FAN

Financial Statement Analysis

Code: **FAN001** Day: **Wednesday**
Abstract ID: **0594** Time: **17.30-18.30**
Room: **Q114**

The relevance of non-financial value reporting

Andreas Wömpener
(andreas@woempener.de)
Westfälische Wilhelms-Universität, Münster
Co-author(s): **Hannes Köhrmann**

Due to the increasingly competitive market for equity, listed companies are investor oriented in order to strengthen their equity base. The reporting of financial and non-financial measures facilitates company appraisal and increases transparency. Financial measures are an integral part of reports, but are usually short-term success figures. Concentration on these figures may lead to a neglect of the long-term goals and performance drivers from the external perspective of investors. This paper focuses on non-financial measures which are published in annual reports of companies listed in the DAX 30 index. After establishing a framework for non-financial value reporting, we use content analysis and analyze to what extend and on which level of quality such information is published. We find that differences exist with respect to the nature of the industry: Companies in industries where the primary drivers of value are of tangible nature report relatively more intensively on supplier and process related information while industries dominated by intangible value drivers report relatively more intensively on information related to investor relations and human capital. This empirical work contributes to existing research by concentrating on non-financial aspects. Furthermore, the results are of relevance for companies who need to decide on which information to publish. The study will also be a basis for future research of the authors.

Code: **FAN002** Day: **Wednesday**
Abstract ID: **1096** Time: **17.30-18.30**
Room: **Q114**

Cost behavior and fundamental analysis of SG&A costs

Surya Janakiraman
(suryaj@utdallas.edu)
University of Texas at Dallas
Co-author(s): **Rajiv Banker**, **Mark Anderson**
Rong Huang

In fundamental analysis, it is customary to interpret an increase in the ratio of selling, general and administrative costs to sales (the SG&A cost ratio) between two periods as a negative signal about future profitability and firm value. Implicit in this interpretation is an expectation that SG&A costs should normally move proportionately with increases or decreases in revenues, and that an increase in the ratio signals management inefficiency in controlling costs. While this expectation provides for a straightforward interpretation for analysis purposes, it ignores important aspects of SG&A cost behavior. We observe that both fixity of costs and stickiness of costs may cause the ratio of SG&A costs to sales to increase, rather than decrease proportionately with sales when revenue declines. Sticky costs, in fact, may represent deliberate retention of SG&A resources based on managers' expectations that revenue will increase in the future. In this case, an increase in the SG&A cost ratio may actually convey positive information about managers' expectations of future earnings. We estimate an earnings prediction model and find that future earnings are positively related to changes in the SG&A cost ratio in periods when revenue declines, inconsistent with traditional interpretation of SG&A cost changes. We also find that abnormal positive returns may be earned on hedge portfolios formed based on increases in the SG&A cost ratio in revenue-declining periods.

Code: **FAN003** Day: **Thursday**
Abstract ID: **0134** Time: **9.00-10.30**
Room: **Q106**

Venture Capital Investor Behaviour in the Backing of UK High Technology Firms: Financial Reporting and the Level of Investment

Gavin Reid
(gcr@st-andrews.ac.uk)
University of St Andrews
Co-author(s): **Julia Smith**

This paper is an empirical investigation into the ways in which venture capitalists value (and invest in) high technology firms, focusing on financial reporting, risk disclosure and intangible assets. It is based on questionnaire returns from UK investors in diverse sectors, ranging from biotechnology, through software/ computer services, to communications and medical services. This evidence is used to examine: (a) the usefulness of financial accounts; (b) the implications of technopole investment; (c) the extent of investor control over the investee's AIS; and (d) the role of investor opinion (e.g. on disclosure, due diligence and risk reporting) in determining the level of equity provision.

Code: **FAN004** Day: **Thursday**
Abstract ID: **0316** Time: **9.00-10.30**
Room: **Q106**

What Determines the Survival of Internet IPOs?

Tjalling van der Goot
(l.r.t.vandergoot@uva.nl)
University of Amsterdam
Co-author(s): **Michiel Botman, Noud van Giersbergen**

This paper investigates the determinants of survival and non-survival for internet firms that have gone public at the NASDAQ stock exchange from December 1996 through February 2001. We identify which variables predict the rate of firm survival in the internet industry and estimate the effect of these variables on the trading (survival) time. Contrary to most other studies, the analysis in this paper considers all the explanatory variables simultaneously. It appears that the average operating history of internet IPOs is remarkably small compared to non-internet IPOs, namely 2.4 and 10 years, respectively. Furthermore, we find that the average number of risk factors for internet IPOs is four times higher than the number reported for non-internet IPOs. Surviving firms can be distinguished in a number of ways from non-surviving firms. The survival time of an internet IPO is an increasing function of underwriter reputation, investor demand, inside ownership retention, and operational cash flow over liabilities. The survival time is found to be a decreasing function of valuation uncertainty and IPO market level. Firm-specific risk appears not related to the survival of internet IPOs. Our findings hold under a number of different model specifications and robustness checks.

Code: **FAN005** Day: **Thursday**
Abstract ID: **1058** Time: **9.00-10.30**
Room: **Q106**

IPO Failure Risk

Philip Joos
(philjoos@uvt.nl)
Tilburg University, Netherlands
Co-author(s): **Elizabeth Demers**

We explore the factors associated with IPO failures by developing an IPO failure prediction model that includes accounting information as well as proxies for the role of information intermediaries and other IPO deal-related characteristics. We document statistically significant differences in failure models applicable to non-tech versus high tech IPOs, and these structural differences are largely driven by accounting-based proxies for firms' investments in intangible assets, operating performance, and financial leverage. We also develop parsimonious, predominantly accounting-based, strictly out-of-sample (i.e., no hindsight) IPO failure forecasting models for each of the two sectors. We find that our forecasts are negatively associated with one-year post-IPO abnormal returns. A pseudo-hedge strategy of going short (long) in high (low) failure risk portfolios yields returns of economically significant magnitudes over the one-year horizon. Results of Fama-French regressions suggest that the IPO long-run returns anomaly persists, but only for high failure risk firms in the non-tech sector.

Code: **FAN006** Day: **Thursday**
Abstract ID: **0061** Time: **11.00-12.30**
Room: **Q106**

Error in constant growth accounting valuation models

Richard Brief
(rbrief@stern.nyu.edu)
New York University
Co-author(s): **John O'Hanlon, Kenneth Peasnell**

The fundamental assumption of accounting-based valuation models is that in the long-run, the accounting component vanishes and dividends are recovered. Therefore, accounting policies do not matter. In the extensive literature on the subject, this assumption has not been questioned. The key proposition of this paper is that when these models are parameterized and constant growth is assumed, accounting policies do matter and impact the valuation. The valuation error is due to the "non vanishing terminal value" in the model. Thus, the characteristics of the accounting system that are implied by the assumption of constant growth violate the core assumption of both the residual income valuation model and the abnormal earnings growth model. There is one exception. When constant payout is assumed, the terminal value disappears.

Code: **FAN007** Day: **Thursday**
Abstract ID: **0837** Time: **11.00-12.30**
Room: **Q106**

Building Benchmark Models of the Intrinsic Value of Equity Using IBES and Value Line Forecasts of Fundamentals

Lucie Courteau
(lucie.courteau@unibz.it)
Free University of Bolzano
Co-author(s): **Jennifer Kao, Terry O'Keefe, Gordon Richardson**

The purpose of this paper is help investors decide whether to buy estimates of fundamental values from IBES, Value Line (VL), or both so as to construct best practice benchmarks of the equity value of US firms. This question is interesting not only in the US context because the differences in the characteristics of forecasts provided by IBES and VL allow us to examine the valuation usefulness of consensus forecasts vs. those made by a single analyst and of estimation of future earnings alone vs. a more detailed forecast containing also future book values and terminal values. We estimate benchmark equity values for the residual income model (RIM), the four-period-forward-price-earnings model (PE4) and hybrid models which combine RIM and PE4. For the RIM model, we examine several combinations of earnings and terminal value forecasts from both IBES and VL. One of the terminal values used, the IHP model (Industry Horizon Premium) infers terminal value from information about current prices, cost of capital, and forecasts of earnings for firms in the industry. Model success is measured by pricing errors (the difference between values computed from each model and current stock prices) and by the forward 36-month abnormal return earned on a hedge portfolio. Preliminary results indicate that the two best models are RIM with either IBES or VL earnings forecast and IHP terminal value. The abnormal returns of these models are nearly equal so there is no benefit from purchasing both investor services.

Code: **FAN008** Day: **Thursday**
Abstract ID: **1163** Time: **11.00-12.30**
Room: **Q106**

The Valuation of Cash Flows and Accruals by Life Cycle Stage

Ervin Black
(erv_black@byu.edu)
Bringham Young University
Co-author(s): **Gary Biddle**

Of long-established and continuing interest in economics is a taxonomy of firms based on life cycle stages. This paper examines how market valuations of cash flow and accrual components vary by firms' life cycle stages of development. Our inquiry is motivated by the intuition that cash flow and accrual components convey different inferences for firms at different stages of development, an intuition reflected in traditional financial analysis precepts. In practice, analysts must forecast value determinants over finite horizons. Life cycle stages may capture conveniently firm characteristics that influence how these determinants map into value over finite horizons. To assess this, we apply variations of the discounted dividend, free cash flow, and residual income valuation models to estimate the equity values per present value unit of dividends, cash flows, income accruals, and book equity for firms in each of six life cycle stages: start-up, growth, growth-mature, mature, mature-decline, and decline. Our results reveal distinct patterns across the six firm life cycle stages in the unit valuations. These valuations are of immediate interest to investors, managers, and researchers for understanding valuation multiples for firms in different life cycle stages.

Code: **FAN009** Day: **Thursday**
Abstract ID: **0272** Time: **14.00-15.30**
Room: **Q106**

Does Negative Income Reflect Bad News Quickly?

Peter Joos
(peter_joos@baruch.cuny.edu)
Baruch College, New York

I study whether the increase in the number of firms reporting negative income (i.e., losses) reflects a change in the usefulness of accounting earnings for contracting or governance. Adopting the definition that accounting earnings need to quickly reflect economic losses or bad news to be useful in contracting and governance, I investigate whether the temporal change in loss reporting also reflects a change in how quickly negative income reflects bad news. I predict and find that the speed at which losses reflect *bad* news has substantially decreased in recent years. I show that an increasing link between R&D intensity and losses explains this temporal decrease in timeliness to bad news: as firms have increased their R&D activities, the mandated unconditionally-conservative accounting treatment of R&D has led not just to more losses, but also to losses that reflect bad news less quickly. My findings suggest that greater *observed* income conservatism does not always imply a general increase in the contracting or governance efficiency of earnings. In addition, my findings imply that, since R&D expenditures affect cash flow from operations, using cash flow from operations as a control for real activity of the firm is not neutral to the effects of conservative accounting measurement of the firm's activities.

Code: **FAN010** Day: **Thursday**
Abstract ID: **0793** Time: **14.00-15.30**
Room: **Q106**

Risk Reports of German Insurance Companies - Could the German Accounting Standard 5-20 (GAS 5-20) lead the way internationally?

Mirko Kraft
(mirkokraft@web.de)
Lehrstuhl für BWL, insbesondere Controlling, Münster
Co-author(s): **Alexandra Nolte, Florian Krol**

Applying a detailed content analysis, this paper presents the results of an empirical study on the development of risk reports of German insurance companies. The research criteria based on formal and content requirements relying on generally accepted accounting principles for management reports in annual financial statements and GAS 5-20. This German accounting standard regulates the risk reporting of insurance companies in a mandatory way (regulated by law). Issued in 2001, it was the first standard on comprehensive risk reporting for insurers worldwide. The study's intent was to collect data of formal and qualitative changes in risk reports and to evaluate their performance over time in fulfilling this industry-specific regulation of risk reporting. Our sample of 22 German life insurance and non-life-insurance companies shows that risk reports improved continuously from 1999 until 2003. The ascending emphasis German insurance companies put on risk reporting can be derived, for example, from the significantly increasing length of the specific risk descriptions and the growing number of risk categories. Nevertheless, in some cases dissatisfying information content could be identified among the risk disclosures (e.g., missing quantification of risks). The results lead to further implications with regard to Solvency II and IFRS 4. This paper suggests improvements in risk disclosures that could be considered in international standard-setting or supervisory regulations.

Code: **FAN011** Day: **Thursday**
Abstract ID: **0822** Time: **14.00-15.30**
Room: **Q106**

The Impact of Incorporating the Cost of Errors into Bankruptcy Prediction Models

Lawrence Weiss
(larry.weiss@unil.ch)
HEC-University of Lausanne
Co-author(s): **Vedran Capkun**

The current methodology to use and evaluate default and bankruptcy prediction models is to determine their precision - the percentage of firms predicted correctly. In this study we develop a framework for incorporating Type I (the amount lost from lending to a firm which goes bankrupt) and Type II (the opportunity cost of not lending to a firm which does not go bankrupt) error costs into the prediction models and their evaluation. Our results indicate that a lending model which accounts for the cost of errors and firm size yields higher profits than a model relying only on precision. This also supports our hypothesis that the usefulness of prediction models cannot be fully assessed independently of the costs of both types of forecast errors.