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Overview

• Comments on research
• Panel discussion
  – Roger Grabowski, Duff & Phelps
    • Valuation
      – Identifying a performance measure to serve as a valuation metric
  – David Marcus, Cornerstone Research
    • Legal disputes involving accounting
      – Restatements
      – Solvency/capital structure analyses
  – Mathew Rothman, Sanford Bernstein
    • Trading rules
      – Identifying accounting performance measures that investors impound in prices with a lag
Evaluating enterprise performance using financial statement analysis

- Dividend yields, EPS and ROI were used to evaluate enterprise performance by 1915
- Disaggregating performance into components
  - Donaldson Brown, pre 1915, identified margins and turnover as factors affecting ROI (DuPont analysis)
- Intertemporal variation in performance outcomes
  - Irving Fisher, 1930, *Theory of Interest*, addressed intertemporal variation of performance by discounting. The alternative is to use a (possibly adjusted) single performance outcome or indicator as representative of the future
- Growth
  - Myron Gordon, 1962, created a (constant) growth model
- Size versus scale of returns
  - David Solomons, 1965, emphasized residual income
  - Adapted by Stern, Stewart (and others)
Characteristics of enterprise performance evaluation using financial statement analysis

– Looks to what has already occurred
– Does not attempt a separate identification of management performance
– Requires a measurement (or measurements)
  • Measurements should separate operations from financing
  • Measurements may require adjustments of reported numbers
  • Measurements must be weighted and calibrated
  • Weighting and calibrating require a benchmark
    – Competitor performance
    – Required rate of return
    – Last period's performance
    – What was planned, budgeted or expected
Accounting data more often used in research on management performance than on enterprise performance

- Sometimes referred to as a stewardship analysis
- Analytical models propose separating out "state of the world" effects from overall enterprise performance indicators

Research tends to use prices (returns) to evaluate enterprise performance

- Returns/prices are often used to calibrate accounting performance measures
  - Market measures are taken as true performance indicators
  - A "good" performance measure is one that is strongly associated with returns or prices
- When prices/returns are not available to researchers, typically neither are detailed accounting data
Research using financial statement analysis to evaluate performance

- Research uses accounting performance measures as inputs to valuation
  - Requires predictions of those measures
  - Sometimes, predictions use multiple performance measures as inputs
  - Sometimes, analysis of financial statements is used to assess whether a given performance measure is representative of the future

- Research uses accounting data to separate actual performance from apparent performance
  - Earnings management and quality of earnings analyses
  - Analyses of frauds and restatements

- Research uses accounting data as the true indicators of performance and assesses whether investors rationally use those data
Evaluating enterprise performance using financial statement analysis

• Questions that might be answered using financial statement analysis
  – Is the performance both real and sustainable?
    • Earnings management/fraud/quality of earnings
    • Transitory/nonrecurring items
  – How does operating leverage (fixed versus variable costs) affect sensitivity of performance to economic changes?
  – What features of GAAP impair the usefulness of accounting data for enterprise performance evaluation?
    • Example: Omitted assets and liabilities
    • Example: Inconsistent use of measurement attributes