Financial Statement Analysis in Enterprise Performance Evaluation

Center for Accounting Research and Education

Conference on Financial Statement Analysis & Valuation: Research, Teaching and Practice

April 2006

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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

Research using financial statement analysis to evaluate performance

- 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