

## **Collected Abstracts: Research Forum Sessions**

**FAN**

**Financial Statement Analysis**

Code: FAN R01  
Abstract ID: 0197

Day: Wednesday  
Time: 16.00-17.30  
Room: Q116

### **Portfolio Analysis of Working Capital Strategies**

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A fundamental objective of management is shareholders wealth maximisation. However, a sufficient level of financial liquidity is needed to ensure the existence of a corporation. Value creation and financial liquidity are a trade-off, they cannot be achieved simultaneously. The analytical framework presented in the manuscript enables an analyst to examine on which aim a corporation is more concentrated. From a simple residual income model a set of ratios is derived in the form of pyramid analysis. Next these ratios are used in a portfolio analysis of the characteristics of working capital strategies: current asset strategy, current asset financing strategy and asset-financing strategy. This is done by means of suitable charts and a final chart which shows an overall working capital strategy.

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Abstract ID: 0471

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Time: 16.00-17.30  
Room: Q116

### **An empirical analysis of the effect of changing from historical cost to fair value accounting for investments on the assessment of company efficiency and profitability**

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Until recently the strict application of the historical cost and prudence principle has guided accounting for investments in Spain, but this situation might change as a consequence of the introduction of IFRS. It is unclear how such a change would affect the analysis of financial statements and to which extent it could modify analysts' opinions. This paper tries to shed some light on this issue by restating the financial investments and tangible fixed assets of a sample of local insurance companies applying fair value instead of historical-cost based valuations and simulating analyst perception of these companies' efficiency and profitability for both sets of data with Data Envelopment Analysis (DEA). The relationship between company characteristics and DEA scores is further analysed with Tobit regression. We find that book values change considerably when investments are accounted for at fair value, and that the magnitude of this change varies between companies and types of assets. However, only in few cases the difference in valuation leads to a relevant difference in efficiency scores; that is, within the sample the overall rank order of the companies with regard to efficiency and profitability remains largely the same under both valuation bases. These findings seem to indicate that a change from historical cost to fair value accounting for investments would alter analyst perceptions of a limited number of companies but would not have any effect for the majority of them.

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### **The influence of institutions on financial performance and the likelihood of financial distress**

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In this paper we investigate whether firm financial performance and the likelihood of financial distress depends on a country's institutional qualities or properties as well as its change in institutional characteristics. The influence of institutional quality on macroeconomic aggregates has been broadly investigated indicating that institutions and ideology shape a countries' economic strength (e.g. North, 1994). However, in this study we look at firm-level rather than country-level performance. In accounting practice on the other hand, institutions have mostly been assessed by investigating their impact on properties of earnings, securities regulation (e.g. LaPorta, 1998),... although they have never been linked to firm financial metrics of performance. However, indicators like bank efficiency, labour market characteristics and the regulatory quality in a country are only some examples of indicators of which one can expect having an impact on firm performance. The results confirm that institutional factors influence firm's financial performance and the likelihood of financial distress. These two questions will be assessed using Data Envelopment Analysis. DEA can be applied to aggregate different aspects of financial performance and country-level institutional factors as well as for identifying possible trade-offs between different financial metrics.

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### **Predicting Financial Distress: Relationship between Continued Losses and Legal Bankruptcy**

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Although bankruptcy prediction can be considered as a classical problem, there are still some topics of interest for researchers, like the definition of failure. So, models that predict insolvency risk take legal bankruptcy as a dependent variable, although companies with financial difficulties not always finish in a bankruptcy process. Also, the opposite case can occur, that is, companies that are still solvent can lead to legal bankruptcy. So, the aim of this paper is to investigate whether there is some relationship between economic and legal failure in order to contribute towards developing a theory on business failure. The economic failure refers to the existence of continued losses for three years, while legal failure refers to firms that have declared themselves bankruptcy before the courts. We have considered two types of independent variables, some obtained from financial statements while others are non-financial data, related to 480 Spanish companies from Infotel database, during 1998 and 2003. Firstly, we have applied parametric and no parametric tests in order to identify significant differences among firms with continued losses and healthy ones. Secondly, we have obtained firm aggregated clusters and extracted the variables that let us make the appropriate characterization of firms included in each cluster. The analysis of the results obtained will allow us to determine whether continued losses lead to legal bankruptcy or there are independent processes.

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**Valuation trends in business valuation:  
the case of Portuguese official auditors**

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The process of business valuation includes methodologies where accounting information is a key input. According to Portuguese Companies Business Code, in line with EU directives, official auditors must be active part in the process of companies' valuation for specific situations such as mergers, acquisitions, and spin-offs & divestitures. However the regulation in force does not specify the methodology to be followed, and so auditors are free to choose among the available methods. Once it not completely known which methods are being used, this paper aims at analysing the practice of companies' valuation by Portuguese official auditors. The research is based on an inquiry with 32 questions and submit to the population of Portuguese official auditors, considering a sample with a confidence level  $\lambda=95\%$  and a precision level  $\epsilon=5\%$ . The paper describes the auditing profession, and valuation rules stated in the law and in the auditors' professional standards. The questionnaire covers valuation models, usefulness of accounting information, adjustments in assets value, estimation of cash flows, discount rates and residual values. The conclusion is that auditors generally apply assets-based and discounted cash valuation. Possible reasons for the prevalence of conservative and legal based models are the average age of auditors being 49, past experience, education and the context. The use of option valuation depends on diffusion and training of these models, as well as legal background.

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Room: Q116

**The Relative and Incremental Explanatory  
Power of Dirty Surplus for Debt Interest Rate**

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This study investigates the relationship between dirty surplus items on the balance sheet and the cost of debt for Japanese firms. We focus on three dirty surplus items, i.e., the unrealized gains and losses on the available-for-sale securities (SEC), and the foreign currency translation adjustment (FOC), and the land revaluation surplus (LAND). While many prior studies on dirty surplus are conducted from value-relevance perspective, we examine the effect of dirty surplus items on the interest rate of bonds from contractual perspective. By using the Vuong (1989) test, we evaluate the relative explanatory power of equity ratio with and without dirty surplus items for interest rate spread of bonds issued. We find that the equity ratio excluding dirty surplus items is more strongly associated with the interest rate spread than that including dirty surplus items. The results suggest that the total amount of dirty surplus items have no explanatory power for interest rate of bonds issued. However, we find that some items of dirty surplus have the relative and incremental explanatory power for bond interest rate. FOC has the relative and incremental explanatory power and SEC has the incremental explanatory power for bond interest rate. We present some possible explanations for the reason why some items have explanatory power

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**Inventories and financial statement analysis:  
Evidence from the wine industry**

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Wine accounting has a significant impact in several European countries, and Portugal is one of them. The traditional accounting framework is unsuitable in the accounting for inventories of high quality and long-lived Port wine because accounting standards and practices recognize long-lived inventories of wine as current assets at their historical cost. Together with inflation, this leads to underestimation of the value of long-lived inventories, leading to financial statement analysis problems. The IASB and other standards setters incite the disclosure of information closely related to the effects of changing prices on financial statements. Disclosing the effect of changing prices in Port wine is such an important issue that the industry regulator (IVDP) publicly discloses its price index. We argue that the industry regulator price index is not useful for financial statement analysis, because it does not incorporate any Port wine quality adjustment. In order to solve this problem, we compute a hedonic or quality adjusted index, based on the Economic Hedonic Price Theory. We use data on prices and other characteristics of more than 56 000 business transactions of Port sold by nine Port wine companies, in a four year period, and test the hedonic price index against the IVDP index. Our index shows better results in terms of stability. A useful disclosure of the Port wine changing prices leads to better financial statement analyses.

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**Sophisticated versus unsophisticated valuation:  
a contextual approach**

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Previous research on the valuation behavior of sell-side analysts have shown a predominant use of simpler comparative valuation models over more sophisticated net present value based models. The aim of this study is to investigate the contextual factors which accompany the choice of valuation models by sell-side financial analysts. To reach this aim the study analyses the valuation content of 260 sell-side financial analyst reports on a respective number of S&P 500 companies. Results show that the choice of valuation model is contextual, with significant relationships between the sophistication of the valuation behavior in reports to the industry of the target firm and the brokerage which issued the report. Additionally, it is argued that the discrepancy between theory and practice is not due to a knowledge problem on the side of the analyst, nor due to a cost-benefit tradeoff on the part of analysts.

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**In Search of a Free Lunch –  
Hybrid Financial Securities in Australia**

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Since the turn of the new millennium, much attention has been focused on the pressing problem of improving corporate governance. A key element of this global trend has been an increased focus on transparency and quality in financial reporting. Yet at the same time as the spotlight has been shone brightly on the quality and transparency of financial reporting, the use of hybrid debt equity securities has undergone a renaissance in Australia. For issuers, these securities typically combine the dual attractions of high tax effectiveness and low cost of funds, while investors have exhibited strong demand for these securities because of the enhanced yields they typically offer in comparison to ordinary equity securities. From a financial reporting perspective however, these instruments can present a range of threats to transparency, consistency and comparability. This paper reports on a study of a sample of hybrid securities issued by large Australian listed corporations between 2002 and 2004. The paper focuses on the key financial reporting impacts of this sample. From a balance sheet perspective these include the frequency with which the securities were classified as equity and the resulting impact on leverage ratios and other traditional risk measures. The impact of these securities on reported earnings and key financial performance metrics is also discussed. Policy implications are drawn from the findings by way of conclusion.

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**Value relevance of book value, retained earnings and  
dividends and: premium vs. discount firms**

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In line with literature that examines contexts/factors affecting value relevance and relative valuation roles of book value, earnings and dividends, our study examines a new such context, which has so far been overlooked. We find that the value relevance and relative importance of book value vs. dividends and earnings is reversed, depending on whether the firm is trading at a premium or discount to book value. We further examine how this finding interacts with the Hayn (1995) sign of earnings phenomenon, the Brgstahler and Dichev (1997) relative levels of earnings and book value phenomenon, the Core et al. (2003) intertemporal variations in the value relevance phenomenon, informational environment of the firm, and the case where the reported book value is negative. Our findings indicate that when firms trade at a discount to book value, the Hayn (1995) and Brgstahler and Dichev (1997) phenomena become inconsequential. Furthermore, the discovered relation between the discount/premium characteristic of the firm and the value relevance of specific accounting value drivers appears to be robust to the effect of time, informational environment and the industry of the firm.