disclosure could be implemented quite easily, given a change of attitude towards public reporting. Other proposals are more radical, in the context of the conceptual framework for accounting which underlies the ASB’s approach, such as the idea that it should become explicit.
that income recognition issues should take precedence over balance sheet criteria where the two appear to be in conflict. The author is not afraid to revisit fundamental issues nor to challenge some widely accepted assumptions. As a result this study combines radical thinking with practical common sense.

The study will undoubtedly stimulate debate and thought as to how the needs and priorities which it identifies can best be addressed. Scottish chartered accountants will not be alone in wanting to see these issues explored and resolved, for by doing so we will strengthen the service we offer to the whole community as well as to the institutional investor.

Nigel Macdonald
Convener
Research Committee

January 2001
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EXECUTIVE SUMMARY

How do institutional investors use accounting information? This is the research question addressed in this report. It is highly topical in view of the considerable changes made to financial reporting by the Accounting Standards Board (ASB). These changes have been motivated by a 'user's perspective', and the ultimate test of their effectiveness must be whether or not investors are better enabled to use accounting information in investment decisions.

Behind the ASB's reform of financial reporting lies a conceptual framework, the Statement of Principles. This represents an unprecedented attempt to bring theoretical consistency to financial reporting. It is not, however, without its critics. There exists a fundamental debate between a 'balance sheet approach', broadly representing the ASB's position, and a 'transactions approach', more closely related to existing accounting practices. At the heart of this debate are the thorny issues of recognition and measurement, notably the extent to which (and the method by which) unrealised economic gains and losses should be reported in the financial statements.

While the ASB is responsible for designing accounting standards, and companies and auditors are responsible for implementing them, there exist few feedback mechanisms whereby the effectiveness of the standards can be assessed. In other words, if institutional investors are the 'customers' of the ASB, then it is difficult to know whether or not the customer is satisfied. This report aims to provide some feedback. It provides evidence from institutional investors on their use of accounting information and draws implications for the design of reporting standards and the role of the ASB.
Executive Summary

Research method

The participants in this study were from both the 'buy side' and the 'sell side' of the stock market. Specifically, interviews were conducted with 39 individual fund managers, who represented firms that together manage approximately one quarter of the total value of UK equities. Interviews were also conducted with 32 stockbrokers' analysts, who represented seven of the nine leading firms of stockbrokers in the UK. Additionally, and finally, a period of one month was spent as a 'participant observer' with a leading stockbroker firm, which involved immersion in the daily routine of equity research and sales. Most of this work was carried out in London although time was also spent in Edinburgh and elsewhere.

Findings

The focus of the research may be summarised broadly under two headings: the financial statements; and the context within which financial statement data are used. Under the first heading are the four main components of financial reporting: the profit and loss account; the cash flow statement; the balance sheet; and the operating and financial review. Under the second heading are the valuation methods used by analysts and fund managers, set in the context of accounting and other stock market information flows.

Financial statements

In general, companies were perceived to differ in terms of the quality of their financial statements. The main concern about this was the level of disclosure rather than underlying differences in recognition and measurement. Indeed, the general view was that creative accounting is not a major concern. The research findings concerning specific financial statements are summarised as follows.
Profit and loss account

FRS 3 was introduced with the aim of encouraging users to look at components of financial performance, rather than simply focusing on the bottom line. In this aim, it has been broadly effective. In particular, analysts make effective use of the components of financial performance in identifying underlying, ongoing ('normalised') earnings. This is true of all three components of financial performance that are highlighted by FRS 3: the disclosure of operating profit for acquired, continuing and discontinued activities; the reporting of exceptional items; and the reconciliation of earnings to changes in reserves. The analysts’ normalised earnings are the basis of the PE ratio, and are thereby linked directly to share prices.

There was, however, little apparent use of recognised gains and losses that are not included in normalised earnings, raising possible concerns about the usefulness of the statement of total recognised gains and losses. Indeed, few analysts are accountants, and (understandably) fewer still are careful readers of financial reporting standards. The effectiveness of FRS 3 relies in part upon its requirements appealing to the common sense of analysts, since the analysts are as likely to assume the content of a standard as to be fully informed of it. The onus is therefore on the ASB to ensure consistency between actual and presumed content of financial reporting standards.

Cash flow statement

Measures of cash flow per share are typically less important than measures of earnings per share, supporting the ASB’s own view (stated in FRS 1) that the cash flow statement is of secondary importance to the profit and loss account. The cash flow statement is of greatest use in assessing a company’s financial position and quality of earnings, and is less important as a direct input to cash flow-based valuation models. Consistent with these findings, the indirect method of reporting operating cash flow is generally preferred to the direct method.
Balance Sheet

The balance sheet is generally viewed as the least useful of the three main financial statements. An important reason is that information is regarded as useful by analysts and fund managers if it causes share prices to change, and so the relative stability and predictability of balance sheet data makes it less useful as a source of information. The relative indifference towards the balance sheet is also, however, manifested in an apparent lack of concern for the interaction between earnings and balance sheet values. This suggests, importantly, that the scope to use the balance sheet as a medium for managing earnings is not well understood.

Operating and financial review

The OFR was generally welcomed, although its usefulness was qualified in two important ways. First, it was generally perceived to contain little that was not already known. Both analysts and fund managers maintain close contact with companies, and both would be disappointed to find many surprises in the OFR. Second, it was considered to be something of a ‘glossy’ public relations exercise, with too much scope for subjective and selective disclosure.

Valuation methods and information flows

The issue of how investors use accounting information is broader than financial statements themselves. Also important are the valuation methods by which financial statement data are related to share prices, as well as the informational environment within which financial statement data are used.

Valuation methods

Consistent with the findings above, the most commonly used financial ratios were those that related most closely to the profit and loss
account and the cash flow statement (such as interest cover and operating margin), rather than those based upon balance sheet data (such as working capital efficiency ratios). Consistent also with the primacy of the profit and loss account is evidence that the most popular valuation models are the price-earning (PE) ratio and the dividend yield.

In general, analysts and fund managers were highly consistent in their preferences between alternative valuation models. Discounting models, such as the discounted cash flow (DCF) and dividend discount model (DDM) were found to be of limited practical importance. This was primarily because of the difficulty of making reliable forecasts beyond the near future. Different valuation models and financial ratios were generally used in conjunction with one another, rather than one approach being preferred to the exclusion of others.

**Information flows**

Information is valuable to fund managers if it helps them to maximise portfolio returns relative to those achieved by the competition (or by a stock market index). The most important information sources for fund managers are meetings with company senior managers, and it is in this setting that accounting information is at its most significant. In particular, the accounts play an important role over time in confirming fund managers' expectations of corporate performance. Managers make implicit 'promises' concerning their strategy and its ability to generate returns, and the accounts ultimately confirm whether or not these promises were reliable. In time, therefore, the accounts serve as a basis of credibility for ongoing meetings. The dynamics of the relationship between company managers and fund managers are therefore of central importance to the role of accounting information in the stock market.

In contrast, information is valuable to analysts if it can be 'sold' to fund manager clients in order to persuade them to trade (or, more generally, it is useful if it raises the fund manager's perceptions of the analyst's ability). Analysts are therefore significantly more interested than fund managers in company results announcements, since these are the occasions when accounting 'news' enters the stock market.
announcements, however, the financial statements are of limited importance, since the share price is changing in response to other news items. Analysts’ earnings forecasts remain of central importance, but these are based only loosely upon historic accounting data.

Conclusions and recommendations

Superficially, at least, accounting information appears to be used well by investors, although underlying issues of recognition and measurement are probably not very well understood. An implication is that accounting standards dealing mainly with presentation and disclosure must be viewed differently from those dealing with recognition and measurement.

Presentation and disclosure standards, such as FRS 1 and FRS 3 have been effective. Recognition and measurement standards, such as FRS 10, FRS 12 and FRS 15, are more difficult to judge. They lie at the heart of the conceptual framework debate between a balance sheet approach and a transactions approach. It cannot be expected that institutional investors themselves should be the arbiters of this debate. Rather, it is the responsibility of the ASB to prescribe a measure of earnings that best captures the economic performance of a given period. To a large extent this is consistent with a balance sheet approach, combined with effective delineation of the components of financial performance. It qualifies the balance sheet approach in favour of a transactions approach, however, to the extent that ‘getting the balance sheet right’ compromises income measurement. The Statement of Principles can therefore be regarded as a sound framework, but not as an all-encompassing guide.

Two principal recommendations arise from these findings. First, the ASB should extend further its improvements in the disclosure and presentation of financial statement data. For example, the OFR would benefit from more regular, more highly segmented and mandatory disclosure, and also from audit (as proposed by the Company Law Review Steering Group (DTI, 1999)). Analysts would also benefit from the identification of further components of earnings and cash flow performance, including extended segmental disclosure. Also,
some effort could usefully be applied to understanding and attempting to resolve differences across companies in the amount of information that they disclose.

The second recommendation is that, since earnings play a primary role in equity valuation, they should be more of a focus for the ASB. Issues of the recognition and measurement of assets and liabilities have direct implications for the measurement of earnings which, in turn, have direct implications for equity valuation. Wherever there is a conflict between, first, the profit and loss account recording correctly a company’s financial performance and, second, the balance sheet stating correctly a company’s financial position, accounting standards should favour the former. In this, it is essential to recognise the importance of the ASB (or similar such international regulator) in determining the basis of measurement. Analysts and fund managers do not themselves have access to the underlying data behind financial statement measures, and neither are they necessarily expert readers of financial reporting standards. The ASB must therefore aim to maximise the economic relevance of the aggregate data that is reported in the profit and loss account.
CHAPTER ONE

INTRODUCTION

How do institutional investors use accounting information? This is the central research question addressed in this report. It is highly topical in view of the considerable changes made to financial reporting by the Accounting Standards Board (ASB). These changes have been motivated by a 'user's perspective', and the ultimate test of their effectiveness must be whether or not investors are better enabled to use accounting information in investment decisions.

This first chapter opens with a review of the ASB's interpretation of the objectives of financial reporting. The chapter raises but leaves open the question of the extent to which the ASB’s approach to financial reporting standards actually benefits the users of financial statements. This question is addressed in chapters two, three and four. Chapter two reviews prior research and identifies areas in which the central research question above remains open. Chapter two also outlines the research methodology employed in this study, which comprises interview research with analysts and fund managers, together with direct observation within a firm of analysts. Chapters three and four then present the findings of the study, addressing specifically the use that investors make of financial statement data. Finally, conclusions and recommendations are made in chapter five.

The objectives of financial reporting

The effectiveness of financial reporting rests ultimately on the analysis and interpretation of accounts by users. This is stated very clearly in the objectives of leading standard-setting bodies in the UK, the USA and elsewhere, and it is also endorsed by associated professional bodies (eg ICAS, 1988; IASC, 1989; AICPA, 1995; and ASB, 1999a).
In the UK, the ASB's Statement of Principles argues that the needs of users are represented by those with 'a reasonable knowledge of business and economic activities and accounting' (ASB, 1999a, chapter 3, paragraph 25). It is also argued (chapter 1, paragraph 11) that investors are the defining class of user:

The rebuttable assumption is made that financial statements that focus on the interests that investors have in the reporting entity's financial performance and financial position will, in effect, also be focusing on the common interest that all users have in that entity's financial performance and financial position.

The Statement of Principles aims to provide a conceptual foundation to this broad objective of meeting users' needs. Particularly noteworthy is the introduction to chapter one:

The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful ... (to investors) ... in evaluating the entity's ability to generate cash (including the timing and certainty of its generation) and in assessing the entity's financial adaptability.

In the specific context of the ASB's first financial reporting standard (FRS 1, Cash Flow Statements) (ASB, 1991) this is interpreted as follows (paragraph 1):

The objective of this FRS is to ensure that reporting entities ... report their cash generation and cash absorption for a period by highlighting the significant components of cash flow in a way that facilitates comparison of the cash flow performance of different businesses; and provides information that assists in the assessment of their liquidity, solvency and financial adaptability.

Similarly, the objective of FRS 3 (Reporting Financial Performance) (ASB, 1992) is (paragraph 1):

... to highlight a range of important components of financial performance to aid users in understanding the performance achieved by a reporting
entity in a period and to assist them in forming a basis for their assessment of future results and cash flows.

Regarding the third primary financial statement, the balance sheet, paragraph 12 of chapter 7 of the Statement of Principles reads as follows:

... users are most interested in the types of assets and liabilities held and the relationships between them, and in the function of the various assets. Information on the reporting entity’s financial position therefore needs to be presented in a way that focuses attention on these aspects.

Finally, the ASB’s Operating and Financial Review (OFR) (ASB, 1993a) describes itself in paragraph 1 as:

... a framework for the directors to discuss and analyse the business’ performance and the factors underlying its results and financial position, in order to assist users to assess for themselves the future potential of the business.

Each of these extracts focuses on assisting the user in the assessment of the level and riskiness of future cash flows and, by implication, in evaluating the share price. The assumption is made that the financial statements are important in the communication of information relevant to investors’ decision making.

**The financial reporting framework**

If investors are the defining class of users, then the test of whether accounting information is useful is whether it affects investment decisions. In other words, useful accounting information is that which is actually (and correctly) used by investors in making decisions concerning share prices. This usage depends critically upon two things, both of which are determined (in the UK) by the ASB. First, it depends upon the information set that is actually made available to investors by the preparers of accounts, ie by public companies, auditors and regulators. While stock market participants might reasonably be expected to make
good use of public domain information, they cannot be expected to have access to privately held information by any means other than disclosure by preparers.

Second, the usage of accounting information depends upon how financial transactions and events are recognised, measured, disclosed and presented. In other words, usage depends upon the financial accounting system that is in place. The implications of this can be illustrated with an example.

Imagine a situation in which there is no financial accounting system by which financial statements are reported, but that instead there is full, disaggregated disclosure of all individual accounting transactions and events. In principle, investors could each prepare their own financial statements from this raw data. There would be no scope for creative accounting in such a system, and neither would there be a role for a body such as the ASB. Such a system would, of course, be unworkable, however, because it would be highly costly and would lead to a wide divergence of opinion amongst investors. In turn, this would cause the market to be highly inefficient – such that share prices would be very poor indicators of the true value of companies.¹

There needs, clearly, to be some ‘central processing’ by preparers, which aggregates and allocates data on financial transactions and events according to a commonly understood and mutually agreed framework of financial reporting. This reduces significantly overall costs and promotes mutual agreement amongst investors about the value of shares. The problem, however, is that the basis of the framework is itself likely to be the subject of considerable contention and disagreement. In turn, this implies that investors might disagree about how best to report financial performance, or else that they might be collectively misled by the use of inappropriate financial reporting methods. In other words, if we accept the necessity of aggregating data within a financial reporting system, then the price we must pay is accepting that the method of aggregation will inevitably be controversial.
The conceptual framework

In practice, two broadly opposing views have emerged on the theoretical basis around which financial reporting should be designed (i.e. on the ‘conceptual framework’). On one side is the ‘balance sheet approach’, which is grounded in Solomons (1989). The opposing view is the ‘transactions approach’, a proponent of which is Ernst & Young (1996). That there is a difference between the approaches reflects that balance sheets (and thereby accounting profits) are only proxy measures for market values (and therefore for economic gains), and that there is scope to disagree over how to define these proxies in the most accurate and reliable way.

Solomons (1995) sets out the criteria upon which a balance sheet approach is ideally based. Assets and liabilities are defined, respectively, as rights to receive or to transfer economic benefits. They are recognised as soon as they arise, subject to the constraint that they are measurable with reasonable certainty. Measurement is on a value to a going concern basis. Owners’ capital is maintained in real terms. The profit or loss for the period is derived by residual difference between opening and closing balance sheets.

The transactions approach, by contrast, focuses on the profit and loss account and treats the balance sheet as the residual. Each transaction is debited or credited to accounting income in the period to which it relates. An asset, in this view, is simply an unexpired cost. Its value need not, therefore, have any market reference. Depreciation is a matching process rather than an attempt to reflect a change in value.

Differences between the two approaches are subtle, yet significant. Income and expenditure may be tautologically defined as changes in the assets and liabilities to which they give rise. When we refer to the profit and loss account, therefore, we also refer to the balance sheet. Moreover, in both approaches the recognition of assets and liabilities can only arise from past transactions and events, and future outcomes have to be estimated (Beaver, 1991). Finally, accounting practices do not (for the most part) have any effect on cash flows. The debate is not, therefore, affected by the value of the firm as such, but only by the periodic representation of that value. Where the balance sheet and
the transactions approaches differ is on the relative emphasis that each places on that which is conceptually desirable, as opposed to that which is actually feasible. The primary impact of the two emphases is on the timing of recognition in the financial statements.

The balance sheet approach is based upon the view that economic value is of greater decision-making relevance than historical cost, and that it is better to be approximately right than precisely wrong. In contrast, the transactions approach takes a more sceptical line. It favours the recognition of that which has verifiably taken place rather than that which requires an element of subjective valuation. In this it is closely wedded to traditional accounting practice. It emphasises the objectivity of historical costs, and it relies upon the principle of prudence, which is a check against the potential over-optimism of companies. Gains and losses are recognised asymmetrically, such that unrealised and less than probable gains are excluded from income. In other words, increases in the net worth of a business are consciously recognised later than they would be under a balance sheet approach.

The objectivity and prudence of the transactions approach should not, however, be overstated. There remains considerable management discretion over the matching process, which can potentially lead to a distortion in the periodic income measure. In principle, this is less of a problem under the balance sheet approach’s requirement to satisfy the definitions of assets and liabilities. In practice, though, the balance sheet approach requires the user to be reliant upon valuations which are arguably more subjective.

**Influences upon the ASB**

In practice, the agenda of the ASB and of other standard-setting bodies is influenced by more than conceptual analysis. There are three factors at work, as shown in Figure 1.1.
The first influence is an inherited legacy, which comprises both the existing body of accounting standards and, perhaps more importantly, the entrenched interests and practices that were (and continue to be) associated with them. This embraces inherited problems that have seemed intractable, such as goodwill, as well as those that have posed perennial problems of creative accounting, such as provisions, and also problem areas that have emerged relatively recently, such as financial instruments.

The second influence is the increasing recognition of the importance of international harmonisation in the setting of accounting standards. Practically, this means that the UK can act independently only with the greatest of caution, and that the ASB has to work closely with its counterpart in the USA, the Financial Accounting Standards Board (FASB), and also with the International Accounting Standards Committee (IASC). To a lesser extent, it also implies consistency with the Australian and the Canadian standard setters, who are two of the other member standard setters of the so-called G4. Finally, the ASB has to be mindful of European reporting practice, in terms
of both the individual member states of the European Union (EU) and the EU itself. This has become especially important with the introduction of the Euro and with the incipient structural change across European stock exchanges.

The third influence on the ASB is partly derived from the second. It is the Statement of Principles, which is the ASB’s own conceptual framework, and which reflects similar statements from the FASB and the IASC. The Statement of Principles is intended to provide logically consistent guidance on the content of accounting standards. It outlines the objectives of financial reporting and it identifies relevance and reliability as the primary characteristics that make financial statements useful. It reflects, for the most part, the balance sheet approach of Solomons, although the major difference between the two is that the Statement of Principles recommends an evolutionary progression towards current values and it sees practical constraints on Solomons’ approach to valuation. In this, the ‘reforming zeal’ of the Statement of Principles has been necessarily constrained by SSAP 2 (Disclosure of Accounting Policies) (ASC, 1971) which, while not purporting to be a conceptual framework, is a statement of that which is deemed to be fundamental and uncontroversial in generally accepted accounting practice. In particular, prudence and matching are defined as fundamental accounting concepts in SSAP 2, which makes their universal application a presumption of financial reporting.2

Each of these three influences has affected the ASB in different ways at different times. The work of the ASB has been at its most widely supported when all three influences have been congruent.

**Are changes in financial reporting beneficial to users?**

An assessment of whether or not developments in financial reporting are effective rests upon the user perspective outlined earlier. The ‘market test’ is, therefore, whether the information needs of users are being met. In this context, financial reporting may be assessed under two headings: presentation and disclosure in the financial statements; and issues of recognition and measurement.
Introduction

Since the ASB came into existence, developments of particular importance to the presentation and disclosure of financial performance have been FRS 1 (ASB, 1991), FRS 3 (ASB, 1992), and the OFR (ASB 1993a). Taken together, these de-emphasise the bottom line, increase disclosure of components of performance, and focus on a distinction between trading and capital items. Also of relevance is FRS 4 (ASB, 1993b), which clarifies the balance sheet presentation of debt and equity, and FRS 5 (ASB 1994a), which aims to ensure the disclosure of all assets and liabilities. Through these standards, the ASB has both increased the level of information available to the market and changed the way in which it is presented.

Issues of recognition and measurement have proved to be more problematic for the ASB than issues of presentation and disclosure. While the ASB has adopted a balance sheet approach in the Statement of Principles, it has wrestled to reconcile this with traditional accounting practice in the form of SSAP 2 (ASC, 1971) and the transactions approach. This is reflected in contentious areas such as goodwill and intangible assets (FRS 10) (ASB, 1997), provisions (FRS 7 (ASB, 1994b) and FRS 12 (ASB, 1998b)), asset valuation (FRS 11 (ASB, 1998a) and FRS 15 (ASB, 1999b)), deferred taxation and pension costs. The crux of the ASB’s problem is a conflict between recognition and measurement. Whilst early recognition of gains and losses is clearly advocated by the Statement of Principles, the problems of reliable measurement can be serious. These problems are generated by the genuine uncertainty of valuations, and they are made serious by the ASB’s desire to restrict management discretion in the accounts, especially in the smoothing of earnings and in the recognition of assets and liabilities.

This report provides empirical evidence (in chapters 3 and 4) concerning both presentation and disclosure and also recognition and measurement. This evidence addresses directly the effectiveness of the financial reporting standards introduced by the ASB. First, though, chapter two reviews prior academic research and then introduces the research methods used in this study.
Summary

The stated objective of the ASB is to meet users' needs, which implies the provision of information relevant to the assessment of the size, timing and riskiness of future cash flows. This objective is problematic in that there is no unique, uncontroversial method for recording financial performance in the financial statements. Indeed, this chapter has reviewed two different conceptual frameworks for financial reporting, which are the balance sheet and the transactions approaches. The ASB's own Statement of Principles leans towards a balance sheet approach, whereby the emphasis is on getting the balance sheet 'right', and then deriving earnings as the residual difference between consecutive balance sheets. In contrast, the transactions approach focuses more pragmatically on periodic earnings measurement, and is less concerned with the theoretical integrity of balance sheet values.

In practice, the ASB's decision-making process is influenced by more than just the Statement of Principles, and in particular it is guided by the demands of international harmonisation and by the views of its many interest groups. In its ten-year life, the ASB has made extensive changes to UK financial reporting, both in the areas of presentation and disclosure and, more controversially, affecting issues of recognition and measurement. Whether these changes have achieved the desired objective of meeting users' needs is the subject of this study.

Endnotes:

1 Fama (1970) defines an efficient market to be 'a market in which prices always 'fully reflect' available information.' This means that prices are set 'correctly', such that the price an equity investor must pay to acquire a share takes full account of all currently available information about the true value of the share. This does not, of course, mean that share prices are correct in some absolute sense - after all, we cannot see into the future. It means only that prices correctly reflect current expectations about how the future will turn out. Fama states the following key assumptions on which the hypothesis of an efficient market is sufficiently, though not necessarily, based: '(1) there are no transactions costs in trading securities, (2) all available information is costlessly available to all market agents, and (3) all agree on the implications of current information for the current price and distributions of
future prices of each security. These assumptions are fairly straightforward. They state simply that if there are no costs of trading or of information flow, and if there is a common understanding of the implications of information for the value of a given share, then the market will set share prices efficiently.

It should be noted, however, that SSAP 2 is currently under review. Specifically, FRED 21 (ASB, 1999c) upholds the importance of matching while playing down the role of prudence, thereby ensuring greater consistency with the Statement of Principles.
CHAPTER TWO

PRIOR RESEARCH
AND RESEARCH METHODS

This chapter reviews prior research into the use of accounting information by stock market participants. There have been two broad methodologies used by researchers, and evidence from both is reviewed here. The first method ('market-based') has been used to demonstrate that the stock market responds quickly to the announcement of accounting information, and that analysts' earnings forecasts play a particularly important role as a focus for investors' expectations. The second method ('behavioural') has been used to place accounting information in context, and to show that it forms part of a wider set of information disclosed by company management to analysts and institutional investors. Collectively, prior research leaves open as many questions as it answers, notably in providing a detailed understanding of investors' methods of processing accounting information.

Categories of prior research

A simplifying distinction between the market-based and behavioural methodologies is outlined in the following diagram.
Figure 2.1: Approaches to assessing the usefulness of accounting information

Financial reporting is represented by the 'accounting information' box. The diagram shows that the output from this box must be considered alongside the 'other information' box, since their combined output represents the total supply of information to the stock market. The subsequent use of this information by the stock market is the subject of this report, and it is the means by which share prices are determined.

The stock market is a 'black box', however, because the information flows and information processing within it are not transparent to the external observer.

Market-based research

Market-based research 'resolves' this problem by bypassing the 'black box' altogether. It tests statistically for relationships between
the readily available information sets of share prices and accounting information. In this way, it is possible to use known information to make inferences about unknown processes occurring within the 'black box'. For example, if share prices respond immediately to the announcement of profits, then it can be inferred that stock market participants must find profit information useful.

There are three major benefits to market-based research:

- objectivity is implicit in the use of 'hard' data such as earnings and prices;
- quantification enables the magnitudes and strengths of relationships to be estimated; and
- the use of market data avoids the problem which arises when research is conducted at the level of individuals' decision making, and where aggregate outcomes do not equal the sum of individuals' behaviour.

Market-based research has considerable practical difficulties, however, and it is also limited in its potential to answer policy-related questions of the type raised in chapter one. For example, market-based research can test only the information that is actually used by the market, rather than that which might be used. This restricts its relevance to policy makers such as the ASB.

**Behavioural research**

Behavioural research, by contrast, attempts to find a path through the 'black box' to understand directly, rather than by inference, the types of information used and the methods of usage. This is achieved by means of interviews, questionnaires, and the like.

There are a number of methodological approaches to behavioural research. Each of these may be characterised as lying on a continuum from a direct observation of the real world to an abstraction from it. At one end of this continuum, it is possible to observe directly the behaviour of market participants during their normal course of business ('participant
observation'). The content of the written reports that they routinely produce may also be examined (‘content analysis’). At one stage of abstraction, interviews can be a means of asking market participants to explain what they do, and how and why they do it. Moving slightly further along the continuum, questionnaires afford a similar process of investigation to interviews but they are narrower and more pre-determined in their focus. Finally, various forms of ‘laboratory experiment’ take market participants out of their normal environment altogether, and they attempt to analyse specific aspects of their behaviour — such as asking them to read through a set of accounts, explaining their method of information processing as they go. It can be seen that moving along the continuum changes, on the one hand, both the amount of data available to the researcher and the reliability of its association with the real world and, on the other hand, the degree of confidence in measurement. These two variables are, however, in conflict with one another such that (for example) direct observation is strong in the former and weak in the latter.

The research literature has made extensive use of both market-based and behavioural research, and the main findings from both methods are reviewed below.

**Usefulness of accounting information - findings from market-based research**

The overwhelming focus of market-based research has been on earnings. As early as the late 1960s, the work of Ball and Brown (1968) established that share prices react to earnings information. Since this early work, there has been an enormous interest in testing the price-earnings relationship. Excellent summaries of this literature can be found in (for example) White, *et al* (1997) and Beaver (1998), and only the main findings will be summarised here.¹

The extent of the share price reaction to earnings will depend upon the difference between the earnings that the market expected and that which was actually reported, indicating that there is a 'news' element in reported earnings that causes investors to reassess their expectations of future returns. The extent to which investors revise their expectations
has been shown to depend upon the 'permanence' of earnings. This notion of permanence - sometimes referred to as earnings quality - refers to the extent to which current earnings are expected to persist into the future. The greater the persistence, the greater the effect on share prices. The importance of persistence is well documented.\textsuperscript{2} An interesting study that demonstrates the greater importance of permanent earnings is Strong and Walker (1993), who disaggregate earnings into permanent and transitory components, where the latter are defined to include exceptional and extraordinary items.

The market-based literature has increasingly concerned itself with financial statement information other than earnings. An important contribution was Ou and Penman (1989), who employed a range of financial statement variables to demonstrate that the accounts contain more information relevant to share prices than earnings alone. Ou and Penman's work has been extended more recently by (for example) Lev and Thiagarajan (1993) and Abarbanell and Bushee (1997), who modelled the market's fundamental analysis of accounting information by means of identifying financial statement variables that are predictive of earnings.

A further, important strand of market-based research concerns the usefulness of cash flows. A consistent finding has been that earnings are more useful to investors than cash flows in determining share prices.\textsuperscript{3} More recent studies do, however, suggest a useful informational role for cash flows. Of particular note is Livnat and Zarowin (1990), who disaggregated cash flows on the basis of the operating, investing and financing components of FAS 95 (which is similar to FRS 1). They found that, if the market already knows a firm's earnings, it will not gain additional information from an aggregate measure of cash flow. It will, though, find that the individual components of cash flow are useful information, indicating that a detailed analysis of cash flows is helpful in extrapolating future performance.

\textbf{Studies of analysts' earnings forecasts}

The market-based literature has been extended in recent years to consider explicitly the role of analysts in the determination of share
prices. This area of research constitutes something of an overlap between the market-based and the behavioural methodologies. This is because a market-based methodology is used to address the mechanism by which information becomes impounded in share prices – or, in other words, the research looks inside the ‘black box’ of market behaviour.

Studies of analysts’ earnings forecasts have shown them to be more accurate than those generated by mechanical forecasting models. Forecast accuracy is reported in Horton et al, (1998) to have improved following the introduction of FRS 3 (ASB, 1992). Analysts’ earnings forecasts have also been shown to be superior measures of share price-impounded earnings expectations, which implies that they are relied upon by fund managers. The literature has raised doubts, however, with respect to the efficiency with which analysts use available information, and it has been found that publicly available information can be systematically ‘ignored’ in analysts’ earnings forecasts.

Method of usage of accounting information - findings from behavioural research

The findings of behavioural research may be categorised under two broad headings. The first is information flows, which concerns the sources of information used by market participants, together with their incentives to supply and demand information. The second category is valuation methodology, which concerns the filtering of information and the selection of specific valuation models with which to estimate share prices.

Information flows

Table 2.1 summarises the findings of the main UK studies that have addressed the sources of information used by analysts.
Table 2.1 Ranking of information sources used by analysts

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct contact with the company</td>
<td>3</td>
<td>3</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Analysts' meetings</td>
<td></td>
<td></td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Results announcement</td>
<td></td>
<td></td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Annual report and accounts</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Interim report and accounts</td>
<td>2</td>
<td>2</td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>Industry sources</td>
<td>4=</td>
<td>4=</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Annual General Meeting</td>
<td></td>
<td></td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Companies House</td>
<td></td>
<td></td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Newspapers</td>
<td>4=</td>
<td>4=</td>
<td></td>
<td>9</td>
</tr>
<tr>
<td>Reports of other analysts</td>
<td></td>
<td></td>
<td>4=</td>
<td>10</td>
</tr>
</tbody>
</table>

The strongest conclusion from these data is that the company itself is the most important source of information to the analyst. Each of the top categories in the table represents information sourced directly from companies. This is a finding that was explored further in Barker (1998), who found that direct, personal contact with companies was the top-ranked category for the following four reasons:

- it is the most timely of all information sources;
- it allows the analyst to ask the questions that he or she wants to ask, and it is therefore a more direct and efficient method of data collection;
- it allows the possibility of gaining a competitive advantage over rival analysts, by means of probing for an interpretation of public domain information; and
it enables a focus on strategic and other forward-looking issues affecting current market value, which is in contrast to the less helpful view provided by historical information. An important aspect of this direct communication is that there is acute awareness of the requirements of securities legislation concerning price-sensitive information.

These findings for analysts may be compared directly with Barker's (1998) evidence for fund managers, which is shown in Table 2.2. This important distinction between stockbrokers’ analysts and fund managers (including ‘buy-side’ analysts) is rarely drawn in the literature. An important paper which does make the distinction explicit is Moizer and Arnold (1984), which differentiates the two groups according to their respective scope of activity and range of skills.

Table 2.2 Ranking of information sources used by fund managers

<table>
<thead>
<tr>
<th>Information Source</th>
<th>Barker 1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formal meetings with senior company management</td>
<td>1</td>
</tr>
<tr>
<td>Annual report and accounts</td>
<td>2</td>
</tr>
<tr>
<td>Interim report and accounts</td>
<td>3</td>
</tr>
<tr>
<td>Analysts</td>
<td>4</td>
</tr>
<tr>
<td>Results announcement and meeting</td>
<td>5</td>
</tr>
<tr>
<td>Newspapers</td>
<td>6</td>
</tr>
<tr>
<td>Industry sources</td>
<td>7</td>
</tr>
<tr>
<td>Annual General Meeting</td>
<td>8</td>
</tr>
<tr>
<td>Companies House</td>
<td>9</td>
</tr>
</tbody>
</table>

Comparing Tables 2.1 and 2.2, it can be seen that the differences between analysts and fund managers are not great - in particular, formal
meetings with senior company management are the dominant source of information for fund managers. As described in both Holland (1997) and Barker (1998), there are two reasons why these meetings are considered to be so important. First, they allow fund managers to understand the strategy of the company, thereby testing their understanding of broad valuation parameters and of the share price's major sensitivities. Second, they allow fund managers to assess the management's capacity to achieve the strategy. This assessment uses accounting information in considering the resources of the business and its performance track record.

The research literature concerning information flows has recently been extended to consider both the underlying incentives of market participants and the channels of communication used by companies to inform the stock market (Marston (1996), Holland, (1997) and Barker (1998)). Holland's work, for example, has shown that companies are motivated to actively manage the flow of information through both public and private information channels. This work seems to support market-based evidence that the propensity to voluntarily disclose information is positively related to firm size and to equity issuance (e.g Lang and Lundholm, 1993), and that the market response to negative earnings surprises is greater than that to positive surprises (Skinner, 1994).

Valuation methodology

While the market-based research methodology has dominated investigation of the price-earnings relationship, both in terms of volume of work and usefulness of findings, other methodologies have also addressed the issue. Survey research, for example, has identified the dominance of the price-earnings (PE) ratio as a valuation method. This finding was supported by laboratory experimentation (Day, 1986), and also by content analysis of analysts' reports (Govindarajan, 1980, and Previts et al, 1994). The paper by Previts et al, also identified a focus on the assessment of earnings 'quality', using both financial and non-financial information. A further, consistent finding is that
discounted cash flow (DCF) models, technical analysis and beta analysis are of little practical importance. There is little direct evidence, however, on the relative importance of other valuation models such as the dividend discount model, the dividend yield, the return on capital employed (ROCE), the price-cash flow ratio (PCF), or net asset value (NAV). Regarding the method of usage of valuation models, market participants are reported to focus primarily on the assessment of the PE ratio over a two-year time horizon (Arnold and Moizer, 1984 and Day, 1986). Analysts are reported by Moizer and Arnold (1984) to conduct more detailed analysis on a smaller range of stocks than fund managers, although they were found to use much the same method of valuation. Finally, survey and laboratory experiment studies have questioned the ability of analysts to interpret and use financial statement information effectively (Lee and Tweedie, 1981, and Breton and Taffler, 1995, respectively).

Research methods in this study

The earlier discussion has identified several open issues with respect to which empirical research is potentially revealing. It has been argued that market-based research is a methodology with limited ability to address these issues. In particular, it does not address directly analysts' behaviour and it is constrained in the data that it is able to use. In contrast, behavioural research is a more appropriate methodology for this study. The design of the specific research approach is, however, critical. Direct observation is a valuable preliminary to a study but, equally, it is too subjective to stand alone as a research methodology. Questionnaires can also be very useful preliminaries, though they are not ideally suited to in-depth analysis. In contrast, the strength of interviews is that they allow a range and depth of differing issues to be addressed. These might include information which is potentially available in addition to that which is currently available. They might also include the motivations of market agents, as well as the context within which valuation models are used and trading decisions are made.

A mixed research methodology was chosen for this study. Interviews were the primary method of research, although use was made also of
participant observation and questionnaires. The first stage of research was participant observation with analysts. Whilst unavoidably subjective, this research provided broadly informative first-hand experience of the analysts' environment that would not otherwise have been available. It served to minimise any misconceptions that might otherwise have been introduced to the survey research, whilst also helping to identify specific issues for the surveys and providing a basis for the corroboration or challenging of survey findings. In this last respect, participant observation strengthened the overall study because it was based on the researcher seeing what analysts actually do, rather than what they say they do.

Questionnaires were used in this study as an 'intermediate step' between participant observation and interviews. They were used both to clarify and quantify the findings of participant observation, and also to suggest areas for further investigation in the interviews, although they did not have the same scope as interviews for in-depth analysis. The interviews were designed to clarify, quantify and probe some of the findings of participant observation and questionnaires. This was useful in two ways. First, the interviews enabled the analysts to express in-depth opinions on predetermined issues, and also to respond to supplementary questions that sought clarity, consistency and full explanation. Second, while participant observation leads to general and qualitative findings, semi-structured interviews allow the construction of questions that seek quantifiably analysable responses.

**Sample selection**

This section describes the sample selection procedures for the analyst and fund manager samples.

**Sample selection for analysts**

In selecting a sample of analysts, the Extel survey\(^{11}\) was used to identify the firms that are of greatest importance in the determination of share prices. The Extel survey indicates clearly that there is a very
small number of firms of analysts that are dominant. A period of one month was spent with one of these firms. This involved working the same hours as the analysts in the same environment. It also included unrestricted time spent with analysts, both within the firm and at corporate results announcements and analysts’ meetings. Subsequent to this first-hand experience, a further seven of the leading firms agreed to take part in the research, though the level of participation varied considerably. Questionnaire responses were received from 42 analysts, whilst 32 analysts participated in a one-hour interview. The distribution of responses is shown in Table 2.3 below, which denotes each of the participating firms by the letters A to G. Firms A, B and C each participated in the questionnaire, whilst A, B, D, E, F and G took part in the interviews. Firm A was the host for the participant observation.

Table 2.3 Analysts – sample description

<table>
<thead>
<tr>
<th>Sector</th>
<th>Questionnaire</th>
<th>Interview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm</td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>Mineral extraction</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Industrials</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Consumers</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Services</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Utilities</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Financials</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>TOTAL</td>
<td>23</td>
<td>14</td>
</tr>
</tbody>
</table>
It can be seen from Table 2.3 that the sample of interviewees is somewhat overweight in financials and underweight in services in proportion to the sample of questionnaire respondents. There are not, however, any substantial differences between the two samples, and there is also a fairly even distribution across sectors within each of the individual firms.

**Sample selection for fund managers**

Consistent with the analysts, the sample selection for fund managers focused on the largest firms, which collectively play a dominant role in the market. The most obvious criterion for ranking the size of firms is the value of funds under direct management. A sample of 40 firms was selected for this study, which included all UK-based firms with approximately £10 billion or more of total funds under management. Sixteen firms agreed to participate in the research, and the total value of their funds under management is shown in Table 2.4.

**Table 2.4 Fund managers – sample description**

<table>
<thead>
<tr>
<th>Client Type</th>
<th>Sample percentage of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension funds</td>
<td>26%</td>
</tr>
<tr>
<td>Life assurance</td>
<td>20%</td>
</tr>
<tr>
<td>Unit or investment trusts</td>
<td>21%</td>
</tr>
<tr>
<td>Other</td>
<td>-</td>
</tr>
<tr>
<td>TOTAL</td>
<td>24%</td>
</tr>
</tbody>
</table>

The final column of Table 2.4 shows that the sample of firms represented approximately 24% of total UK-based institutional investment in UK equities. Moreover, the value of UK equities managed by these firms on behalf of each client type is approximately representative of the
value-weighted proportion of client types in the market as a whole.\textsuperscript{12} In total, 39 individual fund managers participated in the research. Some of these participants are best described as portfolio managers and others as in-house ('buy-side') analysts, although the distinction between these two groups is blurred in practice. Both groups are referred to collectively here as 'fund managers'.

**Summary**

Existing empirical evidence from quantitative research using share price data provides useful background information for this study. In particular, there is strong evidence of share price responsiveness to the 'news' element of reported financial performance. The responsiveness of the share price to earnings data is generally stronger than for cash flow or other financial statement data. The announcement of earnings by a company affects the share price to the extent that it causes a revision in the market's expectations of the size, timing and riskiness of a company's future cash flows. Related to this, the share price impounds analysts' earnings forecasts, and financial statement data can be regarded as useful to the extent that they influence these forecasts.

The importance of published accounting information to stock market participants should not, however, be over-stated. For example, behavioural research studies have shown that both analysts and fund managers rely more heavily upon direct contact with company managers than on financial statements. Moreover, there is evidence that financial statement data are not predicted very far into the future, implying that they are not a comprehensive basis for valuation.

Existing research is limited, however, notably in explaining the processes by which analysts and fund managers actually interpret and use financial statement data. This concerns directly the impact of specific financial reporting standards, and it is the focus of this study.

**Endnotes:**
1. It may be noted that much of this work uses US data, although UK data generally reaches similar conclusions.
2. See, for example, Easton and Harris (1991); Kormendi and Lipe (1987); Collins and Kodhari (1989), and O’Hanlon et al, (1992).
Prior Research and Research Methods

3 See, for example, Rayburn (1986); Bowen et al., (1987); and Board and Day (1989).

4 See Bhaskar and Morris (1984); Brown et al. (1987a); and O'Brien (1988).


6 See, for example, Lys and Sohn (1990); De Bondt and Thaler (1990); Abarbanell (1991); Elgers and Murray (1992); and Capstaff et al., (1995).

7 Although see Weetman (1994).


9 For example, Lee and Tweedie (1981); Arnold and Moizer (1984); and Pike et al., (1993).

10 For example, Arnold and Moizer (1984); Pike et al., (1993); and Vergoossen (1993).

11 The Extel survey provided a ranking of analysts by fund managers in the UK.

12 The number of participants from each firm was not proportional to the value of funds managed by the firm, though correcting for this did not distort the representative quality of the sample that is evidenced in Table 2.3.
Chapter Three

Research Findings - Financial Statements

This chapter reviews investors' perceptions of each of the main components of the financial statements: the profit and loss account, cash flow statement, balance sheet, and operating and financial review.

In response to preliminary, general questions about financial reporting, both analysts and fund managers expressed the view that the overall level of disclosure of accounting information is broadly sufficient. There was also, however, a generally held view that companies differ in terms of the quality of the accounts that they provide. In this context, quality was consistently argued to be an issue of a company's willingness to disclose information. Less important is the way in which information is presented, and even less of a perceived issue is the basis of measurement that is used in the financial statements. Indeed, both analysts and fund managers were surprisingly unconcerned about the types of presentation and measurement issues that are commonly referred to as 'creative accounting'. The analysts did give some examples of creative accounting in their own sectors, but they generally did so without much conviction and with the underlying view that creative accounting is not as important as it once was. In turn, the fund managers were less able to refer to specific examples, but they too shared the belief that creative accounting is not a major concern.

Overall, these views are revealing. They suggest that analysts and fund managers are concerned about disclosure but not about presentation and measurement. Analysts and fund managers, therefore, believe that they are able to interpret information once it is available in the public domain, but they perceive themselves to rely upon the willingness of companies to disclose this information. These general perceptions
will be reviewed below in the specific context of analysts’ and fund managers’ use of the financial statements.

Profit and loss account

Since 1992, the reporting of financial performance has been governed by FRS 3 (ASB, 1992), a reporting standard which was introduced with the aim of encouraging users to look at components of financial performance, rather than simply focusing on the bottom line. The rationale for FRS 3 is that different components of earnings may have different effects on the value of a company. For example, a cost reduction programme might be expected to affect earnings in every year of a company’s future operation, whereas a one-off gain from (say) an insurance claim will affect the amount of invested funds that a company has, but it will not directly affect the future pattern of earnings generation. While both of these examples might have the same impact on profit in the current year, their impact on the share price should clearly be different.

The research evidence reported here confirms that FRS 3 (ASB, 1992) has been broadly successful in its aim, and that analysts do in fact use the components of financial performance to identify underlying, ongoing earnings (which are often called ‘normalised’ earnings).¹ This is true with respect to each of the three components of financial performance that are highlighted by FRS 3 (ASB, 1992), which are:

- the disclosure of operating profit for acquired, continuing and discontinued activities;
- the reporting of exceptional items; and
- the reconciliation of earnings to changes in reserves via recognised gains and losses.

These components are each considered in turn.
Acquired, continuing and discontinued activities

Table 3.1 summarises the evidence regarding the first of the financial performance components of FRS 3. It should be noted that all of the detailed evidence presented here for FRS 3 (including Table 3.1) is based upon interviews with analysts and not with fund managers. This is because it was found that the fund managers generally rely upon the analysts to generate earnings forecasts.

<table>
<thead>
<tr>
<th>Table 3.1  FRS 3 - acquired, continuing and discontinued operations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Analysts' response</strong></td>
</tr>
<tr>
<td>Should the performance of acquisitions and continuing operations be reported separately?</td>
</tr>
<tr>
<td>Should the performance of acquisitions be reported in the first year only?</td>
</tr>
<tr>
<td>Is there sufficient disclosure relating to discontinued activities?</td>
</tr>
</tbody>
</table>

The strong support for the FRS 3 requirement to differentiate the operating results of acquisitions from those of continuing operations was based upon a wish to assess like-for-like operating performance. In other words, analysts want to understand the ongoing performance of the existing business, as well as the independent effect on performance arising from an acquisition. Opinion was divided, however, over the appropriateness of FRS 3's requirement that the operating performance of acquisitions need only be shown in their first year. Seventeen of the analysts conceded either that second year disclosure would be misleading or difficult (due to the integration of acquisitions), or else that it would be unhelpful anyway because the value of the information was in locating the step change in activity, which is achieved by first year disclosure. In contrast, the remaining 15 analysts believed that second year disclosure was possible to achieve and that it would be useful in assessing the ongoing performance of the acquisition.
Two questions were asked regarding the disclosure of discontinued operations. The first was whether analysts believe that the level of disclosure is sufficient. As Table 3.1 shows, most believe that it is. The second question probed more deeply into the basis of disclosure. Specifically, analysts were asked if they approved of individual aspects of the definition of discontinued operations within FRS 3 (see Table 3.2). This question is important because the definition of discontinued activities determines (by default) which aspects of operating performance are reported as continuing, as well as those that are reported as discontinued.

In most cases, it turned out that the analysts were not actually familiar with the detail of FRS 3, such that the categories in Table 3.2 needed to be explained. As the table shows, however, there turned out to be strong support for the ASB's definition.

**Table 3.2** Aspects of the definition of discontinued activities within FRS 3

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Do analysts consider the definition appropriate?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Permanent or completed within 3 months of year end</td>
<td>27</td>
</tr>
<tr>
<td>Materially affects nature and focus of the business</td>
<td>27</td>
</tr>
<tr>
<td>Physically and operationally separable</td>
<td>22</td>
</tr>
<tr>
<td>Need not be a business segment (defined by SSAP 25)</td>
<td>30</td>
</tr>
</tbody>
</table>

These results have two implications. The first is that the definition of discontinued activities within FRS 3 is generally regarded as appropriate by analysts. The second, more general, implication is that the onus is on the ASB to ensure consistency between the actual content of financial reporting standards (such as FRS 3) and analysts' perceptions of that content. Otherwise, the market may make inappropriate use
of information. An example of this would arise if a company decided to discontinue one of its businesses. An analyst might assume that the business would be treated as discontinued, but the FRS 3 criteria might not accept it as such, causing the analyst to be misled.

**Exceptional items**

With regard to the second component of FRS 3 that was outlined above, only two of the analysts in the sample were opposed to the effective abolition of extraordinary items. The majority view was that extraordinary items had been abused by companies and also that, in any case, the distinction between extraordinary items and exceptional items was somewhat artificial from an analytical perspective. Again, these viewpoints imply that investors are concerned about whether they receive information, but they are indifferent to the form in which the information is received. In other words, it does not matter that something is classified as exceptional or as extraordinary, but only that it is disclosed in the first place.

The distinction between different categories of exceptional item was, however, perceived to be important, not least because these categories raise the issue of the level of information disclosure. This is shown in Table 3.3, which reports analysts' views on the inclusion or exclusion of FRS 3 exceptionals in normalised earnings.
Table 3.3 Exceptional items

<table>
<thead>
<tr>
<th></th>
<th>Do analysts include in normalised earnings?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Above operating profit:</strong></td>
<td></td>
</tr>
<tr>
<td>Recurring</td>
<td>32</td>
</tr>
<tr>
<td>Non-recurring</td>
<td>8</td>
</tr>
<tr>
<td><strong>Below operating profit:</strong></td>
<td></td>
</tr>
<tr>
<td>Reorganisation costs</td>
<td>13</td>
</tr>
<tr>
<td>Profit/loss on asset sale</td>
<td>4</td>
</tr>
<tr>
<td>Profit/loss on sale/termination of operation</td>
<td>2</td>
</tr>
</tbody>
</table>

The inclusion of items perceived to be recurring, and the exclusion of those perceived to be one-off (such as asset sales), suggests that analysts are seeking an underlying earnings measure for continuing trading operations. This observation is made notwithstanding the responses for reorganisation costs, which are the only area in Table 3.3 where analysts expressed ambiguity. This mixed response was explored in a follow-up question in the interviews. It was found that if reorganisation costs are perceived to be 'genuinely one-off', then they will be excluded from normalised earnings. If, however, a company reports reorganisation costs regularly, then they are more likely to be viewed as an ongoing cost and will therefore be included. This is an entirely sensible use of information. It is important, however, that the constitution and purpose of reorganisation costs (and of exceptional items generally) are properly communicated to analysts, which is a matter of additional disclosure by companies.

The encouraging evidence from the interviews was that 20 of the analysts believed that there was sufficient overall information disclosure regarding exceptional items, whilst only five believed that there was
not, and the remaining seven occupied the middle ground. This disclosure will not always appear in the annual report and accounts, but it will almost always form a central part of presentations to analysts at results announcements and, where necessary, it will be a focus for personal communication between an analyst and a company (see Holland, 1997, for a systematic elaboration of these channels of communication).

As a qualification on this evidence concerning the disclosure and interpretation of exceptional items, the interviews generated two further findings. First, it was clear that the analysts very rarely made adjustments from reported earnings to normalised earnings for anything other than exceptional items. Second, it was far from clear how exceptional items affect share prices if they are excluded from normalised earnings. Interview discussions suggested that, in cases such as 'big bath' provisions, they simply 'drop out' of the analysis. This implies that there is scope for creative accounting, because it gives companies an incentive to declare one-off exceptional debits but to avoid classifying similar one-off credits as exceptional. It also suggests a lack of concern amongst analysts for the value-relevance of changes in the balance sheet, other than those caused by normalised earnings.

**Recognised gains and losses**

The third and final component of financial performance in FRS 3 concerns full articulation of the profit and loss account and the balance sheet. In this context, a large majority of 26 of the 32 interviewees agreed with the statement that: 'The profit and loss account should be designed to reflect trading performance only, whereas the statement of total recognised gains and losses should incorporate all long term gains and losses.' This viewpoint is consistent with the (already identified) emphasis on underlying (permanent) trading performance, and it is also broadly supportive of the ASB's position. This said, however, it was only by a very small margin (and without much conviction) that analysts claimed to find the statement of total recognised gains and losses useful.
The components of the statement of total recognised gains and losses are at the very heart of a balance sheet approach to financial reporting, and they are generally regarded with caution and scepticism by those with a transactions perspective. As discussed in Johnson and Lennard (1998), its future is currently being debated at an international level. No consensus has yet emerged among the world’s leading standard-setting bodies, although a likely outcome is the emergence of a single, comprehensive performance statement. As a contribution to this debate, the evidence above may be interpreted in one of two ways. In support of a balance sheet approach, it may be that analysts would welcome a regulatory attempt to identify distinct components of financial performance. Alternatively, and in support of a transactions approach analysts’ indifference towards the components of the statement of total recognised gains and losses implies an exclusive interest in the profit and loss account. In the absence of expanded disclosure in the statement of total recognised gains and losses, therefore, in the absence of empirical evidence on analysts’ use of the statement, it is difficult to be conclusive with respect to either of these alternative interpretations.

Cash flow statement

The cash flow statement is relatively new in the UK, having been introduced by FRS 1 in 1991 (and revised in 1996). The perceived need for a statement of cash flows was prompted partially by the desire to harmonise with international practice (notably with Financial Accounting Standard (FAS) 95 in the USA and International Accounting Standard (IAS) 7). It was also a response to UK experience which suggested that the market paid insufficient attention to cash flows, particularly in the validation of reported earnings (a notable example of which was the collapse of Polly Peck - see Gwilliam and Russell, 1990).

FRS 1 positions the cash flow statement as secondary in importance to the profit and loss account, and it describes accruals as the primary foundation for forecasting financial performance. A supporting role for FRS 1 data is nevertheless needed in order ‘to reveal the leads and lags in historical cash flows,’ thereby improving users’ understanding
of the generation and absorption of the cash flows underlying earnings. Several distinct components of cash flow are distinguished in FRS 1, on the grounds that they are each of differential use to investors. The fundamental distinction between them is based upon the separation of capital from revenue, and of operations from finance. Hence, operations are sub-divided into operating activities, capital expenditure and acquisitions. Operating activities are reconciled to operating profit by either a direct method (as an input to a cash flow model) or an indirect method (as a check on earnings quality). Finance is sub-divided into capital flows and servicing payments, with the latter being given by both interest and dividends. The final category, taxation, is somewhat anomalous in that it is separately defined because it cannot be allocated satisfactorily amongst the other categories. At first sight, the distinction between capital and revenue in the context of operations is somewhat curious for a cash flow statement, because it implies differentiation based upon accruals. In practice, though, maintaining the same categories in the cash flow statement as in the balance sheet and the profit and loss account enables users to understand more directly how, and to what effect, accruals have been used. Similarly, users can see the cost of finance as that which is paid in addition to that which is accrued.

**Uses of cash flow data**

On the basis of this interpretation of FRS 1, analysts and fund managers were asked how important, in practice, were three ways in which the cash flow statement might be used. Each method of use was ranked in order of importance.
Table 3.4 Uses of the cash flow statement

<table>
<thead>
<tr>
<th></th>
<th>Rank in order of importance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Analysts</td>
</tr>
<tr>
<td>Assessment of liquidity/net debt</td>
<td>1.6</td>
</tr>
<tr>
<td>Assessment of earnings quality</td>
<td>2.1</td>
</tr>
<tr>
<td>Direct input to cash flow model (DCF or PCF)</td>
<td>3.0</td>
</tr>
</tbody>
</table>

The ranking in Table 3.4 was expanded upon by the analysts’ and fund managers’ explanations of how they use cash flow information. There was argued to be a close link between the assessment of liquidity/net debt and that of earnings quality, since both are concerned with the sustainability of growth. In the case of liquidity/net debt, the issue is whether free cash flow is sufficient to fund capital requirements. In the case of earnings quality, the assessment is whether reported earnings are supported by realised cash flows. So too, the cash impact of exceptional items, capital expenditure, and so on, are helpful incremental information with respect to future performance.

Less important is cash flow as a measure in its own right, which confirms FRS 1’s positioning of cash flow as a ‘secondary’ statement. As will be shown, the discounted cash flow model is not commonly used, mainly because it is perceived to be too sensitive to the assumptions that it makes. As already hinted, however, cash flow per share is routinely calculated and reported by analysts, mostly in support of a measure of normalised earnings. Quotes such as the following were typical:

*Cash from operations is the key line. It's helpful in dealing with the price-earnings ratio.*

*It (operating cash flow) is an alternative measure of profit and loss earnings.*
(The indirect method of) operating cash flow is easier to reconcile to (earnings) forecasts.

Table 3.5 reports that analysts' definition of cash flow per share typically mirror operating profit, with the exception that movements in working capital are included. This is consistent with the finding that the indirect method of presenting operating cash flow is preferred to the direct method by all but three of the analyst interviewees. The exclusion of capital items is, however, only partly due to the focus on comparability with earnings. It also reflects the one-off 'lumpiness' and difficulty in forecasting of capital items.

**Table 3.5 Definition of cash flow per share**

<table>
<thead>
<tr>
<th>Do analysts include in cash flow per share?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net working capital cash flow</td>
<td>19</td>
<td>5</td>
</tr>
<tr>
<td>Provisions utilised</td>
<td>21</td>
<td>3</td>
</tr>
<tr>
<td>Interest payments</td>
<td>23</td>
<td>1</td>
</tr>
<tr>
<td>Taxation payments</td>
<td>23</td>
<td>1</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>8</td>
<td>15</td>
</tr>
<tr>
<td>Acquisition expenditure</td>
<td>1</td>
<td>22</td>
</tr>
<tr>
<td>Income from disposals</td>
<td>2</td>
<td>21</td>
</tr>
</tbody>
</table>

The final interview question on cash flows asked if there is sufficient disclosure associated with each of the categories listed in Table 3.6.
Table 3.6 Cash flow disclosure

<table>
<thead>
<tr>
<th></th>
<th>Is disclosure sufficient?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Business segments</td>
<td>4</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>12</td>
</tr>
<tr>
<td>Provisions</td>
<td>13</td>
</tr>
<tr>
<td>Net debt / equity</td>
<td>17</td>
</tr>
</tbody>
</table>

The responses suggest some serious deficiencies in disclosure. The highest degree of dissatisfaction arises in the area of business segments, where additional information would be welcomed for a number of reasons. In particular, the differing cash profile of each business is vital to an understanding of the strategic management of the group. An example of this would be the financing and channelling of capital expenditure, or the decision to acquire or dispose of a business. In the context of both capital expenditure and provisions, a number of analysts do not believe that they have sufficiently detailed information to understand how, and to what effect, cash is spent. The following interviewee was probably more hopeful than realistic:

*I want to know if there's sufficient cover for interest, dividend, tax. And how cash is used and implications for strategy. A second question is whether returns are sufficient on this.*

Balance sheet

As a general statement, the balance sheet has emerged from this research as the least useful of the three main financial statements. For example, when the analysts were asked whether fixed asset values are (in themselves) useful information, not one believed them to be very useful, while 15 considered them of some use, 15 viewed them as of hardly any
use, and two had no use for them at all. The fund managers expressed similar views. This evidence is perhaps unsurprising. If information is regarded as useful by analysts and fund managers if it causes share prices to change, then the stability and predictability of balance sheet data makes it relatively unhelpful. An analyst might, for example, respond to news of capital expenditure (and the cash flow statement might be the reference for this), but there is little subsequent news in the systematic depreciation of the balance sheet value of the asset.

The relative indifference towards the balance sheet is also, however, manifested in an apparent lack of concern for the interaction between earnings and balance sheet values. This has already been seen with respect to the ‘dropping out’ of normalised earnings of non-recurring exceptionals. There was also little interest or support for the FRS 3 requirement that historical cost earnings should be disclosed whenever materially different from reported earnings. Indeed, most analysts seemed to be unaware of this requirement. Furthermore, there was considerable hesitancy and little conviction on the subject of goodwill. The analysts were asked which treatment they would prefer for purchased goodwill. Their expressed opinions were somewhat ‘forced’ and not strongly held. They were also mixed. Write-off to reserves was preferred by 15 analysts, while capitalisation and review was favoured by four and capitalisation and amortisation by seven. The remaining six analysts were indifferent between the three options. The majority preference for write-off was mostly based upon its simplicity and accepted usage.

The interviewees were also asked (hypothetically) if they would exclude the amortisation of goodwill in their calculation of normalised earnings, to which 18 said they would and 14 said they would not. Arguably, this difference of opinion shows that some analysts view goodwill amortisation as unrelated to trading performance, while others regard it as an appropriate charge to reflect the cost of an acquisition. An alternative interpretation is that there is no clear understanding of how to treat goodwill.

Finally, there was also mixed evidence on how goodwill should be treated in the calculation of return on capital employed. Of the 32 analysts, 15 claimed to add goodwill back to capital employed, while the other 17 took their totals directly from the financial statements.
(thereby leaving it written off). There was little indication of any other adjustments that are made to capital employed in deriving the return.

There are two ways in which to interpret the evidence of this section. The first is that the balance sheet is generally not an intrinsically useful statement from a valuation perspective. In turn, this suggests that we should not worry about getting the balance sheet 'right'. In contentious areas such as provisions, pensions and deferred taxation, it does not matter that assets and liabilities might not meet clearly defined and consistently applied recognition criteria. In short, analysts' and fund managers' indifference towards the balance sheet can be taken as de facto evidence in support of a transactions perspective. Alternatively, however, this argument can be turned on its head, in a way that supports the balance sheet perspective. It may be precisely because little attention has been paid in the past to getting the balance sheet right that low usefulness is currently perceived. With goodwill, for example, while there is little meaning in a write-off to reserves or in a partially amortised balance sheet value, it may be that (post FRS 10 and FRS 11) the balance sheet will convey useful information on impairment that would otherwise have been unavailable; and the same argument might be applied to pensions, provisions, financial instruments, and so on. 'Improving' the balance sheet might cause investors to pay relatively less attention to the profit and loss account, because it might enhance understanding of the information available from using both statements conjointly.

**Operating and financial review**

The OFR is the final important component of the report and accounts on which evidence is presented in this study. The OFR was the ASB's adaptation of the Securities & Exchange Commission's Management Discussion and Analysis, although it differs fundamentally in that it is not mandatory. It offers a sharply contrasting form of disclosure from the financial statements themselves, and it is designed to complement them by offering relevant information to the investor that is explanatory and forward looking. Whereas, for example, accounting
data are point estimates, the OFR can discuss risks and sensitivities; and while the accounts are constrained by the medium of historical transactions, the OFR can discuss likely future developments. The OFR recommends structured discussion of operating results, financial needs and resources, and returns to the shareholder. It is this formal structure of the OFR, together with its detailed recommendations, that give it much greater substance than either the Directors’ Report (which is only weakly guided by statute) or the rather anecdotal Chairman’s Statement. Against this, however, is the lack of objectivity that arises from information that is not audited and that is released at the discretion of the Board. An open question is whether the OFR is actually valued by users, given the strength of its scope but the weakness of its subjectivity.

The analysts were asked simply if they found the OFR to be a useful statement. Some did, and they expressed views (for example) that it indicated the ‘tone and mood of management’, that it provided ‘insight and extra information’, that it gave ‘management’s view of themselves’ and, simply, that it was ‘good to have’. Perhaps surprisingly, though, most were indifferent and considered that the OFR did not contain much information that was incremental to their extant knowledge of the company. In particular, there was a perception that the OFR shares with the rest of the report and accounts the burden of tardiness such that it does not contain useful information for investment decision-making. For example, the following two quotes were typical:

To be honest no, it’s not really useful at all. There’s nothing in it that we don’t know already.

By the time you get it, it’s old news.

The OFR was also considered to be something of a ‘glossy’ public relations exercise, with too much scope for subjective and selective disclosure. One analyst described it as ‘propaganda’, and another two commented as follows:

You’ll never find one that’s critical of the company! And there’s not much real news ... except you find some snippets sometimes.

Companies tell you what they want. They get around bad news.
In fact, only about one third of the analysts supported the OFR and approximately the same number were actually opposed to it. Most considered that the quality of disclosure varied. This evidence would appear to support the ‘doubts about the effectiveness of voluntary compliance’ that were identified by Weetman (1994) in her study of analysts’ and fund managers’ views of the OFR. This does not mean that the OFR is not a potentially very useful statement, but it does suggest that there is scope for improved effectiveness.

Summary

The evidence presented here suggests that differences between companies in the quality of their financial reporting are primarily a matter of willingness to disclose information. Neither analysts nor fund managers were unduly worried about creative accounting, as such, but rather with the amount of information disclosed. In this context, there was a broad consensus that, on the whole, there are no major deficiencies in disclosure.

Concerning the interpretation of accounting data, it was clear that the profit and loss account has a primary role over and above the other financial statements. It was therefore reassuring to find that the components of financial performance presented in FRS 3 are well directed towards users' needs. In particular, they are used effectively in deriving a measure of normalised earnings. It was, however, somewhat concerning that the interactions between the profit and loss account and the balance sheet appear not to be well understood, such that earnings are typically taken at face value. Likewise, the content and purpose of accounting standards appear to be 'assumed' by users rather than necessarily understood. It follows that the direction provided by the ASB on issues of recognition and measurement can have an important effect on users' interpretation of financial statement data.

Further evidence suggests that FRS 1 cash flow data is also well directed towards users' needs. In general, however, cash flow data is of secondary importance to earnings data. Meanwhile, the balance sheet is not used to the same extent as the other primary financial statements, and its indirect importance for earnings measurement is not
fully acknowledged. As might be expected from these findings, financial ratios derived from the profit and loss account are generally more important than those based upon the balance sheet.

The OFR is also of (perhaps surprisingly) limited use, primarily because it rarely adds to the existing knowledge of analysts and fund managers. This reinforces the importance of direct communication with companies, whereby the report and accounts serve, to a significant extent, to confirm what analysts and fund managers already know.

Endnotes:

1 See Barker (2000) for further analysis.
2 The term ‘earnings quality’ refers to the sustainability of reported earnings.
3 Note that the interviews took place while FRS 10 was still at discussion paper stage.
CHAPTER FOUR

RESEARCH FINDINGS: VALUATION METHODS AND INFORMATION FLOWS

The analysis in chapter three was concerned with how investors perceive and respond to specific items of financial statement information. So far, however, consideration has not been given to the analytical framework within which they subsequently use and make sense of accounting information in the specific context of equity valuation. This will be done here by reviewing the financial ratios, and the valuation methods used by investors.

A preliminary observation is that the financial statements can serve either or both of two roles. First, they might simply confirm what is already known, for example when reported earnings match analysts' earnings forecasts. Second, they can represent genuine news, for example when actual performance exceeds that which was expected. If the stock market works effectively, it is only in the second role that accounting information causes a revision in investors' expectations and, thereby, a change in share prices. This distinction between confirmation and news is important, because (as will be seen later) it affects our interpretation of the usefulness of accounting information.

Financial ratios

The evidence presented in chapter three suggests that investors place an emphasis on the profit and loss account in preference to the balance sheet. This is reinforced by Table 4.1, which reports analysts' questionnaire responses concerning the importance to valuations of a range of commonly recognised financial ratios. The responses were on a five-point scale, ranging from 'extremely important' (1) to 'not at all important' (5).
Table 4.1 Financial ratios (analysts)

<table>
<thead>
<tr>
<th></th>
<th>Rank in order of importance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest cover</td>
<td>3.3</td>
</tr>
<tr>
<td>Trading margin</td>
<td>3.5</td>
</tr>
<tr>
<td>Dividend cover</td>
<td>3.6</td>
</tr>
<tr>
<td>Gearing</td>
<td>4.2</td>
</tr>
<tr>
<td>Capital expenditure: depreciation</td>
<td>5.5</td>
</tr>
<tr>
<td>Net profit</td>
<td>5.7</td>
</tr>
<tr>
<td>Liquidity</td>
<td>7.4</td>
</tr>
<tr>
<td>Stock turnover</td>
<td>7.8</td>
</tr>
<tr>
<td>Debt turnover</td>
<td>8.3</td>
</tr>
<tr>
<td>Asset turnover</td>
<td>8.3</td>
</tr>
<tr>
<td>Credit turnover</td>
<td>8.6</td>
</tr>
</tbody>
</table>

This evidence suggests a general preference for income, expenditure or cash flow variables over balance sheet data. A good example of this is the higher ranking of interest cover relative to gearing. Both of these ratios may be interpreted similarly as measures of shareholders' exposure to debt obligations, but whilst interest cover uses profit and loss information, gearing is derived from the balance sheet. Equally, while the ratio of sales to gross profit (trading margin) ranks second in Table 4.1, the ratio of sales to net assets (asset turnover) ranks as low as ninth. An implication is that the importance of the return on capital employed (ROCE - see Table 4.2), which is a hybrid of the profit and loss account and the balance sheet, appears to rely more heavily on the former than on the latter. Finally, all of the working capital ratios are grouped together as being of least importance, which suggests that while the balance sheet contains useful information on capital structure and financing, asset values are less useful information.
Valuation models

A valuation model may be regarded as a means by which accounting information is related to share prices. By choosing to use a specific model, an investor is determining the way in which accounting information will be pulled together and analysed. The choice of valuation model is therefore of central importance to the role of accounting in share price determination.

The analysts and fund managers were asked to rate the importance of a list of valuation models, using a five-point scale. The list is not exhaustive, and there were three criteria for choosing models for inclusion. The first was a simple observation of the valuation models that appeared to be used regularly, both in analysts' reports and also in personal or in observed conversation. Second, use was made of the list selected in comparable academic studies, such as Arnold and Moizer (1984). Finally, some reference was also made to the valuation models commonly referred to in standard finance texts, such as Brealey and Myers (1996). The responses of both analysts and fund managers are summarised in Table 4.2.
Table 4.2 Preference for valuation models

<table>
<thead>
<tr>
<th></th>
<th>Average rank</th>
<th>Overall ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Analysts</td>
<td>Fund managers</td>
</tr>
<tr>
<td>Price-earnings ratio (PE)</td>
<td>2.6</td>
<td>2.9</td>
</tr>
<tr>
<td>Dividend yield</td>
<td>3.2</td>
<td>3.7</td>
</tr>
<tr>
<td>Return on capital employed (ROCE)</td>
<td>3.7</td>
<td>3.1</td>
</tr>
<tr>
<td>Price-cash flow ratio (PCF)</td>
<td>4.4</td>
<td>4.0</td>
</tr>
<tr>
<td>Sales/market capitalisation</td>
<td>5.7</td>
<td>5.1</td>
</tr>
<tr>
<td>Net asset value (NAV)</td>
<td>5.8</td>
<td>5.0</td>
</tr>
<tr>
<td>Discounted cash flow model (DCF)</td>
<td>6.4</td>
<td>7.0</td>
</tr>
<tr>
<td>Technical analysis</td>
<td>7.2</td>
<td>7.6</td>
</tr>
<tr>
<td>Dividend discount model (DDM)</td>
<td>7.5</td>
<td>8.0</td>
</tr>
<tr>
<td>Beta analysis</td>
<td>8.4</td>
<td>8.8</td>
</tr>
</tbody>
</table>

There are four important, general observations that can be made from Table 4.2, each of which will now be explored in some detail.

A shared approach

The first observation is the remarkable similarity in rankings between the responses for analysts and for fund managers. This finding, which is consistent with Moizer and Arnold (1984), is all the more striking when it is recognised that the two samples are entirely independent of one another. The obvious implication is that both analysts and fund managers share a common approach to valuation, which includes similar perceptions of the usefulness of accounting information. In turn, this may be regarded as evidence of strong inter-dependence in the working
patterns of the two groups – for example, analysts’ reports influencing fund managers’ behaviour, or both groups being influenced by ‘generally accepted’ valuation methods. Viewed in this light, the similarity of responses remains striking, though perhaps it is not surprising.

There is a notable (albeit small) difference in rankings between analysts and fund managers, which is that ROCE is relatively more important to fund managers. This might be explained in the context of the different economic incentives of the two groups. ROCE may be viewed as a stewardship measure. It reflects the cumulative historical performance of a company, especially when assessed over a number of periods. It, therefore, forms a basis for a credible record of stewardship, which may give fund managers confidence in making an investment. This is important because a fund manager’s holding is illiquid (or at least costly to divest), and also because underperformance is both highly visible and very costly for a fund manager, which naturally leads to caution underlying investment decisions. In contrast, analysts do not actually invest on their own account and so have less need for such ‘historical confidence’. For them, the lack of forward-looking information in the ROCE makes it of lesser interest, because it is not obviously related to future changes in share price.

**Primacy for the price-earnings ratio**

The second important observation from Table 4.2 is that, for both analysts and fund managers, the price-earnings ratio (PE), dividend yield, ROCE and price-cash flow ratio (PCF) are significantly more important than all other valuation models. This finding expands upon (while being consistent with) the evidence from earlier studies that was reviewed in chapter two.

The PE ratio, in particular, is the preferred basis of valuation for both analysts and fund managers. This is consistent with the greater emphasis outlined earlier on the profit and loss account over the balance sheet. It is also consistent with the evidence on financial ratios, because a primary role for interest cover and for trading margin accords with a focus on the riskiness and the sustainability of earnings, respectively. Both ratios are therefore directly relevant to the PE ratio. Similarly,
Table 4.1 also showed that the level of dividend cover is an important financial ratio. This finding is consistent with the importance shown in Table 4.2 for the dividend yield. Also of note is that net asset values are not ranked highly in either table and that working capital ratios, which do not have any direct relevance to valuation models, are shown in Table 4.1 to be of little importance.

A further observation regarding the PE ratio is that the evidence suggests that it is very much more important than the price-cash flow ratio. This is an encouraging finding for financial accounting because it implies that accruals provide useful information over and above cash flows. In spite, therefore, of the overall conclusion that the balance sheet is of little direct use, it is clear that the balance sheet must be of indirect use because it is a means by which income and costs may be deferred or anticipated in order that cash flows can be converted into earnings. Such an argument is, of course, the basis of the transactions approach that was outlined in chapter one, and the evidence therefore appears supportive of this viewpoint. This might, however, be taking the evidence a little far. After all, the balance sheet approach does not deny the usefulness of earnings, and it is not inconsistent with the dominance of the PE ratio as a valuation model. Moreover, it would certainly support the PE ratio over the price-cash flow ratio. The difference between the transactions and the balance sheet approaches may be characterised as a different perspective on how to derive earnings, and not a different perspective on how to use an earnings figure once derived. The evidence here on valuation model preferences cannot, therefore, be taken to provide conclusive support for one approach over the other.

**Limited role for discounting models**

The third observation from Table 4.2 is that the discounted cash flow (DCF) model, technical analysis, dividend discount model and beta analysis are all of very little practical importance as a means of valuing shares. This might seem a surprising result. A basic knowledge of finance theory or, indeed, an endorsement of recent valuation methods such as shareholder value analysis (Rappaport, 1998) and economic
value added (Stewart, 1991) would lead us to expect that the market should systematically forecast future cash flows and then combine these with an estimate of the cost of capital in order to derive value. Yet this does not seem to be the case. The dividend yield valuation model, which uses only single-period dividends (together, perhaps, with a simple assumption of growth and risk) is very strongly preferred to the dividend discount model, which is theoretically much stronger because it is not forced to make simple assumptions. Equally, the use of cash flow information appears puzzling at first sight. The PCF ratio is a very simplistic measure. In contrast, the informationally-richer DCF model is an extremely versatile and (in principle) accurate and theoretically defensible valuation method. Yet the PCF ratio is preferred to the DCF model. Equally, beta analysis, which is fundamental to the calculation of the cost of capital (and therefore to present value) is not considered to be important by either analysts or fund managers.

In fact, very few of the analysts, and even fewer of the fund managers, actually calculated a cost of capital for their shares. For the fund managers, an assessment of the riskiness of one share relative to another is best described as an implicit, subjective aspect of the valuation process. It is not a separate and explicit consideration in and of itself. Beta, which was regarded as an unhelpful, historical measure, was rarely distinguished conceptually from price volatility. More important at the market risk level are considerations of market sentiment and liquidity of holdings, which are factors that affect market exposure, while at the level of business risk, fund managers referred variously to risk factors such as: expansion into new markets; changes in management; acquisitions; balance sheet and cash flow strength; earnings volatility; economic cycle exposure; and also the fund managers' own understanding of a company and trust in its management. In other words, 'risk' is a subjective assessment of any factor that makes business performance uncertain to the fund manager. It is inseparable as a concept from the overall assessment of value and it is certainly not something that fund managers explicitly monitor for one share relative to another.

These findings were very general, as is illustrated by the range of responses below from the interviewees:
I don't use the discounted cash flow model because fund managers don't buy and sell on this basis. It (valuation) is intuitive not quantitative anyway. You don't need a twenty-five year model. The quality of information post two years is rubbish anyway.

The sensitivities are enormous, especially to revenue. So I don't bother (with the discounted cash flow model) ... but it's becoming more common I think.

We don't (value long-term capital expenditure). It's difficult to do. We use a higher than average price-earnings ratio. And it needs to be visible on earnings. Not one-off but something that's real.

Yes (uses the discounted cash flow model) ... no, it's not that useful to be honest ... the assumptions are too sensitive ... (though) it's interesting ... can suggest interesting thoughts.

(Capital expenditure) has a 'woolly effect ... it changes the price-earnings ratio a little ... eg Terminal 5 (Heathrow) is already in the price somewhat.'

More than one valuation method in use

The fourth, and final, observation is taken from Table 4.2 and also from follow-up interview questions with both analysts and fund managers. It is clear that valuation models are perceived to be important in the context of one another, and not just in isolation. This applies equally to financial ratios such as dividend cover or gearing. Fund managers, in particular, claimed to evaluate a range of valuation indicators on an exception basis. If, for example, the ratio of capital expenditure to depreciation is low and the price-earnings ratio is high, then these might be considered conflicting indicators of expected growth rates. As such, they would signal a need for further investigation. Generally, while there was variation in the specific indicators that any given analyst or fund manager claimed to use, there was a degree of consistency
between fund managers within a specific firm which contrasted the more individualistic approach of analysts.

**The dynamics of valuation**

Valuation models provide a bridge between a record of the past, which is given by accounting information, and an expectation of the future, which is summarised in the share price. The dynamics underlying the use of historical data for valuation are summarised in this section. The cycle of valuation behaviour will be reviewed. This cycle comprises the receipt and interpretation of accounting data, the revision of forecasts in the light of the data, the use of valuation models to underpin ongoing share valuations, and (coming full circle) the receipt of the next set of accounting data and the next round of confirming and/or revising forecasts and expectations.

It is first important to focus on the context within which analysts and fund managers make use of accounting information. For the fund managers it is very clear that their objective is to maximise portfolio returns relative to those achieved by the competition (or, more simply, by a stock market index). The performance of fund managers is very transparent and it is monitored frequently. In contrast, the objectives of analysts are rather more subtle. An analyst needs to be able to understand the industry, to interpret the importance of news items within the industry (such as an oil discovery, a pending law suit, the impact of a merger on competition, and so on), and the analyst must also be able to 'sell' information to clients in order to persuade them to trade. In these activities accounting ability is not necessarily important. Any given analyst may have a core competency in technical knowledge of the industry, or in salesmanship, rather than in accounting. It is commonly assumed by the accountancy profession that analysts should have at the very least a minimum of understanding of accounting, and that they should really have much more. But there may in fact be little incentive or benefit in this. If accounting information is to be reflected correctly in share prices, then this does not require that all analysts are able to interpret all of the complexities of accounting. It could, in principle, be achieved by having only a single 'accounting expert' within any given
market sector. More important, perhaps, is that the analysts' community should have within itself a balanced range of expertise. We would not, for example, wish Glaxo Wellcome to be valued by accountants with no specialist knowledge of pharmaceuticals, but neither would we wish to have pharmacologists interpreting earnings quality.

In this context, a striking research finding was the absence of *ex post* monitoring of earnings forecast accuracy carried out by analysts' firms. There was no perceived need for monitoring because the ultimate performance target of the analysts was the value of sales commissions generated, which (for two main reasons) was not directly related to forecast accuracy. First, there was rarely much divergence between any given analyst and the consensus forecast, such that accuracy was not in itself a unique selling point. Second, the perceived usefulness of the analyst's service was not considered to be closely correlated with (short term) forecast accuracy *per se*, but rather with the 'quality' of advice to fund manager clients, which concerns useful information beyond the short term forecast horizon. These two factors serve to reinforce the point that, while the analysts undoubtedly attached great importance to earnings news, their work environment was such that earnings information was but one of many areas of attention. In other words, while the price-earnings ratio may be dominant as a method of valuing shares, this does not imply that analysts focus on it exclusively.

**Corporate results announcements and price-earnings ratios**

All this said, though, it was clear that the corporate results announcement is an extremely important event in the analysts' calendar. Most public companies report earnings twice a year, in the form of interim and preliminary statements to the Stock Exchange, and both of these announcements are associated with a flurry of activity. The analysts' response to the announcements is broadly consistent across firms and also across stock market sectors, and a convenient way to summarise it is in the form of a 'results day diary', as follows:
Table 4.3 Analyst's diary for a typical results day

(Previous Day) In advance of a specific set of results, the analyst will often prepare a report for circulation to clients, together with a briefing for the in-house equity sales desk.

7.30 am Immediate response to the results announcement as it arrives electronically via the stock exchange. Results statement printed out and skimmed over for evidence of any surprises - notably: are earnings in line with forecast? are there any news announcements? are recent trading conditions in line with expectations? are there any unexpected provisions? etc. In the light of this cursory examination, the analyst might make 'quick and easy' adjustments to reported earnings.

7.45 am The analyst progresses as quickly as possible to broadcasting the results news to all concerned within the firm. The mechanism for this is a microphone in the middle of the trading floor. The analyst will always report actual earnings against his or her own forecast (though differences are rarely large). Further, in order to assess any likely price effect, the analyst always declares whether his or her forecast was high or low relative to the consensus. Then, the analyst conveys what are considered to be the salient news items in the announcement, such as a trading update or a proposed restructuring. This may take up to five minutes, and rarely longer.

8 am The analyst (together with the sales team) then attempts to beat the competition in being first to break the news to fund manager clients. There is a prepared list of client contacts, which is systematically worked through. There is a close working relationship with some fund management firms, but not with others.
10.30 am The company's open meeting in the City with all analysts. Here the pace slows down a little, mostly because most of the news will by now have been absorbed by the market. What follows is simply a 'fleshing out', with some limited scope to extract further useful information. Typically, the chief executive and the finance director of the company formally present and explain their results. This is followed by approximately a dozen questions and answers. Questions to the company tend not to be too insightful, not least because of the listening ears of competitor analysts. In the context of earnings, the focus of questions is on understanding exceptional items, provisions or other items that might affect earnings 'quality'.

Lunchtime and afternoon The rest of the analyst's day is taken up with client contact, report preparation and direct phone contact with representatives of the company itself.

Early evening A report is written summarising the results, for circulation to clients the following day.

The analysts' rapid reaction implies a very narrow time period within which the market adjusts to the receipt of new public domain information. The apparently superficial adjustments that analysts initially make to reported earnings are consistent with this speed. They are in line with the IIMR's (1993) statement on headline earnings, which argues that the market needs a quick and approximate earnings measure as a basis for an immediate share price reaction.

Once the initial market reaction to earnings is over, historical earnings information simply becomes one of a number of inputs to earnings forecast revisions. In turn, the revised earnings forecasts are analysed in the light of the revised PE ratios that they generate. The analysts explained that the PE ratio's importance as a valuation model is because it is a quick and simple means of summarising the growth potential of one share relative to another (or, indeed, relative to the sector or to the market). In addition, it is a widely used measure, and because
fund managers are familiar with conversations that have a PE ratio focus, it is sensible for analysts to sell their services within a PE ratio framework. A few quotes from interviewees will illustrate this:

*Despite criticism of earnings per share, it (PE) is the most used basis for analysts and fund managers. There’s a simplicity to it, it works intuitively.*

*It’s the way the market works, unfortunately.*

*Everyone knows about it (PE). It’s user-friendly, it’s accepted. Stocks trade on earnings, not on net asset values. The historical range, growth relative to market, defensive versus growth status ... they’re all in there.*

There was a strong consensus regarding the way in which the PE is used. For any given company, it is analysed both relative to its own history and relative to the sector (and the market) on both historical trading ranges and, in particular, on a prospective one and two year basis. The analyst is trying to reconcile the relative PE ratio on any one of these dimensions with his or her own, mostly subjective assessment of the risk and growth prospects for the company. Although the PE ratio can, in principle, be disaggregated into a measure of earnings growth and a measure of risk, it was clear that it is not in practice handled in this way. Rather, its use is as a convenient, summary measure that is subjectively assessed and interpreted.

The importance of the PE ratio to fund managers is similar to that for analysts. When asked specifically about the valuation usefulness of the PE ratio, however, fund managers were almost exclusively unforthcoming. Certainly, not one of them was a strong advocate of the PE ratio, and most defended its use on two grounds: firstly, it is used because the market uses it and it cannot therefore be ignored and, secondly, it is only used in conjunction with other valuation indicators and never in isolation. Otherwise, fund managers' use of the PE ratio is very similar to that of analysts. An example of its use would be to indicate whether or not the market had discounted the growth prospects that the fund manager is anticipating. In this case, the difference between the historical and prospective relative PE ratios
would be compared (usually qualitatively) with the company's relative short-term growth prospects.

It is clear, however, that the assessment of the PE ratio is not 'scientific' and it is not analysed as a composite measure of earnings growth and risk. It is viewed as a subjective indicator and not an objective measure. This subjectivity is also evidenced in the determination of the earnings denominator. While there is a general recognition that the PE ratio should be founded on normalised earnings, fund managers do not hold strong views regarding the means by which normalised earnings might be measured. In particular, when asked which categories of FRS 3 exceptional items they like to see included or excluded, their answers tended to be imprecise. A typical response was that, over the longer run, exceptional items (such as reorganisation costs) are a cost of doing business, and that they should, in some way, be borne in mind; and while they might be excluded for the purposes of deriving the PE ratio, this reflects the reality that the PE ratio can only be seen as one of a range of valuation indicators. This is linked to the fund managers' view that the PE ratio is important because the market uses it. In this context, the analysts' consensus earnings forecast is a useful basis for the PE ratio calculation, which itself partly explains the fund managers' relative lack of direct interest.

**Dividend yield**

An important valuation model which fund managers use in conjunction with the PE ratio is the dividend yield, and there are important parallels in the way in which each model is used over time. Not least, there was a high degree of consistency between analysts and fund managers in the way that dividend information in used in valuing shares. As with the PE ratio, the information contained in the trend of past and current dividends is the basis for dividend forecasts, which are typically made over a two-year horizon. The forecasts reflect company-specific dividend policy, balanced with an estimation of growth. For valuation beyond the two-year horizon, both analysts and fund managers rely mostly on subjective judgment rather than on quantitative analysis. In this they focus on those factors considered
to be determinants of longer-term outperformance which, within any given industry, are represented most strongly by the 'quality' and shareholder focus of incumbent management. Generally, the dividend yield is more important for stock market sectors with characteristics such as maturity, non-cyclicality or short-term earnings unpredictability (such as utilities or financials).

For both analysts and fund managers, the subjective assessment of the prospective dividend yield relies heavily upon direct, personal contact with company management. For analysts, the contact is rather ad hoc, whereas for fund managers it takes the form of routine, carefully-planned meetings. The fund managers' meetings are generally conducted within a constructive atmosphere where companies are communicating openly with their major shareholders (Myners, 1995). The meetings address a whole range of factors that are determinants of future dividends, that are mostly subjective and strategic in nature, and that are specific to the company in question. These factors fall into one of two broad types:

- the evaluation of strategic variables such as product-market conditions, the macroeconomic environment and the company's strategic plan; and
- the assessment of the ability of management to achieve good corporate performance.

Neither factor is particularly accounting focused. The qualitative nature of the information discussed in these meetings arises partly because of insider dealing regulations (see, for example, Holland and Stoner, 1996 and Marston, 1996). More fundamentally, however, it arises because there is genuine uncertainty with respect to future business performance, and because there is a general perception that little can realistically be achieved by way of quantifying the future.

Importantly, the evaluation of information at fund managers' meetings with companies is made on a dynamic basis. This means that any given meeting will incorporate implicit 'contracts' (or 'promises') made by management, which will be the subject of review at subsequent meetings and which will form the basis of the strength and credibility of subsequent implicit contracts. The reliability of these contracts,
together with their implied future payoffs, is of critical importance to fund managers’ investment decisions. The role that accounting plays in this process is in verifying past performance and in acting as a basis for extrapolating performance into the future.

Summary

The evidence presented here suggests that analysts and fund managers share a similar approach to valuation, implying similar demands for accounting information. The PE ratio is the most important valuation model, reinforcing the importance of earnings. In contrast, discounted cash flow models are generally perceived to be unhelpful, given the difficulty of forecasting an uncertain future. Indeed, when set into context, accounting information is less important than forward-looking information such as corporate strategy and perceptions of managerial ability. This seems to suggest a limited role for financial statement data in equity valuation, although there are actually good reasons to support the opposite conclusion. In particular, if investors have limited information with which to assess the future value-creation of companies, then this increases the importance of the information that they do actually have. In this context, unexpectedly good or bad earnings performance can have very significant effects on a company’s share price.

In general, there are two distinct roles over time for accounting information. The first is in bringing new information to the stock market. The importance of this for share prices is confirmed by the analysts’ rapid and focused response to results announcements. The second role is in confirming (or refuting) expectations of financial performance. This is extremely important because investment decisions are not one-off but are revised over time, often on the basis of continuous direct communication with companies themselves. Financial statement data are therefore important not only when they cause revisions in share prices, but also when they confirm investors’ existing views of a company’s value.

Endnote:

1 See Barker (1999, a and b) for further analysis.
CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

There have been widespread calls for significant changes to the content and mechanism of financial reporting (eg ICAS, 1999). While this need for change is not in doubt, it is reassuring to be reminded that, even in its present form, accounting information is important to institutional investors. For example, this report presents evidence of the usefulness of accruals in the form of investors' preference for earnings-based valuation over cash flow-based alternatives.

In general, accounting information is important to the stock market in two contexts. The first, which relates primarily to stockbrokers' analysts, is the corporate results announcement. This is the time at which accounting 'news' changes investors' expectations about future returns, with a direct effect on share price. The second, more subtle, role for accounting information relates primarily to fund managers. It is a confirmatory role, whereby the financial statements underpin fund managers' confidence in the credibility of information conveyed during their ongoing cycle of meetings with corporate managers.

Disclosure and presentation

In the context of the role of accounting information in bringing news to the stock market, the profit and loss account is very clearly the dominant financial statement. It is seized upon by analysts as soon as it is released in the results announcement, and it supports the most important of valuation models, the PE ratio. In this environment, FRS 3 (ASB, 1992) is well designed for its purpose. It allows users to identify quickly and easily the major components of financial performance, ensuring that profit and loss account information is used
effectively in the derivation of normalised earnings. Likewise, FRS 1 (ASB, 1991) supports users' needs for clear and simple presentation, and it is effective in conveying information concerning financial position and earnings quality. In contrast to the profit and loss account and the cash flow statement, the balance sheet performs a very limited role in bringing new information to the stock market, and it is regarded as the least important of the primary financial statements. Likewise, the statement of total recognised gains and losses is of clearly secondary importance to the profit and loss account. The OFR, too, is regarded as bringing little new information relevant to the determination of share prices.

**General recommendation** — The ASB should extend further its improvements in the disclosure and presentation of financial statement data.

Specific recommendations:

- The OFR would benefit from more regular, more highly segmented and mandatory disclosure, and also from audit.
- Analysts would benefit also from the identification of further components of earnings and cash flow performance, including extended segmental disclosure.
- Effort could usefully be applied to understanding and attempting to resolve differences across companies in the amount of information that they disclose.

**Recognition and measurement**

Superficially, at least, accounting information appears to be used well by investors, although underlying issues of recognition and measurement are probably not very well understood. An implication is that accounting standards dealing mainly with disclosure and presentation must be viewed differently from those dealing with recognition and measurement. Indeed, both analysts and fund managers were surprisingly
unconcerned about issues of creative accounting, and both seemed to have a limited understanding of the impact on the profit and loss account of the many and varied recognition and measurement decisions underpinning the balance sheet. Moreover, the evidence is that neither analysts nor fund managers can reasonably be expected to be diligent readers of accounting standards.

This is important to the news role of accounting information because investors appear to rely upon earnings as an effective measure of periodic economic performance. The underlying basis upon which earnings are measured must therefore be such that investors are not misled. Equally, the confirmatory role of accounting requires the financial statements to give a reliable picture over time of a company’s actual performance against its expected performance. Here, too, issues of recognition and measurement are fundamental, and the onus is on the ASB to ‘get them right’.

Strict adherence to a balance sheet approach does not address directly the problem of earnings measurement. Rather, earnings simply ‘drop out’ after the values of assets and liabilities have been measured. If, for example, assets are conservatively valued and incompletely recognised, while liabilities are conservatively recognised in full, and if assets and liabilities must both be ‘true’ rights and obligations regarding future economic benefits (as required by the Statement of Principles), then the economic meaning of the resultant earnings measure is not clear. There is, therefore, a danger that the balance sheet approach leads to an inappropriate earnings measure for use either in PE ratios or, more generally, in the measurement of economic performance and the extrapolation of future performance.

This said, however, it is likely that the use of market values in the financial statements will lead to earnings being a more meaningful measure of economic performance, since gains and losses are more likely to be recognised in the time periods in which they occur. If, given the findings of this study, the role of accounting information rests upon the effectiveness of earnings as a measure of economic performance, then it is these fundamental and complex issues that determine the relative merits of the balance sheet and the transactions approaches to the conceptual framework.
**General recommendation** — Wherever there is a conflict between, first, the profit and loss account recording correctly a company's financial performance and, second, the balance sheet stating correctly a company's financial position, accounting standards should favour the former.

Since earnings play a primary role in equity valuation, so too they should be more of a focus for the ASB. Issues of the recognition and measurement of assets and liabilities have direct implications for the measurement of earnings which, in turn, have direct implications for equity valuation. It is essential to recognise the importance of the ASB in determining the basis of measurement. Analysts and fund managers do not themselves have access to the underlying data behind financial statement measures, and neither are they necessarily expert readers of financial reporting standards. The ASB must therefore aim to maximise the economic relevance of the aggregate data that is reported in the profit and loss account.

In summary, presentation and disclosure standards such as FRS 1 (ASB, 1991) and FRS 3 (ASB, 1992) have been effective. Recognition and measurement standards such as FRS 10 (ASB, 1997), FRS 12 (ASB, 1998b) and FRS 15 (ASB, 1999b) are more difficult to judge. They lie at the heart of the conceptual framework debate between a balance sheet approach and a transactions approach. It cannot be expected that institutional investors themselves should be the arbiters of this debate. Rather, it is the responsibility of the ASB to prescribe a measure of earnings that best captures the economic performance of a given period. To a large extent this is consistent with a balance sheet approach, combined with effective delineation of the components of financial performance. It qualifies the balance sheet approach in favour of a transactions approach, however, to the extent that ‘getting the balance sheet right’ compromises earnings measurement. The statement of principles can therefore be regarded as a sound framework, but not as an all-encompassing guide. Further research is needed to address the complex issue of whether the ASB's impact on financial reporting has been to generate a measure of earnings that better captures economic performance. If this has been achieved, then users' needs have been better met.
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References


INSTITUTIONAL INVESTORS,
ACCOUNTING INFORMATION
AND THE ASB

How do institutional investors use accounting information? This is the research question addressed in this report. It is highly topical in view of the considerable changes made to financial reporting by the Accounting Standards Board (ASB). These changes have been motivated by a ‘user’s perspective’, and the ultimate test of their effectiveness must be whether or not investors are better enabled to use accounting information in investment decisions.

While the ASB is responsible for designing accounting standards, and companies and auditors are responsible for implementing them, there exist few feedback mechanisms whereby the effectiveness of the standards can be assessed. In other words, if institutional investors are the ‘customers’ of the ASB, then it is difficult to know whether or not the customer is satisfied. This research report published by the Research Committee of The Institute of Chartered Accountants of Scotland aims to provide some feedback. It provides evidence from institutional investors on their use of accounting information and draws implications for the design of reporting standards and the role of the ASB.

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