

# The Usefulness of Financial Information to Investors

By

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# How To Examine Usefulness

❖ The primary objective of financial information:

“Financial reporting shall provide information to help investors, creditors, and others assess the amounts, timing and uncertainty of prospective net cash inflows to the related enterprise.”

“Information about enterprise earnings based on accrual accounting generally provides a better indication of an enterprise’s present and continuing ability to generate favorable cash flows than information limited to the financial effects of cash receipts and payments.” (FASB concept Statement No. 1, 1978)

- ❖ This is a testable proposition which was examined by various researchers.
  - ❖ Prediction tests generally fail to support the FASB proposition (e.g., Finger, 1994).
  - ❖ Regression analyses find an association between current accruals and subsequent cash flows and earnings (e.g., Barth et al., 2001).
  - ❖ But accruals are a mixed bag.

# Accruals: The Essence of Accounting Measurements and Valuations

- ❖ An example: Pfizer Inc.
- ❖ Most of the problematic and controversial accounting issues involve accruals.
- ❖ Examples:
  - ❖ Restructuring charges
  - ❖ Asset and goodwill impairments
  - ❖ Employee stock options
  - ❖ Deferred taxes
  - ❖ Provisions for bad debts and warranties
  - ❖ Pension expenses (and post-retirement benefits)
  - ❖ In-process R&D

# Pfizer's Cash From Operations

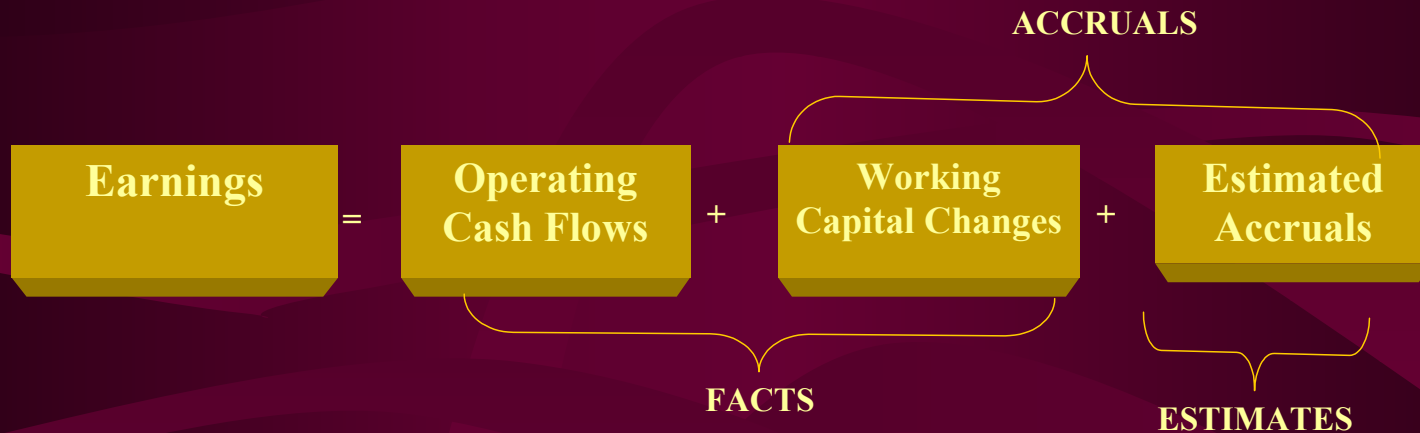
(MILLIONS OF DOLLARS)	2002	2001	2000
Operating Activities			
Net Income	\$ 9,126	\$ 7,788	\$ 3,726
Adjustments to reconcile net income to net cash provided by continuing operating activities:			
Cumulative effect of a change in accounting principle	410	-	-
Discontinued operations	(278 )	(251 )	(165 )
Harmonization of accounting methodology	-	(175 )	-
Loss on sale of animal health feed-additive products	-	-	85
Costs associated with the withdrawal of Rezulin	-	-	102
Gain on sale of business	(77 )	-	(19 )
Gains on sales of product lines	(34 )	-	(117 )
Gains on sales of equity investments	-	(17 )	(216 )
Asset impairment charges	63	-	-
Depreciation and amortization	1,036	972	879
Deferred taxes and other	(385 )	193	(208 )
Changes in assets and liabilities, net of effect of businesses divested:			
Accounts receivable	(963 )	81	(502 )
Inventories	(129 )	(110 )	(410 )
Prepaid and other assets	(1,423 )	106	369
Accounts payable and accrued liabilities	461	(412 )	818
Income taxes payable	1,736	332	1,319
Other deferred items	321	354	251
Net cash provided by continuing operating activities	9,864	8,861	5,912

# The Major Vulnerability of Accruals

- ❖ Most accruals are based on managers' estimates, which are never publicly verified. This is an invitation to manipulation.
- ❖ Indeed, extensive research (starting with Sloan, 1996) shows that: (a) accruals are widely manipulated, and (b) investors are systematically deceived.
- ❖ And yet, perhaps, on average, accruals are doing the job of predicting future cash flows?

# Lev 2003 Study (in process)

❖ The basic relationship:



❖ Accordingly, I regress Operating Cash Flows in years  $t+1$ ,  $t+2$  on year  $t$ : Operating Cash Flows, Working Capital Changes, and estimated Accruals. Period: 1988-2001. Sample: Russell 3000 Companies (excluding financial services).

❖ Note, this is not a strict prediction test, but suggestive nonetheless.

# Regression Estimates

(t-values in parentheses)

	Cash Flows (t)	Working Capital Changes (t)	Estimated Accruals (t)
Cash Flows t+1	0.946 (21.89)	-0.478 (-14.05)	-0.056 (-1.48)
Cash Flows t+2	0.964 (18.39)	-0.502 (-13.05)	-0.037 (-0.86)

Inference: While cash flows from operations and working capital changes predict future cash flows, accruals are, on average, unrelated to future cash flows, in contradiction of the FASB's fundamental premise. (However, certain individual accruals, such as depreciation, do appear to be correlated with subsequent cash flows.)

# Reasons for Accounting's Failure

- ❖ Fundamentally deficient accounting rules and procedures.

Examples: ♦ In-process R&D

- ♦ Unrealized gains/losses on “available for sale” investments.

- ❖ Large estimation errors in an uncertain environment.

Examples: ♦ Return on pension assets.

- ♦ Restructuring charges.

- ❖ Manipulation of accruals and other items.

Examples: ♦ Bristol-Myers' stuffing of the channels.

- ♦ Enron's gains from own shares.

# What's to Be Done?

- Minimize managerial estimates in financial reporting. Many estimates are probably not worth the effort and risk of manipulation (IRS does not allow most estimates).
- Separate estimates from facts in financial reports.
- Revise earnings periodically, based on comparison of key estimates with realizations.