

# Issues and Trends in Financial Statement Analysis

Pedagogy, Practice and Research

# Why We CARE

To start an ongoing conversation intended to advance FSA pedagogy, practice and research.

A conversation that:

- begins primarily with a group of ~~self-absorbed~~ curious academicians of various vintages wishing to ~~schmooze~~ engage other ~~victims~~ scholars who share a common ~~angst~~ interest in researching and teaching FSA.
- includes a smattering of ~~sell-outs~~ intrepid souls who have crossed over to the ~~dark-side~~ real world of investments, standard setting and litigation and have come back to ~~exploit~~, ~~recruit or browbeat~~ engage their ~~ivory tower~~ old colleagues.

The first ~~gripe~~ session conversation focuses mostly on the intersection of FSA and valuation and promoting practical relevance in our teaching and research.



# A CAREing Agenda

- Trends and issues in FSA pedagogy.
- Musings on FSA research.
- Controversial and potentially vacuous statements and recommendations for future CARE conferences.

# Trends in Pedagogy

- Evolution of FSA pedagogical approaches
  - Intrinsic Value/Value Investing perspective. Heuristic fundamental analysis with a touch of forensics, and a strong normative flavor: “Price is not value.”  
  
Presentation and organizational style is familiar progression through the sections of the individual financial statements with an analysis tool kit thrown in (Graham and Dodd 1934).
  - The introduction of theory and empirical evidence from finance and accounting research. Levers off of empirical evidence from large samples applied to various “decision contexts” (Foster 1978).
  - Appeal to Business Strategy to motivate and frame the material (Palepu, Bernard and Healy 1996 and Stickney and Brown 1998).  
Accounting-based valuation plays a bit part in the form of the RIM
  - Fully integrated framework combining finance theory, fundamental analysis, and the use of accounting-based valuation in all its glory as a tool for security valuation (Penman 2001).

# What to Include and Emphasize?

- Decision context
  - equity valuation, distress prediction, credit analysis
- Topics
  - earnings management, earnings quality, disclosure accounting choice, financial reporting and corporate financial policies.
- Some focus on setting or event
  - M&A, fraud, IPO, MBO, venture capital

# What to Include and Emphasize?

## ➤ Tools:

### ➤ Basic tools

- common size and trend analysis, ratio analysis, comparable firm and industry benchmarking.

### ➤ Normative and/or evidence-motivated tools

- recasting/converting financial statements, reformulation, adjustments and restatements, normalization, red flags and signals, “quality” diagnostics.

### ➤ Pro forma analysis:

- Forecasting techniques (with or without recasting/converting)

### ➤ Accounting-based valuation

- The good news is that accounting doesn't matter (infinite flexibility)
- The bad news is that accounting doesn't matter (finding the “sweet” spot) .
- To what extent has this tool gained real world valuation acceptance?
- How and to what extent are new accounting based formulations used in non-valuation settings (e.g., enterprise and individual performance evaluation)?

# What to Include and Emphasize?

## ➤ Theory and concepts

- linking theory and concepts to the empirical world.
- integration of economic, finance and strategy theory and empirical evidence to motivate the use of certain tools.
- presentation of a body of rules and standards (GAAP, legal, regulatory).
- analysis of the logical foundation, benefits, and shortcoming of rules.

## ➤ Scope and style of analysis:

- Firm specific (forensic approaches, case studies).
- Contextual (e.g., industry, and comparables).
- Broad applicability (e.g., portfolio formation, large sample evidence)

In short, there is wide variation in the content, methods and emphasis of materials in FSA text books and courses.

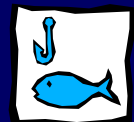
# Factors Affecting FSA Pedagogy

- Integration of FSA into traditional introductory, intermediate and advanced accounting courses, as well as corporate finance, investment, and entrepreneurial finance courses.
- Increasing demand for international content.
- Diversity of curriculum design and multiple programs.
  - Graduate versus undergraduate
  - Executive education - degree and custom programs
  - Specialization versus general knowledge
  - Shorter class durations



# Factors Affecting FSA Pedagogy

- Increasing demand for post-degree training
  - Analysts
  - portfolio managers
  - investor relations
  - Auditors
  - Managers
- Calls from students and employers to make coursework more immediately relevant to their potential careers.



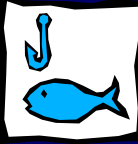
# Changing Demand for FSA

- The “usual” suspects
  - Equity investors
  - Analysts
  - Debt investors
  - Regulators
  - Other government agencies
  - Customers and Suppliers
  - Employees
  - Financial press
  - Courts
- Demand for FSA is increasing. More important, there is increasing *diversity* in the demand for FSA teaching and research.
  - “Consider, for example that types of “Equity Investors” today vary by size, side, horizon, style, etc. How they use the tools, concepts and research in FSA differs considerably.\*
- Yet the supply of accounting researchers is fairly sticky, and the way we are rewarded doesn’t change much.

\* See Bruce Johnson’s thoughtful discussion in this session and David Modest’s excellent breakdown of equity markets in the final panel of the conference.



# The Search for Relevance in Research



- Research informs pedagogy
  - Communicating with the real world and identifying ways to better exploit existing and generate new research that affects FSA pedagogy can be one role of CARE conferences.
- Direct products
  - Some literatures are tailored-made for providing direct products, e.g., accounting-based anomalies, fundamental analysis, fraud scores.
- Realistic expectations
  - Personal taste and ability do matter for being relevant in the real world.
  - For the moment we seem to be getting along quite well with our current reward system.
  - The path from research to real world application is not so obvious.
  - Someone has to do the pointy-headed work.
- A little soul searching might be productive.
  - Are we progressing in our research or bogging down?

# Awkward Transition Slide

- We're more nimble in the way we use research in teaching than the way we use research in research.
- Perhaps we are less aware of the internal inconsistencies.
  - do we need to challenge and destroy more
  - are we missing opportunities to cross-fertilize across research areas?

# A Fable: The Blind Men and the Elephant

*It was six men of Indostan  
To learning much inclined,  
Who went to see the Elephant  
Though all of them were blind,  
that each by observation  
Might satisfy his mind.*

# The Blind Men and the Elephant

*The First approached the Elephant,  
And happening to fall  
Against his broad and sturdy side,  
At once began to bawl:  
'God bless me! but the Elephant  
Is very like a wall!'*

# The Blind Men and the Elephant

*The Second, feeling of the tusk,  
Cried, `Ho! what have we here  
So very round and smooth and sharp?  
To me 'tis mighty clear  
This wonder of an Elephant  
Is very like a spear!'*

# The Blind Men and the Elephant

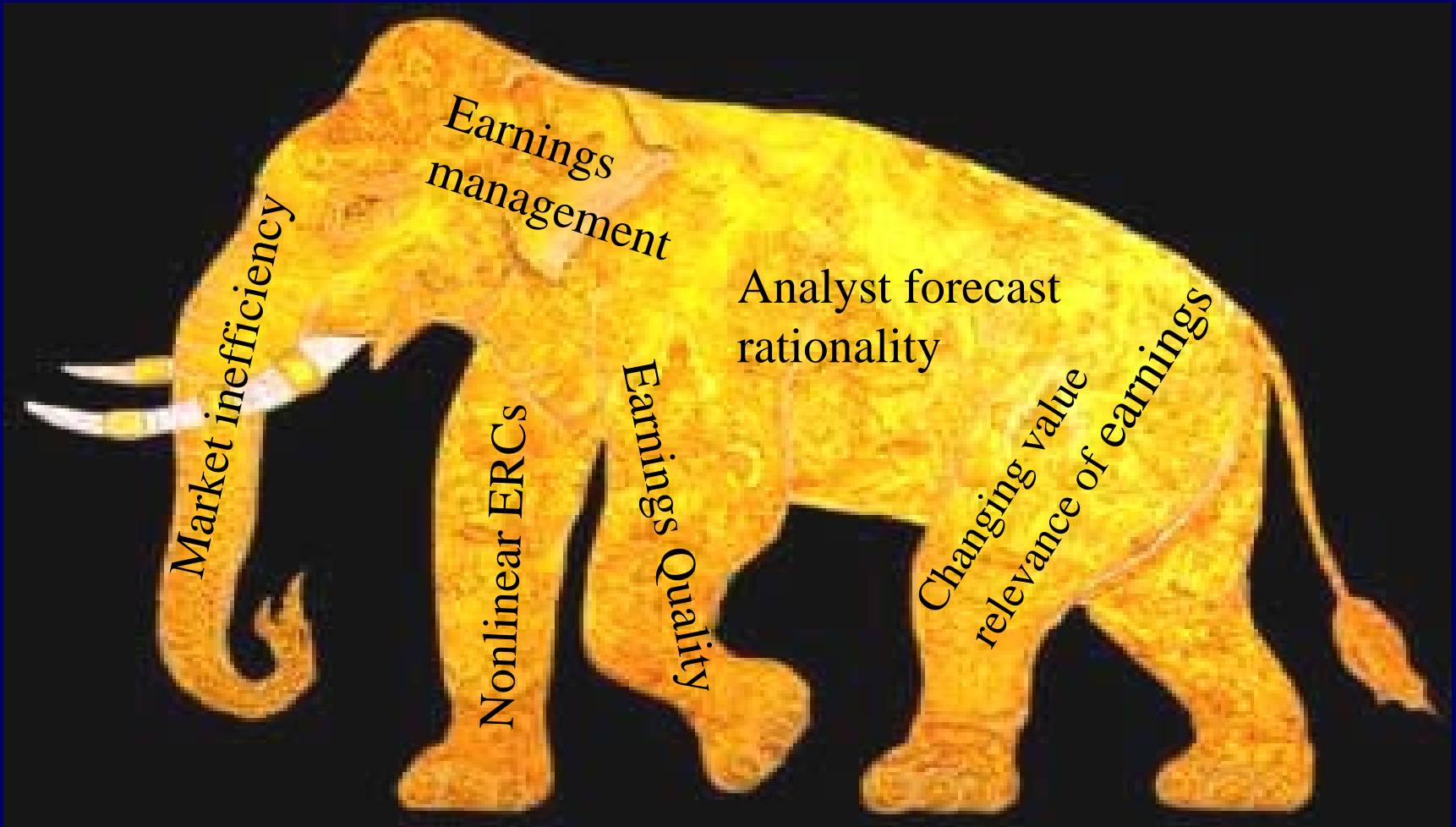
*The Third approached the animal,  
And happening to take  
The squirming trunk within his hands,  
Thus boldly up and spake:  
'I see,' quoth he, 'the Elephant  
Is very like a snake.'*

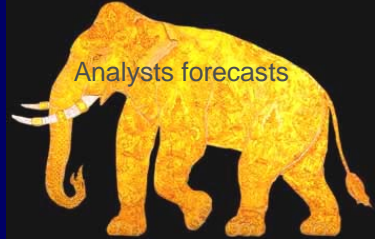


Let's skip the other three verses and get to  
the punch line

*And so these men of Indostan  
Disputed loud and long,  
Each in his own opinion  
Exceeding stiff and strong,  
Though each was partly in the right,  
And all were in the wrong!*

# FSA Research





# Stove-Piping



- Analyst forecast literature: The bulk of this research hypothesizes and concludes that analysts forecasts ( $F$ ) are biased and inefficient. Empirical tests designs rely overwhelmingly on benchmarking the forecast with the realization of reported earnings, ( $A$ ), where  $A$  is assumed unbiased. That is, the characteristics of  $(F-A)$  are used to infer something about  $F$ .
- Earnings response literature: The ERC literature often employs analysts forecasts as an unbiased estimate of market expectations of earnings when measuring price responses to possibly biased/noisy earnings ( $A$ ). Empirical tests designs rely overwhelmingly on the forecast error  $(F-A)$ .

*The assumptions and interpretations of these two literatures are clearly inconsistent with each other. Too little work has been done to deal with the nature of endogeneity in the determination of  $F$  and  $A$  in capital markets research.*



# Stove-Piping



Recent research suggests that the interpretation of biased and inefficient analysts earnings forecasts (F) gleaned from the study of forecast errors has been heavily influenced by a relatively small number of observations for which the actual earnings benchmark (A) is not “unbiased.”

- Possible explanations include:
  - unforecasted exercise of management discretion over reported earnings.
  - unforecasted effects of accounting conservatism.
  - Collusion between analysts and managers in determining the forecast error.

*One implication of these findings is that the evidence of non-linearities in ERCs and irrational analysts forecasts may be relevant to the search for the elusive “smoking gun” in the earnings management literature.*

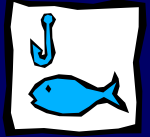


# Awkward Transition Slide

- There's a value to specialization but a cost to compartmentalization.
  - to what extent should specialization be expected to lead to internal contradictions that weaken or nullify the basic framework?
  - to what extent should specialization lead one group to dismiss and/or disdain the work of other groups?

Can CARE come to the rescue?

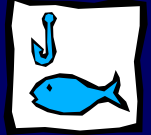
# Potentially Vacuous Statements and Recommendations



- Don't think of an elephant!  
Just kidding! Do think of the elephant.
- Develop and destroy new FSA taxonomies.
- Toward a common language and agreed upon definitions.
  - Identify and acknowledge the disconnects and, perhaps, toss the offending culprits.

Is it time to vote the term "earnings quality" off the island?

# Potentially Vacuous Statements and Recommendations



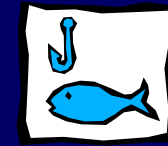
- Expand our horizons. Conferences can promote interdisciplinary work on subjects already important to FSA
  - Forecasting
  
- Unique research perspectives on FSA
  - Behavioral
  - Experimental
  
- Time for some research M&A work
  - Taxation
  - Public policy

Floss twice a day!

# Obligatory Plug

## ***FSA and Security Valuation***

Stickney, Brown and Wahlen  
Easton, Wild, and Halsey  
White, Sondhi and Fried  
Soffer



Return to presentation

## ***Valuation texts with a good dose of FSA***

Cottle, Murry and Block  
Copeland, Koller and Murrin  
Damadoran  
Stewart  
Fridson and Alvarez

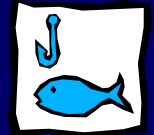
***Assorted books on International Accounting too numerous to mention***  
Comparative and country or continent-specific



# Earnings Management Taxonomy

- Objectives of earnings management

e.g., opportunism, altruism, informative.



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- Earnings management targets and goals

e.g., affect earnings surprises, avoid debt covenant violations, improve bonuses.

- Methods

e.g., discretionary accruals, special items, transaction timing, “real” decisions, accounting method choice.

- Impact

e.g., investor reaction, bonus received, bullets dodged, etc.

# What is Quality?

“Quality . . . you know what it is, yet you don't know what it is. But that's self-contradictory. But some things are better than others, that is, they have more quality. But when you try to say what the quality is, apart from the things that have it, it all goes poof! There's nothing to talk about.

But if you can't say what Quality is, how do you know what it is, or how do you know that it even exists? If no one knows what it is, then for all practical purposes it doesn't exist at all. But for all practical purposes it really does exist. What else are the grades based on? Why else would people pay fortunes for some things and throw others in the trash pile?

Obviously some things are better than others . . . but what's the betterness? . . . So round and round you go, spinning mental wheels and nowhere finding anyplace to get traction. What the hell is Quality? What is it?”

~ *Zen and the Art of Motorcycle Maintenance*

