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Briefing

UNDERSTANDING THE EARNINGS REPORTING PRACTICES OF UK FIRMS AND THEIR INTERACTIONS WITH ANALYSTS' EARNINGS FORECASTS

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Executive summary

1. Overview

Reporting financial performance is a topical and important policy issue currently under consideration by the International Accounting Standards Board (IASB) in conjunction with the Financial Accounting Standards Board (FASB) and other accounting regulators. Issues under discussion include the role and importance of earnings as a performance metric, the scope for reporting fair values in the financial statements, the design of appropriate formats for reporting income and expenses and other value changes, and the desirability or otherwise of firms reporting non-GAAP measures of earnings either within or outside their audited financial statements.

Central to these debates is the desirability of orienting financial reporting around earnings measurement. Barker (2004), for example, has pointed out that, 'the increased use of fair values in accounting standards is unlikely unless the income statement focus shifts from earnings measurement to the display of components of comprehensive income'. Furthermore, Barker argues, 'If this shift could be achieved, then a change in financial reporting ... would be assessed not by its impact on earnings, but by its impact on decision relevant information.'

One approach to reporting financial performance is to include all recognised gains and losses arising in an accounting period in a single comprehensive performance statement. This is the approach favoured by the IASB and the FASB. However this proposal has run into stiff opposition from financial statement users and preparers, many of whom are concerned about the absence of a meaningful earnings number and the potential for excessive focus on the bottom line of a single comprehensive statement.

Another possibility is to encourage, require, or allow financial statement preparers to construct and disclose their own measures of 'earnings' within a disciplining framework that provides full details of the principal assumptions and judgements underlying the disclosed earnings measures. Under this approach preparers should also disclose sufficient information to allow users to construct alternative measures of earnings should they so wish. This approach represents an extension of Financial Reporting Standard No.3 (FRS 3) introduced in the UK in June 1993. FRS 3 was a pioneering standard that radically altered the way UK firms report financial performance. The reporting changes associated with FRS 3, and the way managers and financial statement users responded to those changes, offer potentially useful insights concerning the ongoing performance reporting debate. With this in mind, we conducted a series of research studies aimed at shedding light on the how UK managers used (or misused) the reporting discretion afforded by FRS 3, and how the UK stock market accommodated these performance reporting innovations. This Briefing summarises our main findings and discusses their implications in the context of the ongoing policy debate.

Our research methodology consists of two distinct yet complementary approaches. A substantial proportion of our analysis employs large-sample statistical methods to model managers' accounting and disclosure choices, together with their associated stock market impact, surrounding the implementation of FRS 3. These statistical tests were supplemented by directly canvassing the views of preparers and analysts through a series of interviews and a questionnaire survey. The insights gained from the interviews and survey helped refine our empirical predictions and validate our statistical findings.

2. Principal findings

Our findings relating to the impact of FRS 3 are organised around the following three core themes:

- Manipulation of reported earnings and users' perceptions of periodic performance (subsequently referred to as 'earnings management')

- Earnings per share disclosure choices
- Analysts' earnings forecasts and earnings guidance.

While this Briefing summarises the main results and conclusions from the project, more detailed information regarding research methods and findings are available in 10 working papers available for downloading at www.mbs.ac.uk/cair/frs3. Our principal findings are summarised below.

Earnings management

FRS 3 changed how earnings is measured and reported, with the intention of improving the transparency with which performance is reported and reducing the incentives to manipulate bottom-line earnings. Our first set of tests therefore examined the impact of FRS 3 on the form and extent of earnings management.

Reported earnings can be managed in a variety of ways. One mechanism involves classifying certain earnings components as exceptional or discontinued in the hope of influencing users' perceptions of core earnings performance (often referred to as **classificatory earnings management**). FRS 3 changed the scope and nature of classificatory earnings management. We therefore examine how FRS 3 affected this type of earnings management. Our findings point to an overall increase in classificatory earnings management designed to smooth pre-exceptional earnings post-FRS 3, and that this increase coincided with a sharp rise in the incidence and magnitude of transitory losses and exceptional costs. However, in contrast to extraordinary items pre-FRS 3, post-FRS 3 exceptional items were more evenly distributed between positive and negative values. These findings suggest that the standard succeeded in removing the bias towards classifying only costs as extraordinary that existed pre-FRS 3. Moreover, further analysis reveals that FRS 3 increased the use of classificatory choices to better highlight sustainable earnings performance. Interview and survey evidence based on financial professionals' perceptions of earnings management confirms our statistical findings.

An alternative earnings management method that has attracted widespread attention in the academic literature is operating accrual choices such as bad debt provisions, warranty provision, inventory write-downs, etc. Such operating accruals choices are known as **discretionary accruals** in the academic literature. If discretionary accruals and classificatory choices represent substitute ways of managing earnings, then changes in the incidence of one method should affect use of the other. We therefore tested whether FRS 3 influenced discretionary accrual activity. Consistent with the increase in classificatory choices highlighted above, we document evidence of a significant decline in the level of discretionary accruals management following the implementation of FRS 3.

We also present evidence on the stock market pricing of discretionary accruals. A large body of US research concludes that investors overestimate the persistence of accounting accruals. In particular, the market appears to be misled by discretionary accruals. We therefore examined whether accruals mispricing also occurs in the UK and if so, whether the extent of this mispricing changed following the introduction of FRS 3. Mispricing occurs if stock returns in the year following a published set of accounts can be predicted by reference to the accruals reported in the accounts ie, high positive (negative) accruals predict positive (negative) returns. Results demonstrate clear evidence of significant accruals mispricing prior to FRS 3; in contrast, we find little evidence of accruals mispricing post-FRS 3. At this stage we are unable to infer whether the apparent disappearance of accruals mispricing is due to the market learning how to value discretionary accruals, or due to the decreased use of discretionary accruals.

EPS disclosure choices

FRS 3 required firms to disclose earnings per share (eps) based on an all-inclusive measure of profit and loss. Meanwhile, FRS 3 also allowed

management to disclose alternative eps measures based on any definition of ‘earnings’ they considered appropriate. These voluntary eps figures (which we refer to as **non-GAAP eps disclosures**) enabled management to report a customised view of performance by highlighting important firm-specific earnings streams. Critics, however, argue that such disclosures can help management opportunistically to influence users’ perceptions of sustainable earnings performance by blurring the distinction between transitory and recurring earnings components. We therefore conducted a large-scale statistical study of the incidence and properties of these non-GAAP eps figures in an attempt to shed light on the motives underlying managers’ reporting choices.

We find that the number of firms reporting non-GAAP eps figures increased steadily following FRS 3’s introduction, such that most UK non-financial firms disclosed at least one such metric. Many items excluded from non-GAAP eps by management correspond to items considered transitory by analysts. Nevertheless, differences between managements’ non-GAAP eps figures and analyst-produced measures of recurring earnings are relatively common (about 45% of cases). We find that disagreements rarely involve non-operating items. The underlying nature of non-operating gains and losses supplemented by clear income statement disclosure under FRS 3 appears to render such items transparently transitory. Instead, disagreements typically centre on operating exceptional items and discontinued operations where the idiosyncratic nature of gains and losses combined with opaque disclosure create confusion over the persistence of certain items (for example, certain restructuring and reorganisation costs, amortisation of certain intangibles, legal and professional fees, other unspecified exceptional items, etc.).

On the question of whether such disclosures serve to inform or mislead investors, our results are mixed. In the majority of cases, non-GAAP eps disclosures appear to reflect appropriate classification of earnings components by management into permanent and transitory elements. However, we also find evidence consistent with misclassification in a minority of cases. In particular, non-recurring gains tend to be included in the non-GAAP figure despite their transitory nature. Nevertheless, such cases account for only 10% of our non-GAAP disclosure sample. While some firms may therefore be using non-GAAP eps disclosures to artificially boost reported performance, opportunistic reporting does not appear to characterise UK reporting practices on average.

Analysts’ earnings forecasts and earnings guidance

Analysts’ earnings forecasts represent an important benchmark against which firm performance is measured. A firm’s ability to regularly meet its consensus earnings forecast is believed to help reduce perceived business uncertainty and improve external perceptions of managerial competence. As a result, some commentators and academics believe that consistently meeting or beating analysts’ earnings targets leads to capital market benefits in the form of a higher share price (often referred to in academic research as ‘a meet or beat premium’). Not surprisingly, therefore, the interaction between management and analysts over the production of earnings forecasts is often characterised as a complex relationship in which managers attempt to guide analysts’ earnings forecasts towards internal expectations; and when internal expectations are not realised, managers face incentives to avoid negative earnings surprises by artificially boosting reported earnings.

Our interview and survey evidence confirms that management regularly provide earnings guidance to analysts. Survey evidence also reveals a strong and widespread perception of a meet or beat premium: UK firms that consistently meet or exceed analysts’ earnings expectations are believed to command higher stock market valuations. To complement these qualitative findings, we also conducted a large sample statistical test for the presence of such a valuation premium in the London market. Results suggest the existence of a meet or beat premium for UK firms in the region of 8%. This work is very preliminary, however, and our findings must therefore be interpreted with considerable caution.

If management are concerned about meeting or beating market expectations, then what kinds of actions might they take to bring earnings in line with forecasts? Interview and survey results suggest that management indeed take actions to ensure that reported performance conforms to market expectations by managing earnings using both accounting choices and real economic decisions. To further explore this issue, we performed large sample statistical tests examining the use of accounting choices (discretionary accruals and classificatory earnings choices) to meet or beat consensus earnings forecasts. We find no evidence that discretionary accruals are used to meet or beat market expectations. In contrast, results reveal widespread use of classificatory earnings choices designed to bring reported earnings into line with forecasts.

3. Policy implications

Our findings yield a series of policy insights relating to the impact of FRS 3 specifically, and to the question of reporting financial performance more generally:

- Our results suggest that FRS 3 and related developments improved the overall quality of UK financial reporting. In particular we find that the use of discretionary accruals declined post-FRS 3. We also we find that the phenomenon of accruals mispricing decreased. This suggests that increased transparency combined with greater discretion over the classification of earnings components serves to limit such opaque forms of earnings management.
- Although we document increased reporting of exceptional items following the introduction of FRS 3, such items are typically transparently disclosed. Exceptions include operating exceptionals and discontinued operations where disclosure rules appear to create confusion over the persistence of certain items. Thus there may be a need for more transparent disclosure in relation to such items.
- Firms disclosing non-GAAP eps measures appear to do so mainly to provide a more precise indicator of sustainable earnings. Overall, therefore, the licence granted to management to disclose supplementary eps figures appears to have been used beneficially. However, exceptions to this rule are apparent, suggesting the need for caution when interpreting such disclosures.
- One aspect of performance reporting identified by analysts as being particularly important relates to the tax implications associated with exceptional items. Transparent disclosure of such tax effects is essential for users wishing to construct their own measures of (post-tax) performance. FRS 3 made some progress on this issue by requiring management to disclose the tax effects related to certain non-operating exceptional items. However, greater transparency in relation to these items is still desirable.
- We provide evidence that firms (a) manage external earnings expectations and (b) take actions to bring reported earnings into line with market expectations. While this ‘earnings management game’ is well understood by analysts and professional investors, we suspect it is much less transparent to non-professional investors. An important policy question is whether regulators should seek to intervene in this game to provide a more level playing field for all investors (for example, by requiring that firms publish all earnings guidance provided to analysts). While current stock exchange rules require equal access to information that is price sensitive, investors also need to know the extent to which analysts’ forecasts are guided by firms.

Overall we believe that FRS 3 was a successful development that deserves the attention of the IASB, the FASB, and other standard setters as they move towards a new framework for reporting financial performance. We suggest that an important feature of this framework should be the

scope it provides to firms to present their own preferred measures of sustainable earnings, subject to fully transparent disclosures on how these preferred measures are calculated. In addition performance statements should provide sufficient information to allow informed users to construct their own alternative earnings metrics.

Detailed briefing

1. Introduction

Earnings per share (eps) is one of the most widely quoted statistics in financial analysis. Not surprisingly, therefore, the measurement and reporting of eps by UK companies has been the focus of considerable attention from the Accounting Standards Board (ASB) since its inception in 1990. Central to these developments was the publication of Financial Reporting Standard No. 3, *Reporting Financial Performance* (FRS 3) in October 1992 (ASB, 1992).

FRS 3 heralded a major change in the UK system of corporate financial reporting. Prior to FRS 3's introduction, reported income was computed using the current operating performance concept, whereby certain unusual transactions (referred to as extraordinary items) were excluded from bottom-line earnings in an attempt to emphasise firms' ordinary, sustainable periodic performance. While conceptually appealing, the system was prone to abuse as managers used their discretion to classify more and more items as extraordinary.

In particular numerous commentators noted an apparent tendency for a disproportionate number of negative items to be classified as extraordinary, although others have argued that this is a natural feature of an accounting system that requires the rapid recognition of losses. Moreover, significant inconsistencies emerged in the way different firms disclosed the effect of apparently similar events in their profit and loss account. The result was an earnings number that was perceived as being subject to widespread manipulation.

Motivated by the desire to curb earnings management and overcome the general fixation on a single, bottom-line, measure of firm performance, FRS 3 effectively outlawed the classification of accounting gains and losses as extraordinary and forced firms to report an all-inclusive earnings measure. The standard introduced many significant changes to the way UK companies report performance-related information, including:

- Introduction of a 'layered format' to the profit and loss account to highlight different components of performance including the impact of continuing operations, discontinued operations, acquisitions, and exceptional items such as the sale or termination of an operation, fundamental reorganisations and restructurings, and asset disposals.
- Elimination of most (if not all) extraordinary items. Transactions previously classified as extraordinary under SSAP 6 (Revised) were now treated as exceptional.
- Elimination of the incentives to define certain items as either exceptional or extraordinary by requiring eps to be calculated **after** extraordinary items.
- The opportunity for firms to develop and report one or more supplementary eps figures on the face of the profit and loss account (in addition to the FRS 3 figure).
- A requirement to disclose a statement of total gains and losses containing items recognised during the year but which are omitted from the profit and loss account.

As a result of these innovations, the eps number required by FRS 3 merely served as the starting point for further analysis.

The implementation of FRS 3 raised a series of important questions concerning the way UK firms reported their financial performance. The first question relates to management's discretionary accounting choices: did FRS 3 reduce the level of earnings management? The second

question relates to the ability of users to understand the reported figures: did FRS 3 provide financial statement users with a more complete understanding of reported performance and its implications for future performance? The third question relates to management's disclosure strategy: what factors determined management's disclosure of supplementary eps figures and what form did such measures take? The fourth question relates to the way analysts forecast firm performance: precisely what eps measures did analysts forecast and did this vary with management's eps disclosure strategy? The aim of this Briefing is to shed light on these and related issues.

Although International Financial Reporting Standards replaced UK accounting standards from January 2005 onwards, the issues that motivated FRS 3 remain a source of continued dispute between preparers, users and regulators. In particular, the role and definition of earnings as a performance metric continues to be debated, as do related issues such as the scope for fair value reporting and the relative importance of the balance sheet and income statement. Accordingly, reporting financial performance is a key policy issue on the agenda of the International Accounting Standards Board (IASB) and other leading national standard setting bodies including the ASB in the UK and the Financial Accounting Standards Board (FASB) in the US.

The IASB's preferred solution to the performance reporting problem is a performance statement that captures all gains and losses recognised during an accounting period. Initially the IASB proposed a matrix framework for this purpose, but this proposal was dropped prior to the IASB embarking on a joint project with the FASB on Reporting Financial Performance. The recently revised version of IAS 1, *Presentation of Financial Statements* allows preparers to present income, expenses, and other components of comprehensive income either in a single statement of comprehensive income or in two separate statements.

However the IASB/FASB have yet to resolve questions as to whether firms should be required, encouraged, allowed or forbidden to disclose supplementary earnings numbers within this framework. Such reporting frameworks can be viewed either as alternatives to earnings reporting, or they can be viewed as structured and transparent frameworks within which alternative measures of earnings may be highlighted by financial statement preparers, and from which financial statement users can construct their own desired measures of performance.

This latter interpretation can be viewed as a natural development of the approach adopted by FRS 3. Viewed in this context, the UK experience with FRS 3 offers potentially important insights into how firms and investors might be affected by the introduction of a comprehensive performance statement where managers have discretion over which performance line items to highlight as sustainable 'earnings'. In this context, our research highlights how fully transparent performance reporting disclosures can yield clearer insights about earnings quality. If it can be established that greater transparency leads to improved measures of earnings that are more value relevant, within a framework that increases investor confidence in the reported figures, then this points to the desirability of developing the IASB/FASB framework in the direction of producing more informative measures of earnings.

2. Overview of the working papers

We employed a mixture of statistical analysis, face-to-face interviews with managers and investment professionals, and survey responses from equity analysts to examine a series of issues relating to reporting financial performance generally and FRS 3 in particular. The detailed findings of this work have been translated into 10 working papers (WPs). The Appendix contains full references to these working papers. The main findings of the working papers are reviewed in sections 3 to 5 of this Briefing. Section 6 draws together our main conclusions and the potential policy implications of the research.

Findings concerning the impact of FRS 3 on the income smoothing practices of UK firms are reviewed in section 3 below. We examine the extent of income smoothing via (i) working capital accrual choices and (ii) classificatory choices relating to exceptional items. Section 3 also examines two other aspects of the financial reporting process, earnings timeliness and discretionary earnings management through real economic choices. Earnings timeliness is an important attribute of earnings quality. External investors, especially creditors, are interested in the extent to which they can rely on bad news being rapidly reflected in measures of financial performance. Financial reporting systems that allow company managers to delay the reporting of bad news threaten the interests of external investors. Thus, it is important to know if the implementation FRS 3 influenced the timeliness of earnings for UK firms.

Earnings management through real economic choices is a potentially costly side-effect of any financial reporting system. In general it is in the best interest of a company if its managers accept all profitable (positive NPV) projects (subject to taking into account the appropriate option to delay). However it is known that some managers sometimes delay or even reject positive NPV projects because of the consequences for short-term measures of reported performance. Inappropriate measures of financial performance can induce inappropriate real economic choices. Section 3 examines this issue in the context of the R&D choices of UK firms and FRS 3.

While FRS 3 **requires** firms to report eps based on an all-inclusive measure of bottom-line net income, it also **allows** management the opportunity to disclose one or more supplementary (non-GAAP) eps metrics on the face of the profit and loss account. Section 4 examines the reasons why management disclose supplementary eps figures and the properties associated with such disclosures. In particular we focus on the question of whether supplementary eps figures provide improved indicators of sustainable financial performance.

Section 5 summarises our findings concerning the influence of analysts' forecasts on financial reporting behaviour. We examine a series of issues concerning the interaction between management and analysts over the production of eps forecasts. First we test whether investors place a valuation premium on firms that consistently meet or exceed analysts' eps forecasts. Second, given that firms appear to face significant valuation incentives to avoid undershooting analysts' forecasts, we examine the actions managers take to ensure that reported earnings are line with expectations.

3. Research findings on discretionary accounting choices

3.1 Discretionary accruals management pre- and post-FRS 3

One of the primary objectives of FRS 3 was to reduce the level of earnings management by de-emphasising bottom-line earnings as a basis for performance measurement and valuation, and by requiring increased levels of disclosure both on the face of the profit and loss account and in the notes accompanying the profit and loss account. If FRS 3 was successful in this goal, we should observe lower levels of earnings management post-1993. We examined this prediction using a comprehensive sample of UK listed companies. Following Healy (1985) and Jones (1991), much of the earnings management research focuses on the manipulation of operating accruals (working capital accruals and depreciation). Accruals allow managers to distinguish between the time when revenues and expenses are deemed to occur and the time when cash is paid or received. For example, sales made on credit, for which cash is yet to be received, is a working capital accrual. Management have some discretion over the level of accruals recognised in any particular period. For example, they can report higher (lower) earnings by reducing (increasing) the provision for bad and doubtful debts in a particular reporting period.

Distinguishing between accruals that managers must make (non-discretionary or normal accruals) and those that reflect a degree of choice (discretionary or abnormal accruals) is problematic. Academic research on

accruals management typically exploits the law of large numbers by applying a statistical model to identify the normal level of accruals. In WP1 we use a standard statistical model of normal working capital accruals applied to a large sample of UK firms pre- and post-FRS 3 to control for time, industry and business cycle factors (Jones 1991). Abnormal working capital accruals (AWCA) for firm i in time t are then calculated as the difference between total working capital accruals (TWCA) and our estimate of normal working capital accruals (NWCA):

$$AWCA_{it} = TWCA_{it} - NWCA_{it}$$

Since our research question does not condition on the underlying motives for earnings management, our analysis focuses on changes in the overall level of accruals activity rather than on the sign of accruals management (ie, income-increasing or income-decreasing). Accordingly, we use the absolute value of AWCA ($|AWCA|$) as our primary test variable. WP1 generates and uses estimates of $|AWCA|$ for 10,646 firm-year observations over the period 1986–1998. Our sample comprises 993 UK non-financial firms with at least one financial year in both the pre- and post-FRS 3 periods. Tests reveal a 25% reduction in the level of abnormal working capital accruals activity following the implementation of FRS 3: the median value of $|AWCA|$ was 4.8% of lagged total assets in the pre-FRS 3 period, compared with only 3.6% in the post-FRS 3 period. (The difference in medians is statistically significant at the one per cent level.) We also find that the level of income smoothing via abnormal accruals declined post-FRS 3.

We carried out a number of regression-based tests in order to control for other known determinants of earnings management such as firm size, leverage, and growth. These additional tests, which are reported in tables 6 and 7 of WP 1, consistently reveal a significant reduction in the level of accruals management post-FRS 3. Overall the evidence is clearly consistent with the hypothesis that discretionary accruals management declined post FRS 3.

Prior to FRS 3, bottom-line earnings were calculated after charging exceptional items but before charging extraordinary items. This distinction resulted in pervasive classificatory earnings management (Beattie et al. 1994). In an effort to eradicate such practices, FRS 3 restricted the items that management could classify as extraordinary and adopted an all-inclusive definition of income whereby bottom-line earnings are calculated **after** charging extraordinary items. Rather than reducing the level of earnings management as intended, however, FRS 3 may have simply caused firms to replace classificatory manipulation with other (potentially more opaque) forms of earnings management.

We therefore examined the impact of FRS 3 implementation on accrual activity for firms that systematically reported extraordinary items pre-FRS 3. Of course, we recognise that not all firms that reported extraordinary items were attempting to manage earnings. Nevertheless, we hypothesise that a sample containing regular extraordinary item reported during the period 1989 through 1993 is likely to contain a higher proportion of classificatory manipulators than the population as a whole. We predict that when such firms are forced to abandon the use of extraordinary items they will turn to other income smoothing devices, in particular AWCA, in the year that the new standard is introduced. Our tests reveal evidence that supports this hypothesis. The sample of firms that consistently reported extraordinary items in the years prior to FRS 3 experienced a sharp increase in $|AWCA|$ in the year that FRS 3 was implemented. Our results are also consistent with the hypothesis that a significant proportion of firms that regularly reported extraordinary items in the years prior to FRS 3 were behaving opportunistically.

3.2 Accruals mispricing before and after FRS 3

A series of US studies have documented a negative relation between current accruals and subsequent abnormal stock returns (Barth and Hutton, 2004; Bradshaw et al. 2001; Chan et al. 2004; Collins and Hribar, 2000; Collins et al. 2003; Desi et al. 2004; Gu and Jain, 2004; Pincus et al. 2005; Richardson et al.

2005; Sloan, 1996; Thomas and Zhang, 2002). The results suggest a profitable trading strategy based on shorting (buying) stocks with relatively large positive (negative) levels of accruals in reported earnings.

Several theories have been used to explain the accruals mispricing anomaly. On the one hand, the functional fixation hypothesis (Hand, 1990) suggests that investors fail to appreciate the differential persistence of the accrual and cash flow components of earnings and therefore overprice companies with higher level of accruals. On the other hand, Merton's (1987) incomplete information hypothesis predicts that uncertainty in the minds of investors about how the economic events and transactions affecting a firm are reflected in the financial reports and other disclosures produced by the firm can lead to the appearance of risk premiums or asset pricing anomalies. For instance, Xie (2001) finds that the accrual anomaly documented by Sloan (1996) is largely driven by the abnormal accrual component. In other words the quality of accounting information supplied by companies may drive the accrual anomaly.

If FRS 3 improved the ability of investors to understand the properties of reported earnings, then we should observe a reduction in accruals mispricing following the implementation of FRS 3. WP7 examines the impact of the change in financial reporting regime heralded by FRS 3 on the accruals mispricing anomaly in the UK. FRS 3 requires UK companies to disclose detailed components of financial performance on the face of the statement of financial performance. To reduce earnings manipulation through accounting classification, FRS 3 requires firms to disclose key non-operating items separately after operating income. Extraordinary items have been narrowly defined and are virtually eliminated from reporting practice. Many studies conclude that FRS 3 significantly increased the transparency of reporting firm financial performance (Lin, 2002; Acker, Horton and Tonks, 2002; Lin, 2005).

WP7 examines the incidence of accruals mispricing for UK non-financial firms with December year-ends for the period 1979–1999. The study confirms evidence of the accruals mispricing anomaly in the UK. More importantly, the study shows that the return predictability of total operating accruals was significantly more pronounced before FRS 3. In addition, we find that the strength of the pre-FRS 3 accrual anomaly was greater for firms with extreme accounting conservatism, high analyst forecast error, and low accruals quality. The findings support the prediction that accrual mispricing in the UK was driven by a relatively poor financial reporting environment in the pre-FRS 3 regime, and by firms with low quality accounting information. Our findings support the incomplete information hypothesis of Merton (1987).

3.3 Classificatory income smoothing

WP1 finds that the overall level of abnormal accruals management declined following the implementation of FRS 3. However, accruals are not the only weapon in management's arsenal for influencing reported earnings. Prior to FRS 3 UK firms were primarily concerned with managing their earnings before extraordinary items (eg, by reporting large, mostly negative, items as extraordinary). While FRS 3 removed the possibility of this form of classificatory smoothing by outlawing extraordinary items, it did not eliminate the opportunity for other forms of classificatory smoothing. Instead FRS 3 shifted the focus away from extraordinary items and onto the choice of exceptional items. In WP2 we therefore examine the impact of FRS 3 on classificatory income smoothing via exceptional items.

Studying whether exceptional items are used to smooth earnings requires an assumption regarding the line in the profit and loss account at which earnings is being smoothed. Pre-FRS 3, it was generally believed that the smoothing target was earnings before extraordinary items. Post-FRS 3 it is less clear which earnings number is the object of smoothing. Moreover, it is possible that the smoothing object varies across firms. In WP2, our primary results are based on the assumption that firms are smoothing earnings before all exceptional items. This assumption is supported by our survey findings and other evidence (Acker et al. 2002) indicating that most

analysts forecast earnings before all exceptional items. It is also consistent with the rising frequency of firms disclosing alternative eps on earnings before all exceptional items after the introduction of FRS 3 documented in WP3.

Table 2 in WP2 reports measures of the overall level of classificatory income smoothing pre- and post-FRS 3. The results reveal a sharp increase in classificatory income smoothing post-FRS 3: the level of classificatory income smoothing is some 2.5 times higher post-FRS 3 than in the pre-FRS 3 regime. Multivariate and additional analysis shows that this rise is robust to the overall increase in the magnitude of exceptional items post-FRS3 (Tables 3 and 4 of WP2). Therefore, the increase reflects greater use of classifications of exceptional items to reduce the variation in reported earnings.

At first sight the evidence that classificatory income smoothing increased dramatically after FRS 3 may seem problematic for proponents of the new standard. It raises the possibility that the abuse of extraordinary items observed prior to FRS 3 has simply been replaced by greater abuse of exceptional items. However, what really matters is whether the new regime has resulted in improved measures of sustainable earnings. Table 3 of WP2 shows that the main reason for the rise in classificatory smoothing post-FRS3 is that deviations of net income from expected earnings (ie, lagged earnings before exceptional items) induce greater use of classifications over exceptional items post-FRS3. Also Table 12 of WP2 reports measures of earnings persistence pre- and post-FRS 3. Comparing bottom-line pre- and post-FRS 3 reveals no significant change in the overall level of earnings persistence. However, the persistence of 'sustainable' earnings does appear to have increased post-FRS 3. In particular we find that earnings before all exceptional items post-FRS 3 is 14% more persistent than earnings before extraordinary items and exceptional items pre-FRS 3 (the difference is statistically significant at the one per cent level).

3.4 Earnings timeliness and FRS 3

The concept of earnings timeliness refers to the speed with which economic events are incorporated into reported earnings. Earnings timeliness is an important attribute of earnings quality. In particular recent research has tended to focus on the speed with which bad news is reflected in measures of reported earnings. This is because external investors, especially creditors, are better protected if company managers are required to rapidly incorporate bad news into reported earnings. We therefore examine the impact of FRS 3 on earnings timeliness.

WP9 studies the timeliness properties of earnings relative to stock market movements. To the extent that stock returns impound economic events as they occur, earnings timeliness can be measured by the association between annual earnings and contemporaneous annual stock returns, with a strong positive association indicative of high earnings timeliness. The association can be measured by calculating the line of best fit between current earnings and current stock returns. Separate lines of best fit are calculated for years in which returns are positive and negative. In a perfect world where all information, both positive and negative, is automatically reflected in current earnings, and where reported earnings is equal to permanent (sustainable) earnings, the slope of both of these lines of best fit would be equal to the average cost of equity capital for the economy ie, about 0.1.

Previous studies for the US and the UK have shown that the slope of the line of best fit between earnings and stock returns differs between good news years and bad news years. WP9 replicates this finding for a large sample of UK firms over the period 1988 to 2001 for four alternative measures of earnings. Focusing on the results for bottom-line earnings (EPS4 in the paper), we find that the slope of the line of best fit in negative return years is 0.24. In contrast, the slope of the line of best fit is only 0.02 in positive return years. These results indicate that UK earnings are slow to impound good news. In addition, bad news is incorporated much more rapidly into earnings than is good news. Furthermore bad news is

incorporated into earnings much more rapidly than it would be incorporated into permanent earnings. This is because many items of bad news are reported as large one-off losses, rather than the losses being gradually fed through into reported earnings over a number of years.

Following Pope and Walker (1999), WP9 compares the responsiveness of bottom-line earnings with other measures of earnings. We are especially interested in comparing bottom-line earnings with earnings before all exceptional items (EPS1 in the paper). The average responsiveness of EPS1 to good news is the same as for net income ie, about 0.02. However the responsiveness of EPS1 to bad news is 0.13, which is significantly less than the corresponding figure for bottom-line earnings. Consistent with Pope and Walker (1999) these results confirm that a large proportion of bad news is reported through exceptional and (pre-FRS 3) extraordinary items.

One particular set of accounting issues that may affect earnings timeliness is the way that transactions involving corporate restructuring and refocusing activities are reflected in earnings. Given that such activities often involve large one off losses, it is interesting to test the sensitivity of earnings to stock returns around such events. WP9 therefore investigates whether the association of earnings with good and bad news changes around refocusing years. News is measured using annual stock market returns, with good news proxied by returns greater than zero, and bad news proxied by returns less than zero. Results indicate that reported earnings are significantly less responsive to good news in refocusing years. Indeed we find that, within the set of restructuring firms with good news in the refocusing year, the higher the level of good news, the lower the level of earnings. We also find an increase in the sensitivity of reported earnings to bad news in refocusing years compared to non-refocusing years. These results clearly indicate that the relation between earnings and stock returns is radically different between refocusing and non-refocusing years.

For the purposes of this Briefing we are especially interested in whether the timeliness properties of earnings, proxied by the relation between earnings and stock return, have changed since the introduction of FRS 3. WP9 documents a significant change in the earnings timeliness properties of UK refocusing firms before and after FRS 3. In particular, following the implementation of FRS 3 reported bottom-line earnings of refocusing firms in the year before a refocusing event exhibited lower sensitivity to positive stock market returns, and higher sensitivity to negative stock market returns.

3.5 Summary of interview and survey evidence relating to earnings management

WP1 and WP2 are based on statistical analyses of published accounting numbers. WP6 provides complementary findings based on interview and survey evidence. We interviewed three highly respected equity analysts, the finance director of a leading FTSE company, and a senior accountant and the director of investor relations at another FTSE-100 company. We also used a questionnaire survey to elicit the views of a further 26 analysts and professional investors. Responses revealed a general perception that the level of accruals management has declined since the introduction of FRS 3. This supports our statistical evidence reported in WP1. Consistent with WP2, one of our interviewees also suggested that manipulation of exceptional items had increased post-FRS 3.

Unsurprisingly, our two corporate respondents both insisted that their own firms would not make use of material accounting adjustments to manage earnings (although one did indicate that he believed some firms would manipulate accruals in order to meet earnings targets). Interestingly, both respondents felt that management of operations to achieve a budgeted operating target was a much more important influence on reported performance than the manipulation of accounting choices. Indeed, both managers indicated that their firms would be more likely to change short-term operating decisions in order to meet budgeted earnings targets than they would be to change their accounting decisions. This is consistent with evidence reported by Graham, Harvey and Rajgopal (2005) for a sample

of 401 US financial executives, 80% of whom indicated that they would consider reducing investment spending to meet an earnings target.

One of the main findings of our survey is that UK analysts focus on earnings before all exceptional items and goodwill amortisation for forecasting purposes. This in turn implies that the decision to classify transitory items as exceptional may influence the possibility of meeting or exceeding analysts' consensus earnings forecast. In addition, to the extent that analysts disagree over which items should be classified as exceptional, managers may be able to influence the earnings concept that forms the basis of forecasting activity. Thus, as one of our interviewees remarked:

'It is especially the case in the US that companies are very pushy in trying to persuade you which number to focus on. So in the US there is this First Call number. First Call collect all the analysts' forecasts, but there is the First Call historical earnings per share figure and generally that is not the GAAP earnings number. It is not what the analysts say; it is what the companies say. If the company says last year we earned x excluding this, this, and this, and whatever they say they exclude First Call adopts and this becomes the official record of what the company earned. And I think this is wrong because it should not be for the company to decide but it should be up to users to decide or other people. There is a case of the companies trying to persuade people what their earnings are and saying, "look this is not relevant".'

3.6 R&D expenditure and earnings targets pre- and post-FRS 3

Motivated by our interview and survey evidence that managers might be more likely to use operating decisions rather than accounting choices to meet budgeted earnings targets, we performed a large sample statistical analysis of the association between research and development (R&D) spending patterns and corporate earnings targets. Prior research suggests that US managers cut R&D expenditure to achieve short-term earnings benchmarks (Baber, Fairfield and Haggard 1991, Perry and Grinaker 1994, Bange and De Bondt 1998, Bushee 1998, Cheng 2004). WP10 produces comparative evidence for a large sample of UK firms between 1989 and 2002. Consistent with US evidence, we find that UK firms appear to reduce R&D spending when there is a risk of reporting an earnings loss or an earnings decline. This tendency is especially apparent in firms that have relatively low levels of R&D intensity, perhaps because such firms have less to lose by delaying such expenditures to more profitable times.

If FRS 3 restricted the scope for classificatory earnings management then it is possible that managers may have become more inclined to use real economic decisions to meet short-term earnings targets following FRS 3's implementation. Interview and survey evidence reported in WP6 suggests that managers view manipulation via operating decisions more favourably than via accounting choices. The notion that changes in accounting standards can affect the level of operational earnings management has been demonstrated in theoretical work by Ewert and Wagenhofer (2005) and in experimental work by Tan and Jamal (2003).

WP10 documents some evidence of an upsurge in unexpected R&D cuts following the introduction of FRS 3. Further, this upsurge is most pronounced among firms that regularly reported extraordinary items pre-FRS 3. These results are consistent with management switching from classificatory earnings management using extraordinary items to earnings manipulation through operating decisions as a result of FRS 3. Note, however, that these results are preliminary and as such should be interpreted with considerable caution.

4. Research findings on non-GAAP eps measures

4.1 Non-GAAP eps measures disclosed under FRS 3

FRS 3 allows additional eps figures to be calculated at other levels of profit provided they are presented on a consistent basis over time, reconciled to the FRS 3 eps figure, given no more prominence than the standard eps

figure, and accompanied by a statement explaining the reason for their inclusion. Proponents argue that non-GAAP disclosures give management the opportunity to report a customised view of performance and highlight important firm-specific earnings streams. Critics, however, claim that management use such disclosures to further obscure the distinction between transitory and recurring earnings components.

WP3 examines the choices firms make in exercising their discretion over whether or not to disclose a non-GAAP eps measure. Conditional on disclosure, WP3 also analyses the properties of adjustments made by management to net income in arriving at their preferred non-GAAP eps measure. The study is based on hand-collected data for the 500 largest UK quoted companies. Full details of the non-GAAP eps disclosures are collected for financial years 1994, 1996, and 2001.

Results show that the proportion of firms disclosing non-GAAP eps rose from 39% in 1994 to 76% in 2001. Analysis of the exclusions from bottom-line earnings made by management in arriving at non-GAAP eps reveals that the majority of items relate to non-operating activities. Following the implementation of FRS 10, *Goodwill and Intangible Assets* in December 1998, many firms also began to exclude goodwill amortisation. Interestingly, we also observe an increasing tendency for non-GAAP eps figures to exclude certain operating exceptionals.

WP3 goes on to study the properties of exclusions made by management. We compare exclusions made by management with exclusions made by stock market investors and their advisors. We use Thomson Datastream as a proxy for the inclusion (retention) and exclusion of exceptional items by stock market professionals. A novel feature of WP3 is that we can identify exclusions that are common to both management and Thomson, exclusions that are unique to Thomson, and exclusions that are unique to management. The latter two cases represent disagreement over the treatment of earnings components and these are the ones of greatest interest to us.

Descriptive statistics reveal that although non-operating items represent a large fraction of total exclusions in our sample, they account for a disproportionately small fraction of disputed cases. The underlying nature of non-operating gains and losses supplemented by clear income statement disclosure appears to render such items transparently transitory, thereby reducing scope for disagreement. Instead, disagreements centre on operating items and discontinued operations where the idiosyncratic nature of gains and losses combined with opaque disclosure create confusion over the persistence of certain items.

As previously noted, disagreement cases could reflect opportunistic reporting by management designed to present the firm in the most favourable light. We refer to this as the opportunistic behaviour hypothesis. Alternatively, disagreement could reflect management's superior ability to distinguish between permanent and transitory earnings components. We call this the information provision hypothesis. WP3 presents a number of tests designed to assess the balance of evidence concerning these two alternative hypotheses. Overall, the evidence is more consistent with the information provision hypothesis. For example, management often include persistent losses even when these items are excluded by Thomson. However, we do find some evidence of firms failing to exclude gains that subsequently turn out to be transitory.

4.2 Summary of the evidence from interviews

Our interview and survey evidence helps shed further light on the causes and consequences of non-GAAP eps reporting under FRS 3. Analysts suggested that most firms tend to focus on earnings before goodwill and exceptional items. One analyst complained that some firms failed to provide enough information about the nature of all their exceptional items and in particular their separate tax consequences.

In general analysts believe that the majority of firms exclude non-operating exceptionals when reporting a non-GAAP eps figure. They also highlighted that some firms exclude certain operating exceptional items as well. When asked if the decision to publish a non-GAAP eps figure was driven by firms themselves or by the demands of analysts, responses suggested that the decision normally originated from management.

When asked if firms that report non-GAAP eps are managing alternative earnings or basic earnings, the responses from our interviewees were mixed. Although all three interviewees recognised earnings management as a phenomenon they were much less clear as to which earnings concept firms are seeking to manage. One respondent felt it more likely that firms disclosing a non-GAAP eps figure would manage that number rather than the GAAP figure.

5. Research findings on analysts' earnings forecasts under UK GAAP

5.1 Market premium to meeting or beating analysts' forecasts

A well-developed academic literature review demonstrates that US firms that meet or exceed analysts' consensus earnings forecast are valued at a premium by investors. In WP5 we test for evidence of a similar premium in the UK using a large sample of non-financial firms from 1990 through 2003.

Studying the meet and beat premium (MBP) in the UK is restricted by the fact that analysts' forecasts are largely confined to annual earnings. In contrast, US firms publish quarterly earnings and there exists an 'expectations industry' centred on the production of quarterly earnings forecasts.

In the context of quarterly earnings forecasts it is natural to use quarterly stock returns in order to measure the MBP. The standard approach involves calculating an estimate of risk-adjusted stock returns starting from the date of the first forecast at the start of the quarter (ie, the forecast produced just after the previous quarter's earnings have been announced) to the date that the earnings for the quarter are announced. In contrast, the period used to estimate the MBP is much less obvious in the case of annual earnings. To address this problem, we used a variety of 'windows' ranging up to 12 months.

Results reported in WP5 indicate the presence of a significant return premium to beating the consensus analyst forecast of a magnitude between 8% and 10% per annum. This valuation premium is both statistically and economically significant. Our findings compare to a quarterly premium of 3.4% documented by Bartov et al. (2003) for US firms, which equates to approximately 14% on an annual basis. Despite the apparent similarities between our findings and those reported by Bartov et al. (2003), we view the evidence reported in WP5 as very preliminary. In particular, our results are sensitive to the choice of return window: we only find clear evidence of a MBP using abnormal returns computed over a 12-month window (starting from the first consensus forecast established following the announcement of the previous year's earnings and ending on the preliminary earnings announcement day). Thus, while we document some evidence of a MBP, considerable further work is needed to produce a more reliable set of results. We therefore caution against placing too much emphasis on these results. In particular more work is needed on the premium to consistently meeting forecasts, and also on the penalties suffered when firms fail to meet or beat. For example is a failure to meet or beat viewed negatively by the market as a bad signal of loss of 'control'?

5.2 Accounting choices or guidance to meet or beat expectations

Given our findings that firms appear to face significant valuation rewards to meeting and beating the consensus forecast, we expect managers to face strong pressure to ensure that reported earnings do not undershoot the target. The pressure becomes even stronger in view of the severe market

penalties to reporting negative earnings surprises (see Lopez and Rees 2002). Even in the absence of stock price implications, prior research shows that managerial concerns over their job security and reputation gives them strong incentives to achieve market expectations (Graham et al. 2004). In WP4 we report the results of a large-scale empirical study designed to test whether UK managers guide analyst forecasts or make accounting choices to meet or beat the consensus analyst earnings forecast. The study is based on a large sample of non-financial firms from 1994 through 2002 and we use analysts' earnings forecasts from the Institutional Brokers' Estimation Service (IBES) as a proxy for the market's earnings expectations.

WP4 studies the distribution of UK eps surprises and provides evidence consistent with the view that UK firms appear to be taking actions to meet or exceed the consensus earnings forecast. Figure 1 in WP4 shows that there is a suspiciously large number of firms that just meet or beat the consensus forecast compared to the number that just miss the consensus earnings per share forecast. Gore et al. (2007) report similar findings for a different sample of UK firms.

If and how managers of UK firms manipulate reported earnings to meet and beat the consensus forecast remains an open question. Both Burgstahler and Dichev (1997) for the US and Gore et al. (2007) for the UK find some evidence of the use of abnormal accruals to meet or beat the consensus. There is also US evidence that firms might be guiding analyst forecasts to the desired figure instead of, or in addition to, managing reported earnings (Bartov, Givoly and Hayn 2002, Matsumoto 2002). Empirical evidence reported in WP1 along with survey evidence presented in WP6 suggests that while earnings forecast guidance might be common practice in the UK, accruals manipulation is unlikely to be the preferred earnings management method. We therefore predict that UK firms are more likely to engage in earnings forecast guidance or classificatory earnings management, rather than in accruals management to meet or exceed analyst forecasts.

WP4 tests this prediction. First, we examine whether a downward bias in forecast revisions or positive AWCAs increase the probability of meeting or beating the earnings forecast (MBE). Second, we explore whether exceptional and other non-recurring items are associated with abnormal rises in core profitability within subsets of firms that are increasingly likely to use classificatory earnings management to achieve analyst expectations. We decompose total non-recurring items into non-operating exceptional items (NOEI) and operating exceptional and other items (ONRI). We expect greater use of ONRI to MBE. In both analyses we report two sets of results; one set that shows all MBE against all fail-to-MBE cases and another set that reports all just-MBE cases (JMBE) against all just-fail-to-MBE cases. Previous work in this area has argued that the JMBE tests are likely to be more powerful. For the JMBE cases we also focus on small ONRI as we might expect to see a greater incidence of relatively small operating-exceptional items to JMBE.

The results show no evidence that firms use positive AWCAs to meet analyst forecasts (Table 4 of WP4). In contrast, we find that firms that guide analyst forecasts downwards have a higher probability of meeting or beating the final forecast. The associations are robust to a number of incentives to achieve analyst expectations. At the same time we find that while classificatory earnings management is not widespread post-FRS 3, there is some evidence consistent with the practice within a subset of large UK firms. In particular we find that for larger firms that just meet analyst expectations, disclosures of small operating exceptional losses coincide with abnormally high core profits (Table 5 of WP4). The unexpected rise in core profits of these firms reverses in the subsequent period when the small 'exceptional' losses recur and cause a fall in profitability (Table 6 of WP4). Additional analyses show that the exceptional items of these firms help in predicting future operating cash flows in the following three years.

5.3 Summary of interviews and survey evidence on earnings expectations

Our interview and survey evidence reveals a number of interesting findings concerning the interaction between reported earnings and earnings forecasts. The main views to emerge from the analysis are summarised below:

- Many UK-listed firms fear that their share price will suffer if they fail to meet or beat the market's earnings expectations.
- The consensus analyst earnings forecast is perceived by institutional investors and firm managers as a good proxy for what the market expects.
- Most UK-listed firms provide guidance to analysts to ensure that their forecasts are close to what the firm believes it is likely to be able to achieve.
- Some firms are likely to manage their reported earnings into line with market expectations if they are likely to undershoot or overshoot the consensus.
- Only a minority of respondents felt that management would use accounting manipulations (eg, accruals) to meet or beat the consensus forecast.
- Firms are more likely to alter short-term economic decisions to hit the consensus than they are to change accounting decisions.

5.4 Does expectations or earnings management fool investors?

We have seen that firms can take a number of actions to ensure that their reported earnings meet or beat the consensus earnings forecast. We have also seen evidence that some firms appear to guide analyst forecasts or engage in classificatory smoothing to meet or beat the forecast. WP8 explores the capital market consequences of achieving analysts' earnings expectations. It asks whether the market reward to meeting or beating the consensus forecast differs between firms that achieve the forecast through genuine or managed means. This research is the first that we are aware of to conduct a comprehensive analysis of this issue using UK data.

The results suggest that the market rewards firms that achieve analysts' expectations compared to firms that miss the target. The market reaction appears rational in that the reward pertains to firms that achieve the earnings target without guiding analyst forecasts or managing earnings (Table 5 of WP8). For firms that guide analyst forecasts downwards or engage in classificatory earnings management the market discounts the reward. When relating the market reaction to information about future profitability, we find no evidence of overvaluation for firms that hit the target through managed means (Table 6 of WP8). This suggests that the market is not generally misled by earnings forecast guidance or earnings management to achieve analyst expectations.

6. Conclusions and policy implications

FRS 3 can be viewed as a policy experiment on the important issue of reporting financial performance. It required all UK firms to routinely report net income per share as the only mandatory measure of eps, and effectively banned the use of extraordinary items. In addition FRS 3 required further disaggregation of profit and loss and increased levels of disclosure with regard to both operating and non-operating exceptional items. FRS 3 also allowed firms to disclose alternative measures of eps where these might provide a more reliable guide to sustainable performance.

We have seen that a majority of firms took advantage of the discretion allowed by FRS 3 to disclose alternative measures of eps. On the whole the evidence suggests that firms chose these measures in order to present more

reliable indicators of sustainable performance. However, some firms were more willing to highlight transitory losses than transitory gains. Overall we believe that FRS 3 served to elicit superior information about future financial performance. Thus our view is that the IASB should encourage continued development of this approach. Measures to require all firms to highlight transitory gains as clearly as transitory losses should form part of this development.

In developing this approach firms should be encouraged to supply as much detail as possible on all exceptional items. One particular issue drawn to our attention was the need for the identification and disclosure of the detailed tax consequences of all exceptional items.

Perhaps because of the heightened levels of disclosure required by FRS 3, or perhaps because of other accounting changes that followed on from FRS 3, we found that the use of discretionary accruals in the UK has declined. To some extent this has been associated with a heightened use of classificatory smoothing. Thus FRS 3 seems to have encouraged a more transparent way of smoothing reported earnings. This is consistent with firms wishing to present measures of sustainable earnings to external investors.

Our Briefing has drawn attention to the 'earnings game' that is played out between companies and financial analysts. We found clear evidence that management engage in earnings guidance to influence the consensus forecast, and that firms also manage reported earnings to meet or beat the consensus. However we also found that investors were not generally misled by the earnings game. In particular, we found that firms that genuinely meet or beat the consensus forecast are rewarded by a premium, and firms that meet or beat either through earnings guidance or earnings management earn a lower premium or no premium at all. Thus we do not believe that professional investors are caught out by the earnings game, so long as they are provided with full information about the classificatory choices and other judgements underlying the reported figures.

Nevertheless, we still have some concerns about the fairness of the earnings game in relation to retail investors. We think that management could do more to ensure such investors are better informed. Most firms have web sites on which they post their annual reports and investor briefings. Some firms also include the identities of analysts with whom they have regular contact, and a few firms actually publish either individual analysts' forecasts or the consensus number. We would like to see all firms encouraged to provide information about their analyst following to make it easier for retail investors to find relevant analysts. Since it is clear that many firms provide guidance to analysts, retail investors need to know which analysts are being favoured in this way. In addition, it would be helpful if firms produced an ex-post comparison of their published results with the consensus analyst forecast.

We document evidence of some confusion regarding the line in the income statement that is the object of analysts' forecasts. While most investment professionals we surveyed believe that the earnings forecast relates to earnings before all exceptional items, a significant minority believe that earnings forecasts relate to earnings after operating exceptionals. We would like to see much clearer information about the definition of earnings to which the forecast applies. In other words, analysts should indicate whether their forecast includes or excludes goodwill amortisation and any expected goodwill impairments, and they should indicate whether their forecast relates to earnings before all exceptional items, or before non-operating exceptionals.

In concluding this Briefing we attempt to relate our findings to the current debate on performance reporting. We have already alluded to the fact that the economic role of earnings is likely to prove central to the resolution of this debate. The enthusiasm of some regulators for the abolition of the income statement is driven partly by their belief that earnings have lost relevance, and partly by the view that fair values have somehow become

more relevant. Advocates of fair value accounting tend to deny the importance of earnings, and tend to advocate the abolition of the income statement in favour of a single comprehensive statement of all gains and losses recognised during the accounting period.

The IASB, for example, has exhibited a consistent tendency to downplay the importance of earnings while at the same time advocating the use of fair value measurement for an increasing range of balance sheet items.

However the IASB has encountered significant difficulties in agreeing a comprehensive framework for reporting financial performance and strong opposition to its attempts to downgrade the importance of stewardship as a fundamental objective of financial reporting.

It is our view that these difficulties arise because of the reluctance of the IASB to recognise the importance of earnings as a core product of the financial reporting process. High-quality measures of earnings are needed both as a starting point for forward looking company valuation and as a feedback measure for assessing whether the capital invested in the firm has yielded a satisfactory return. Thus we suggest that the IASB should develop its new framework for reporting financial performance to ensure that it provides an adequate platform for the provision of high-quality and transparent earnings numbers.

The UK experience with FRS 3 suggests that a comprehensive accounting framework that transparently discloses all gains and losses is more likely to be supported by investors and other financial reporting users if firms are encouraged to disclose audited measures of sustainable earnings and if the financial statements supply sufficient information to allow end users to calculate their own preferred measures of earnings.

However, we are aware that a number of doubts have been raised about the desirability of a focus on earnings reporting, and so in this final section we discuss the limitations of accounting earnings. Critics of earnings point to three main problems:

1. The lack of a standardised definition of earnings

Barker (2004) argues that 'earnings *cannot* be defined satisfactorily for the purpose of accounting standards'. From this he concludes, 'A change of mindset is required that takes us away from attempting to identify earnings (and its corollary, "below the line" items)'.

We are inclined to agree with Barker that accounting standard setters should not attempt to force on firms one particular definition of earnings. However, accepting this point does not necessarily imply that firms should be prevented from reporting earnings numbers as part of their financial statements. Rather, firms could be encouraged to supply their own preferred measures of earnings within a framework that provides full transparency about the judgements made in producing these preferred measures, and that also provides an information set that is rich enough to allow the users of the accounts to produce their own preferred measures of earnings.

The IASB and the FASB have recently piloted experimental formats for the comprehensive reporting of all gains and losses within an accounting period. Such frameworks have been admired for their comprehensiveness, but they have been criticised because of their failure to identify a clear bottom line earnings figure.

Perhaps a change of mindset is needed at the IASB/FASB. Rather than seeking to write earnings out of the rulebook, the IASB/FASB should consider how best to develop a comprehensive framework for the reporting of all gains and losses that allows and encourages firms to produce measures of sustainable earnings. The IASB/FASB should not attempt to define measures of sustainable earnings themselves. They should leave this to management and to the users of the accounts. What matters is that the comprehensive financial reporting framework has sufficient flexibility to

allow preparers to produce measures of earnings that are both auditable and transparent (ie, the judgements on which the earnings measures are calculated are fully disclosed).

2. The scope for earnings manipulation

Firms have considerable discretion over accounting choices and economic choices that affect the reported level of earnings. Choices over discretionary accruals alter the timing of revenues and expenses recognition, but without affecting operating cash flows, unless they affect the taxable income of the firm.¹ Discretionary classifications of gains and losses serve to highlight some gains and losses while obscuring others. Firms can also make real economic decisions that improve short-term reported earnings while reducing firm value.

Influential accounting practitioners such as Eccles et al. (2001) have identified the scope for earnings management as a major policy concern. In particular they point to the 'earnings game' played between US firms and US investment analysts as a major area of abuse. They highlight a number of potential concerns about this game.

- Excessive focus by all the parties on short-term earnings numbers rather than long-term value creation.
- Company managers spending too much time managing the earnings game rather than managing the firm.
- Managers making real economic decision that destroy value in order to achieve a particular earnings outcome.
- Privileged access to the game by some players at the expense of others (eg, retail investors lose out to institutional investors).
- Analysts becoming dependent on the earnings guidance supplied by firms rather than producing their own independent analyses.

We agree with Eccles et al. that the earnings management game has the potential for inappropriate behaviours and inefficient or inequitable economic consequences. Also, we cannot disagree with their view that the game got out of hand in the US up to and after the year 2000.

However we are reluctant to accept their conclusion that the earnings game is inherently incapable of satisfactory reform. Eccles et al. do not explain why stock markets value the reporting of earnings. Observing that the earnings game is subject to abuse is not in and of itself an argument for writing earnings out of financial reporting altogether. Our evidence on how the earnings game is played in the UK does not lead us to conclude that this game is, on balance, harmful to the UK economy. While it is certainly true that the UK earnings game does have the potential for abuse, we believe that on the whole this game contributes a valuable degree of stability to the pricing of UK-traded equities.

Eccles et al. also do not consider the theoretical literature which shows that earnings management is not inevitable. In particular, it is important to understand the fundamental causes of earnings management before jumping to conclusions about what kinds of reforms are needed. Arya et al. (1998) provide a helpful explanation of the fundamental causes of earnings management. These are lack of transparency, or what they call, blocked communication, and the need to take into account the contractual uses of accounting information. If policymakers are concerned about excessive focus on short-term earnings, and earnings forecasts, then actions should be taken to shift the emphasis to longer-term earnings and earnings forecasts, rather than abandoning earnings altogether. If company managers need to be better motivated then this should be achieved by

¹ Accounting choices also affect the distribution of wealth between various stakeholders where contracts link payoffs to accounting numbers.

changing reward contracts and governance structures. It is not at all obvious why this would necessarily involve the abandonment of earnings.

We also doubt that destroying the earnings game will do much to deal with the lack of independence of analysts and the privileged access of some classes of investors to information. These problems should be regulated more directly by requiring greater transparency about the information supplied to analysts, the contacts between firms and analysts, the information supplied privately to institutional investors, and the contacts between institutional investors and the firm. Getting rid of the 'earnings game' will not address these more far reaching concerns.

3. Current earnings are a poor guide to underlying firm value

The third argument frequently made against encouraging a focus on accounting earnings is the problem that short-term earnings are often a poor indicator of long-term value. This is certainly true, but this is equally true of all auditable accounting numbers. In particular, auditable balance sheet values are also a poor guide to firm value. Moreover earnings have two important properties that are often not appreciated. First of all, it can be shown that company value can always be expressed in terms of a multiple of expected future earnings and the present value of expected future abnormal earnings growth (Ohlson 2007). Second, in the long run company value is equal to long run expected earnings divided by the cost of equity capital Ohlson (2007).

The first point is important in relation to claims about the failure of the earnings-based financial reporting model to represent the value of intangibles. The truth is that investments in intangible assets produce real value for shareholders if and only if they increase expected future earnings. In other words, earnings properly reflect the value created by investments by intangibles only with a lag. If managers want to persuade investors to recognise the value of intangibles earlier than this, then they should focus on improving the unaudited disclosures they provide about such items rather than trying to cloud the financial statements with their highly subjective and essentially unauditable financial beliefs. The neat thing about the earnings construct is that it provides auditable estimates of realised payoffs against which the forecasts of managers can be evaluated.

The importance of the second point is that, by recognising that the notion of permanent earnings is theoretically robust, it points to the need for information to enable investors to make their own estimates of sustainable/permanent earnings. This point is especially important in relation to current attempts to design comprehensive statements of financial performance. One view of these efforts is that they will provide decision-relevant information in which the concept of earnings has no essential role, thereby making way for a greater focus on fair value balance sheets. An alternative viewpoint, and one that we favour, is that these developments should focus on providing a comprehensive set of auditable financial statements that permit users to make their own estimates of sustainable earnings and to compare these against the firm's view. Such developments should also focus on engineering the relation between current earnings (and related numbers that appear in the audited accounts) and the unaudited information flows between firms and investors. In particular, investors need information that allows them to trace the link from the previous unauditable claims and forecasts of managers to current earnings.

Appendix: working papers

The detailed findings of this study are contained in the following 10 working papers (WPs). These papers are available for downloading at www.mbs.ac.uk/cair/frs3.

- WP1: Accruals management under changing regimes of reporting financial performance. May 2006 version (Athanasakou, V., Strong, N.C. and Walker, M.).
- WP2: Classificatory income smoothing: the impact of FRS 3. June 2006 version (Athanasakou, V., Strong, N.C. and Walker, M.). [A revised version of this paper is forthcoming in the *Journal of Accounting and Public Policy* 2007. Some of the table numbers have changed in this new version.]
- WP3: Disagreement over the persistence of earnings components: evidence on the properties of management-specific adjustments to GAAP earnings. June 2006 version (Choi, Y-S., Lin, S., Walker, M. and Young, S.). [A revised version of this paper is forthcoming in *The Review of Accounting Studies* 2007. Some of the table numbers have changed in the revised version.]
- WP4: Earnings management or forecast guidance to meet analyst expectations? November 2006 version (Athanasakou, V., Strong N.C. and Walker, M.).
- WP5: Market premium to meet or beat analysts' forecasts: further evidence from the UK. June 2006 version (Choi, Y-S. and Lin, S.).
- WP6: Earnings reporting and analysts' earnings forecasts: the perceptions of UK analysts and financial managers. February 2006 version (Choi, Y-S, Young, S. and Walker, M.).
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The research on which this Briefing is based was produced as a joint project by Lancaster University Management School (LUMS) and Manchester Business School (MBS). The project was led by Professors Steven Young and Martin Walker. Dr Stephen Lin started as one of the project leaders at MBS, but moved to Florida International part way through the project where he continued to make a contribution to the research.

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