

How is GAAP information used?

Apart from theoretical equity valuation models, relatively little is known about how investors actually use accounting information in the investment evaluation process. However, there are a few exceptions and the papers we are going to examine here are all concerned with how analysts use accounting information. The general thrust of the results suggest that the role of accounting information in investment decisions is limited; information not contained in the annual accounts is also important. The implications of these results might suggest that:

- analysts use accounting reports inefficiently;
- accounting reports need to re-focus to reflect investor usage.

The papers to be considered here are:

Bouwman, Frishkoff and Frishkoff in Accounting Horizons, December 1995

Barker, Accounting & Business Research, Spring 2000

Breton & Taffler, Accounting & Business Research, Spring 2001

Bouwman, Frishkoff and Frishkoff, “The relevance of GAAP based information: a case study exploring some uses and limitations”, Accounting Horizons, December 1995, 22-47.

The paper is a study of 20 financial analysts who examine an unfamiliar NYSE listed company. The analysts were asked to think aloud during the investment appraisal and their thoughts were recorded.

The task selected was the initial evaluation of a stock, the [screening process](#) and takes about an hour. This task is important because many stocks do not make it to the next round, which is a full analysis taking about a week and involving site visits and detailed discussions with management. The study (obviously) does not investigate whether GAAP information is used at the full analysis stage either to corroborate management information or as part of the company valuation process.

1. The experimental setting

Analysts were given a 79 page case pack containing both GAAP and non GAAP information. Specifically, the material covered:

GAAP information:

- sales
- net income
- balance sheet
- cash flows
- segment information
- quarterly information

Ratios on:

- profitability

leverage
liquidity
turnover

Non GAAP information about
the company
the segments
the management
management projections
stock price
dividends

2. The screening task

The screening task consists of 4 activities:

- 1 familiarising information search aimed at getting familiar with the company, getting a feel for the nature of the prospective investment
- 2 exploring directed search behaviour which has specific objectives, such as identifying the ages of key managers and the trend in cash and earnings performance
- 3 scanning a superficial review of the company, looking for something unusual (either good or bad)
- 4 reasoning reviewing and integrating the evidence they have identified

3. The role of information in the first 3 stages

The relative importance of financial statements, financial ratios and non GAAP information in the first 3 stages of the screening process is given in their Table 1, which is summarised below.

Information usage during the first 3 stages of the screening process			
	Familiarising	Exploring	Scanning
Financial statements	46%	38%	48%
Ratios	24%	13%	8%
Non GAAP information	30%	49%	44%
	100%	100%	100%

The table shows that financial statements are relatively more important in the familiarising and scanning stages, which are rather indirect and non-specific tasks. In the exploring stage, when specific questions are asked, accounting numbers are less important.

The use of ratios decline as the process goes on.

Non GAAP information is more important during 2nd and 3rd stages.

4. The role of information during the reasoning stage

The reasoning stage is the one in which the analysts review and integrate the evidence they have identified. This means that information mentioned by analysts here is actually considered in the investment screening decision.

Information usage during the (4th) reasoning stage	
Financial statements	27%
Ratios	11%
Non GAAP information	62%
	100%

This shows clearly the importance of non GAAP information.

5. Some implications

All the discussion must be subject to the caveat that the paper considers only one aspect of the investment decision, the screening process. However, since the next process (full analysis) involves site visits and detailed discussions with management, it is likely that GAAP information will not be used at the later stage.

One implication might be that accounting measures need not be too precise, since it is used for non specific purposes. There has been some discussion in the UK professional press¹ that perhaps shareholders might be given shorter financial statements, with the full accounts being used for the public filing.

Another implication might be that agreement on international accounting standards could be easier, and that the standards could be suitable for a wide range of economies.

¹ Ron Paterson, Accountancy, June 2000, p107.

Richard Barker, “FRS3 and analysts’ use of earnings, Accounting & Business Research, Spring 2000, 95-109.

1. The sample and approach

The study consisted of 2 parts:

- the author being an observer for one month in a stockbroking firm employing 40 analysts;
- conducting semi structured interviews with 32 analysts from 6 different stockbroking firms.

The results presented as Tables relate to what analysts thought about the particular provisions of FRS 3 Reporting financial performance (for example, the definition of discontinued activities). The most interesting results, from our perspective are reported as general impressions from being with the analysts for one month, during all their working hours. Although this evidence is more subjective than is typical in research reports, it needs to be taken seriously. It is difficult to imagine that the researcher significantly misunderstood the situation.

2. The results

I - THE ROLE OF THE ANALYST

The role of the analyst when annual earnings are announced is to interpret the results in the context of the industry and the economy. This interpretation includes adjusting or normalising earnings. These generally are consistent with the IIMR’s statement about headline earnings. A formal way of expressing this is to say that analysts try to identify transitory and permanent components of the reported performance.

II - FORECAST ACCURACY

Since there is little divergence from the consensus forecast, forecast accuracy is not a major selling point. It is the quality of the interpretation which is important. For example, within the firm there is no ex post review of the accuracy of the forecasts. This ties in with what we know about the herding of forecasts (see for example, DeBondt & Forbes, European Financial Management, 1999, vol5(2), 143-163).

III - THE IMPORTANCE OF EARNINGS

The announcement of earnings is an important event because it needs to be explained. But after that, it seems to have little implications for the future beyond revision to the forecast of next year’s earnings. Earnings seems to perform the standard function of a public (noisy) signal which impacts on private beliefs. However, once it has been “explained”, then it has little impact on future price changes. This seems to be consistent with the underreaction literature (see for example, Abarbanell & Bernard, “Tests of analysts’ overreaction/underreaction to earnings information as an explanation of anomalous stock price behaviour”, Journal of Finance, July 1992).

The intricacies of accounting measurement are not a priority for analysts. They have a basic understanding, but other analytical tools (such as micro/macro economics and the technology of the industry in which the company operates, for example) are probably more important.

IV - THE IMPORTANCE OF THE BALANCE SHEET

The keen interest in earnings is matched by a fair indifference to the balance sheet. This is what might be expected from analysts trying to estimate the sustainable cash flow of the company. It seems to contrast with the IASB's concern with assets and liabilities as the building blocks of financial reporting.

Breton & Taffler, "Accounting information and analyst stock recommendation decisions: a content analysis approach", Accounting & Business Research, Spring 2001, Vol 31(2), 91-101.

The purpose of the paper is to identify the themes about the company which distinguish Buy reports from Hold and Sell reports written by analysts.

1. The sample and data

The sample was 105 full text reports which were taken from the 1989 & 1990 summary books of 5 of the top London brokerage houses.

5 themes were identified in the reports by the use of particular words. Examples of the words associated with each theme are illustrated below.

Themes	Examples of words associated with the theme
Growth	Growth, addition, investment, merger, acquisition
Management & strategy	Management, productivity, innovative, objective, restructuring, leadership
Profitability	Profit, earnings, results, margins, losses
Financial position	Equity, gearing, capital, debt, liquidity, dividends
Market conditions	Market, demand, volume, orders, contracts, customers.

In addition, when a word was found which identified a theme, a classification was made as to whether the theme was referred to in a positive, neutral or negative context. For example, the phrase "disappointing results" was classified as mentioning a profitability theme in a negative manner.

Therefore at the end of the data assembly part of the project, each analyst report was examined for 15 aspects (5 themes by 3 contexts). Therefore all of thematic comment of analysts was classified in to these 15 aspects.

2. Is there a difference between Buy, Hold and Sell reports, with respect to these 15 aspects?

I - UNIVARIATE ANALYSIS

Taking each of the 15 aspects in turn, a test was undertaken to see if the aspect was mentioned with a different frequency across Buy, Hold and Sell reports. Only 3 aspects gave significant differences, as follows:

The frequency of particular aspects, as a % of all thematic comment (15 aspects)			
Aspects	Buy reports	Hold reports	Sell reports
Market conditions - negative	5.7	7.4	9.2
Management & strategy - neutral	5.2	3.4	2.6
Management & strategy - positive	4.1	3.3	2.3

This analysis suggests that market conditions and management strategy are important in distinguishing between Buy, Hold and Buy recommendations. The accounting themes of profitability and financial position were not important.

II - MULTIVARIATE ANALYSIS

A logit model was estimated to explain the Buy (1) Sell (0) conclusions of the reports. The explanatory variables are not explained, but presumably are the % in the above table.

Logit model explaining Buy (1) & Sell (0) recommendations by the mention of aspects as a % of all thematic comment		
Variable	Coefficient	t value
constant	-0.376	-0.54
Profitability - positive	0.096	1.97
Management & strategy - positive	0.246	2.35
Market conditions - negative	-0.144	-2.29

The coefficients, all of which are significant, suggest that buy recommendations have a greater mention of positive comments about "Profitability" and "Management & strategy" and a smaller mention of negative comment about "Market conditions".

In contrast with the univariate analysis, profitability is now significant. However, the size of the coefficient is very small. At 0.096, it is nearly 3 times smaller than the management and strategy coefficient (0.246).

This result supports the finding of the other studies that:

- non accounting information is probably more important than earnings;
- balance sheet information is not really important at all!