Decision usefulness explored

An investigation of capital market actors’ use of financial reports
Contents

Foreword ......................................................... 2
Acknowledgements ............................................... 3
Executive summary ............................................. 4

1. Why investigate the use of financial reports? .................. 6
   1.1 Perceptions of a financial reporting problem ............... 6
   1.2 What we set out to learn more about ...................... 7

2. Behavioral studies of capital market actors’ use of financial reporting .......... 9
   2.1 Forward-oriented and model-based analysis of profitability ........ 9
   2.2 Information density ...................................... 10
   2.3 Framing effects and grouping of information sources .......... 11
   2.4 Concluding comment .................................... 12

3. Our approach ................................................. 13

4. The situated process of using financial reports ............... 15
   4.1 Information use is shaped by context ..................... 15
   4.2 Strategies for using financial reports .................... 17
   4.3 Concluding comments .................................... 23

5. Financial reports in the hands of capital market actors .......... 24
   5.1 Interim reports ........................................ 24
   5.2 Annual reports .......................................... 28
   5.3 Concluding comments .................................... 32

6. What financial reporting information is used? ................. 33
   6.1 The statement of profit or loss .......................... 33
   6.2 The statement of other comprehensive income ............. 38
   6.3 The statement of cash flows ............................ 39
   6.4 The statement of financial position ...................... 42
   6.5 Concluding comments .................................... 42

7. Conclusions and implications .................................... 44
   7.1 Information overload and information inadequacy ........... 44
   7.2 Decision useful financial reporting information ............ 46
   7.3 Timing of financial reporting: interim and annual reports ..... 48
   7.4 Decision-usefulness vs stewardship ........................ 49

8. References .................................................................. 50

Appendix 1: Interview guide ....................................... 53
Foreword

Financial reports from companies should provide useful information for different groups of users. One of the main issues in financial reporting standard setting is to identify what information users need and to turn that knowledge into financial reporting standards. This is a very difficult task since users might have diverging needs. There is also a need to balance information requirements in order to avoid clutter and information overload.

Listed companies in the EU shall apply International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB), as adopted by the EU according to the IAS Regulation (1606/2002/EC).

In 2013 the IASB hosted a public Discussion Forum on Financial Reporting Disclosure to foster dialogue about disclosure requirements between users of financial statements, preparers, standard-setters, auditors and regulators. The issue at stake can be summarized as: Do we have a disclosure problem in financial reporting for listed entities? If so, is this a problem of information overload or inadequacy, or both?

In order to further contribute to this debate, the Confederation of Swedish Enterprise and the Swedish Enterprise Accounting Group (SEAG) decided to support a study performed by three researchers from the Stockholm School of Economics. We are very pleased to present the findings from the study in this report. We believe that this will be an important contribution to the discussion about future financial reporting requirements.

Dr Claes Norberg

Director Accountancy, Confederation of Swedish Enterprise

---

1 The Swedish Enterprise Accounting Group (SEAG) represents more than 40 international industrial and commercial groups, most of them listed. The largest SEAG companies are active through sales or production in more than 100 countries.
Acknowledgements

This report presents findings from an interview-based study of capital market actors’ use of interim and annual reports. We would like to thank all interviewees who generously took time to share their practices, experiences and views with us. Without you, this research would not have been possible.

The study was initially conceived following discussions with representatives of the Swedish Enterprise Accounting Group (SEAG), a group within the Confederation of Swedish Enterprise. The Confederation of Swedish Enterprise has kindly supported the research by financing direct outlays for travel and transcriptions. However, all conclusions are our own.

April 2014

Anja Hjelström*, Tomas Hjelström and Ebba Sjögren
Department of Accounting
Stockholm School of Economics

* Corresponding author: Anja.Hjelstrom@hhs.se
Executive summary

Perceptions of a significant financial reporting problem have triggered a number of initiatives to reform financial statement presentation and disclosure requirements. However, these initiatives have been undertaken in a setting where there are disparate understandings of the problem which is to be addressed. Somewhat paradoxically, current presentation and disclosure practices are characterized by some as giving rise to information overload, while others argue that the problem is rather one of information inadequacy.

In this report we present findings from 40 in-depth interviews with experienced users about their use of specific financial reports from identified companies. The interviewees include buy-side as well as sell-side actors, and equity as well as credit side actors. Interviewees were based primarily in Sweden and the UK, but also in other European countries and the US. You can read more about our research design in Section 3.

Our chosen methodology is different from commonly used approaches in previous studies of capital market actors’ use of financial reporting information. These approaches include on-line surveys with pre-defined response alternatives and experimental studies where more or less experienced respondents address hypothetical situations. In contrast, we have posed open-ended questions to experienced users concerning their actual usage of specific financial reports. By talking with these users about how and when they use what information, we seek to contribute to a more precise understanding of what characteristics make financial reporting useful.

We present our findings in three steps. First, we discuss the process of using financial reports on a general level. Here we found that information usage was shaped by the context of use, including organizational purpose and access to resources. Various combinations of contextual factors were observed to give rise to variations in the time pressure between experienced users for the use of the financial reports, especially in relation to interim reports. We also observed that the interviewees used a variety of strategies to navigate their information rich environment under time pressure. A key strategy was to establish what we call a company thesis. This directed their search for, and interpretation of, information. You can read more about contextual factors and strategies for information use in Section 4.

Second, we focus on the use of interim and annual reports. Most interviewees told us that they actively awaited the interim reports of companies that they follow. Interim reports were used to get an update on recent developments in order to assess if the company was ‘on track’ and if the company thesis remained valid. Forecasts of specific line items guided information search. Explanations were sought for observed deviations. As a result, interim reports were generally used for a short period of time close to their release. Often, they were read on an iterative basis, with a first, second and even third wave of attention. Several buy-side actors who did not regularly trade on information in interim reports also described this type of process.
On the release of the annual reports these were used to source information that was not available in the interim reports and to gain a general update of the company. Otherwise, the main use of an annual report was as a book of reference; the place to look for information to answer questions about the entity on an ad hoc basis. The interviews also indicated that the annual reports of the reporting entity had been used extensively, when first getting to know the company. You can read more about how the interviewees used interim and annual reports in Section 5.

Third, we focus on what financial reporting information the interviewees told us that they searched for and used. In general, they did not refer to looking for information in the financial statements. Instead, they looked at the first summary page(s) of the interim report or the notes to the financial statements. One exception was the statement of cash flows, which many interviewees told us that they used.

Interviewees talked much about earnings-related information. In particular, we found that both sell-side and buy-side actors focused on understanding the ‘quality’ of income. You can find more details about these findings in Section 6.

Our findings have several potential implications both for financial reporting standard setters and preparers. For example, our study indicates that capital market actors are unlikely to perceive information overload as a problem. Second, although the interviewees did not indicate that they were constrained by information inadequacy in general, some suggested that there were large variations in the quality of information provided by listed entities.

Our findings also give some contours to what is perceived as useful information by experienced users of financial reports. For example:

- Users are primarily concerned with understanding entities’ past performance and cash conversion patterns. Information that explains the variability of outcomes, in particular with regard to revenue and operating income, is therefore considered useful. The interviewees indicated a clear preference for this information to be provided on a disaggregated basis, because this is how they tend to build their forecasting models.

- For experienced users with a company thesis, consistent disclosure of relevant information (i.e. transparency) is more important than comparability.

We discuss these and other conclusions in Section 7.
1. Why investigate the use of financial reports?

1.1 Perceptions of a financial reporting problem

Financial reporting\(^2\) that allows actors outside a reporting entity to evaluate its financial performance and position is widely considered to be a cornerstone of effective capital allocation. Since the 1970s, many standard setters also state that their objective is to promote financial reporting that is useful to existing and potential capital providers when these parties make decisions about providing resources to an entity.\(^3\) The International Accounting Standards Board (IASB) has concluded that their decision usefulness imperative means that financial reporting should help capital market actors\(^4\) assess “the prospects for future net cash inflows to an entity” (IASB Conceptual Framework, OB 3). Without going into any detail as to how investors and creditors either can, or should, make such projections about the future, the IASB has also concluded that, to do this, users need information provided in the three primary financial statements and related notes.\(^5\)

Despite significant standard setting activities since the 1970s, several recent reports\(^6\) suggest that there remains a financial reporting problem. Somewhat paradoxically, present financial reporting practices are characterized as giving rise to both information overload and information inadequacy. Claims of insufficient disclosure have, for example, been linked to the 2007/2008 financial crisis (e.g. CFA Institute 2013). At the same time, other actors have expressed concerns that financial reports have become too voluminous with the effect that key messages are obscured by clutter (e.g. FRC 2011).

The IASB has responded to these discussions in several ways. A paper discussing a number of possible changes to its current Conceptual Framework, including two chapters relating to disclosure and presentation issues, was published in July 2013 (IASB 2013b). A short-term project to amend IAS 1, Presentation of Financial Statements, has been initiated and there are plans to start a short-term project considering how to provide further guidance on the application of materiality and a medium-term project exploring whether a set of present standards should be replaced with a single standard on presentation and disclosure. There are also plans to review disclosure requirements in existing standards.\(^7\)

---

\(^2\) The terms “financial reporting” and “financial reports” are used to denote general purpose financial reporting/reports in a broad sense. However, our main focus is on the (primary) financial statements (as defined in the IASB’s D9/2013/1, i.e. items (a)-(d) in IAS 1 para 10) and related notes.

\(^3\) Ever since the introduction this objective has been contested (e.g. Young, 2006 and Murphy et al, 2013). There is also an ongoing debate whether investment decisions subsume or are different from stewardship/contracting decisions (e.g. Cascino et al. 2013, p. 19–21).

\(^4\) In this report, the term “capital market actors” is used to denote existing and potential capital providers, i.e. equity and debt investors, and information intermediaries such as sell-side analysts and rating agencies.

\(^5\) “To assess an entity’s prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources” (IASB Conceptual Framework, OB 4). See also “Information about a reporting entity’s cash flows during a period also helps users to assess the entity’s ability to generate future net cash inflows” (IASB Conceptual Framework, OB 20).

\(^6\) A list of these reports, as well as summaries, is provided in the IASB’s May 2013 Feedback statement on its Discussion forum on Financial Reporting (pp. 5, 23–30). Recent reports are also listed and commented in the CFA Institute’s July 2013 report (CFA Institute 2013, p. 43).

\(^7\) For more details and examples of the IASB’s Disclosure Initiative, see http://www.ifrs.org/Current-Projects/IASB-Projects/Disclosure-Initiative/Pages/Disclosure-Initiative.aspx
1.2 What we set out to learn more about

Research has shown that, in practice, capital market actors use structured and future oriented analyses based on a variety of theoretical valuation models. Research has also shown that actors rely on financial reports, as well as a number of other information sources as a basis for forecasting the required input to these models. However, as elaborated on further in Section 2, previous research leaves many questions unanswered about the situated process of information use by capital market actors.

The findings of academic research are largely mirrored in various surveys by professional associations. One shared conclusion is that while financial reports are a key source of information, they are only one of many sources. For example, when the Association for Investment Management and Research (AIMR)\(^8\) asked respondents\(^9\) to rank 19 sources of information in a 1999 survey, annual reports were ranked second, just after company executives. Interim reports were ranked as number four, following news releases and earnings announcements. Annual reports were similarly ranked as the most important source in follow-up surveys made in 2003 and 2007 (CFA Institute 2013). Cascino et al. (2013) also note similar findings in a review of 11 European surveys.\(^10\) In about half of these studies, only direct contact with company representatives was ranked higher than financial reports.

While financial reports are only one of several sources of information, they are considered to be important ones. Thus, it is important to note that a number of surveys indicate that capital market actors express an overall satisfaction with financial reporting practice, which are also perceived to have improved over time. However, there are also identified rooms for improvement. For example, in 2000 the AIMR noted significant gaps between the importance attached to, and the satisfaction with, disclosure practices for four topic areas: (1) segments/disaggregate data, (2) forward looking information (strategic and business plans, forecasts), (3) off-balance sheet assets and liabilities and (4) extraordinary, unusual, non-recurring charges (including restructuring). The three latter topics were also identified in follow up surveys by the CFA Institute in 2003 and 2007. These surveys also identified an additional four topics where investors desired improvements in reporting quality: (1) fair values, (2) accounting estimates (key assumptions and sensitivity analysis), (3) derivatives hedging and contingencies and (4) contractual future cash flows. Based on a similar type of analysis of the gap between ranking of importance and adequacy, PWC (2007) similarly identify a number of areas of information inadequacy.\(^11\)

At the end of 2012 the IASB conducted a survey to gain a clearer picture of the “disclosure problem”. While over 80% of the respondents agreed with the statement that there is a “disclosure problem”, respondents were divided as to its nature. For example, while over 50% agreed with the statement that not enough relevant information is provided, almost 40% disagreed. Similarly, while 80% agreed with the statement that too much irrelevant information is provided, over 10% disagreed.\(^12\) Taking capital market actor categories into consideration, the IASB concluded that capital providers and preparers perceive the problem differently:

---

\(^{8}\) In 2004, the AIMR changed its name to the CFA Institute.

\(^{9}\) The survey is based on 346 questionnaire responses from analysts and portfolio managers. 86% of the respondents were from the US and Canada.

\(^{10}\) Only five of 11 studies include interim reports in the top four. In four of these five, annual reports are ranked higher than the interim reports (see Table 2, p. 26).

\(^{11}\) The PWC report from 2007 is based on an interview survey with 262 investment specialist with wide geographic base.

\(^{12}\) For a summary of the survey findings see IASB 2013a, p. 35. It should be noted that one limitation of this survey is that only 18% of respondents characterized themselves as users of financial reporting.
Those preparers who responded to the survey viewed the disclosure problem as primarily one of disclosure overload. Many users who responded saw disclosure overload as an annoyance rather than as a barrier to understanding the financial statements. Overall, users who responded focused on poor communication and a lack of relevant information to describe the disclosure problem (IASB 2013a, p. 36).

This suggested split in perception between preparers and users is also found in a recent report by the CFA Institute (2013). Lamenting the general lack of user input in the debate, the CFA Institute also emphasizes that 96% of respondents to their 2012 member survey answered that the primary objective of the disclosure framework project of the US standard setter should be more effective and integrated disclosures. Only 3% answered that the objective should be reduced volume. Also in this survey, however, respondents were split; while 51% answered that volume is not an issue, 18% answered that current disclosures are too lengthy and that there are redundancies.

While a number of initiatives to reform financial statement presentation and disclosure requirements are thus on the way, or about to be launched, these initiatives seem to be undertaken without a sound understanding of the financial reporting problem that they are meant to handle. In order to contribute to this debate we set out to probe the notion of decision useful information by opening the black-box of how capital market actors use information in financial reports.

You can read more about our research design in Section 3. Our findings are presented in Section 4 (the process of information use), Section 5 (use of interim and annual reports) and Section 6 (what information is used). In Section 7 we discuss implications of our findings. We start, however, with a brief review of previous research in Section 2.
2. Behavioral studies of capital market actors’ use of financial reporting

There is a long-standing interest in the functioning of financial markets and the behavior of capital market actors. A wide range of empirical studies of capital market actors’ behavior confirm the practical importance of financial reporting information as one key source of information (see Beyer et al. 2010 for a recent review). A recurrent observation has also been that earnings-related information is perceived as particularly important by capital market actors for assessing companies’ prospects (e.g. Govindarajan 1980; Previts et al. 1994; Block 1999; see also review in Dumontier and Raffournier 2002), to the point where some scholars have described a specific phenomenon of earnings fixation (Bushee 1999). This is understood as the excessive reliance on accounting earnings as the primary source of information, without fully considering other information that may be relevant to evaluating a company’s prospects. However, there is widespread agreement that a “black box” still remains concerning the situated process of information use by capital market actors and their broader decision context (Ramnath et al. 2008; Beyer et al. 2010).

In recent decades, a behavioral approach to studying capital market actors’ use of financial reporting has emerged. A number of studies, several of which are described in greater detail below, have specifically focused on how experienced practitioners use financial reporting and related information about known entities in realistic conditions. These studies characterize capital market actors’ information usage as: 1) directed towards forward-oriented analysis of profitability, typically supported by valuation models, 2) taking place in an information-dense setting and 3) grouped, with different actor groups using different combinations of sources.

2.1 Forward-oriented and model-based analysis of profitability

Various studies have found that capital market actors’ routinely focus on undertaking forward-oriented analysis of profitability (e.g. Barker 2000). One important reason for this focus is an industry-wide orientation towards quantitative finance and the widespread use of valuation models (Rutherford 2004; Hall 2006).

In a recent survey of sell-side analysts’ perception of earnings quality (Barker and Imam 2008) respondents expressed a focus on ascertaining core earnings. This translated into a concern with the persistence and predictability of future operating earnings. In subsequent interviews, these analysts described a practice of classifying different sources of earnings based on perceived persistence and predictability. Interviewees also discussed the importance of probing the relationship between earnings and cash flow. These findings echo the outcome of previous research, which also suggests that a focus on earnings and cash flow is a common feature of all categories of capital market actors and highlight the importance of different valuation models for making predictions of future profitability (e.g. Arnold and Moizer 1984; Carter and Van Auken 1990; Vergossen 1993; Barker 1999).
Several studies have been made of which valuation models sell-side equity analysts use. In contrast to the normative prescription of finance theory, which privileges discounted cash flow (DCF) as the basis for equity valuation\[^{13}\], these studies have found that the comparatively unsophisticated price earnings (PE) multiple is the dominant valuation model, followed by DCF (e.g. Arnold and Moizer 1984; Barker 1999). This finding has been both reified and qualified in some more recent studies. For example, Demirakos et al. (2004) observed a growing prevalence of DCF-models. Imam et al. (2008) further nuanced the understanding of valuation model use through their observation that DCF-models were more commonly discussed in sell-side equity analysts’ public communication, even when other models had also been used in the analysts’ work. The same study also found that the choice of a particular valuation model was influenced by perceptions of appropriate tools for analysis among other actors. Notably, sell-side analysts express a client-orientation in their choice of valuation models (Imam et al. 2008).\[^{14}\]

2.2 Information density

While valuation models are important for framing the use of financial reports, a second overarching conclusion of previous behavioral research is that the full information environment of capital market actors includes more than the financial statements and associated notes. Various studies highlight that a variety of written and verbal information sources are considered relevant and useful by capital market actors. For example, content analysis studies of sell-side analyst reports have described a relative and absolute importance of non-financial qualitative factors (Breton and Taffler 2001) and non-regulated parts of financial reports such as outlook and management commentary (e.g. Rogers and Grant 1997; Healy et al. 1999).

In a recent contribution, Barker and Imam (2008) elaborate on these findings using a mixed method approach. First, in interviews with sell-side analysts, non-accounting sources\[^{15}\] of information were characterized as a means of contextualizing and adding meaning to financial reporting data. In a second step, the significance attached to other data sources in these interviews was investigated through a content analysis of reports issued by the interviewed analysts. This analysis found that the amount of non-accounting-based information was greater than the accounting-based, in particular when analysts expressed an opinion about the prospects of the company. However, when accounting and non-accounting information gave conflicting signals, the accounting-based view was typically privileged. In other words, accounting-based information was found to play an important role in anchoring analysts’ stock recommendations. However, if analysts had a positive view of the company based on accounting aspects of earnings quality, then both positive and negative views were expressed regarding non-accounting aspects.

\[^{13}\] This is in line with finance theory stating that capital allocation decisions should be based on discounted future cash flows (DCF). Alternative DCF valuation models exist. A number of other valuation models also exist (e.g. Economic Value Added, Residual Income and Price-Earnings). In theory, these models are just alternative expressions of the same fundamentals and should therefore produce the same values. Whether or not the practical use of different valuations models fulfills this theoretical assumption, however, is a topic of extensive scholarly debate (see Demirakos et al. 2010 for a recent contribution and review of the literature). Irrespective of this, they all suffer from the same practical problem: they require input about future events which remain unknown.

\[^{14}\] This conclusion echoes that of studies of corporate-capital market interfaces, where the perceived expectations of capital market actors have been found to strongly influence the structure and content of company’s information provision (see e.g. Roberts et al. 2006; Kraus and Stromsten 2012). An even stronger argument of interdependent behavior is put forward by Beunza and Stark (2012) who coined the term “reflexive modeling” to denote how traders used models to calculate rival traders’ estimates and calibrate their own models.

\[^{15}\] The authors distinguish between accounting-based information (relating to notions of core or sustainable earnings, cash and accrual components of earnings and accounting policies) and non-accounting-based information (relating to information drawn from outside the financial statements).
Moving beyond the use of information in financial reports, other studies have painted a complex picture of information flow between preparers, institutional investors and intermediaries such as sell-side analysts. In addition to the flow of financial reporting from companies to intermediaries and fund managers, there is also information that moves between intermediaries and fund managers (Barker 1998). Studies have highlighted that there is a value for investors of direct communication with company managers, both in conjunction with the release of financial reports and as part of an on-going relationship (see review in Hellman 2005). For intermediaries, direct contact with the company is perceived to provide timely, focused, forward-looking information that offers a potential competitive advantage over rival analysts. For fund managers, meetings offer an opportunity to assess the company’s strategy and the ability of management, in the light of information from previous meetings as well as the performance record in the report and accounts (e.g. Barker 1998, 1999). As regards the second information flow, studies of buy-side analysts and institutional investors work have found that sell-side analysts’ reports is an integrated part of the information that is deemed relevant to take into account and even an alternative to usage of financial reporting. In an interview-based study of how institutional investors used information in relation to specific transactions, a heavy reliance on highly trusted external advisors – including sell-side analysts – was one factor that was linked to institutional investors’ limited use of financial reporting information (Hellman 2000, 2005).

2.3 Framing effects and grouping of information sources

There are several examples of observed framing effects in relation to the use of financial information. For example, scholars have found that the specification of valuation models orients towards earnings-related information (e.g. Barker 2000). Other studies have shown that framing effects can also arise in relation to capital market actors’ own judgments. In the study of how sell-side analysts use accounting information as part of making their recommendations, a complex process of price target/recommendation formation was observed. Valuation models were used opportunistically to corroborate a particular outcome as “the data therein [was] made to fit the analyst’s prior, subjective judgment about the market’s view of a stock” (Imam et al. 2008, p. 526). Based on analysis of data from the same study, the observation that the ratio of accounting- to non-accounting-based information was very similar across sell-side analysts’ reports in different sectors was taken to suggest that “a standardization of reporting-writing style and analytical approach dominates any inherent variation in the usefulness of accounting information that might exist across sectors” (Barker and Imam 2008, p. 320).

Studies have also observed a grouping effect in relation to the use of information by capital market actors. In an early ethnographic study of one institutional investor, Gniewosz (1990) found that investment decisions drew on a variety of information from different sources. These various pieces of information were considered concurrently, without a discernible hierarchy of importance. In a subsequent interview study of experienced users, Bence et al. (1995) found that while both sell-side analysts and investors used information from a range of sources, they ranked these sources differently. Sell-side analysts ranked the preliminary statements, interim statements, personal interviews, annual reports and company presentations highest. In comparison, the four highest-rated sources of information from the point of view of institutional investors were company visits, personal interviews, the company annual report and company presentations.

16 This finding by Gniewosz (1990) differs somewhat from that of Hellman (2000), in which there were indications of relative importance between different sources. However, these conclusions could perhaps be understood as a consequence of the two studies’ respective methodology: participant observation as compared to semi-structured interviews.
One important difference between the two user groups was the importance attributed by the sell-side analysts to what the authors called “short-term” sources of information: the preliminary and interim statements. The authors characterized these sources as having a higher quality of timeliness rather than completeness, and as being more useful for short-term decision-making. Three of the information sources prioritized by the sell-side analysts were also routinely “received information”, as compared to the sources prioritized by the institutional investors which were primarily “sought information”. Bence et al. (1995) saw this as an indication of institutional investors having a more long-term interest and being willing to conduct search activities to obtain the necessary information.

2.4 Concluding comment

In summary, previous behavioral research on the use of accounting information by capital market actors provides an overarching framework for understanding the actions taken by these individuals. The structured approach to company analysis, which is largely based on particular valuation models, shapes their work. A smaller number of key value drivers in these valuation models, particularly related to earnings and cash flows, are of focal interest. The objective is to make accurate future predictions about the development of these items. However, given the core attention of the capital market actors, they are also exposed to a very large set of both accounting-based and non-accounting based information via a large number of sources.

However, there is still a limited understanding of the detailed use of information in financial reports. Notably, the study of accounting information usage has often been limited to aggregated measures of performance such as earnings, cash flows and certain balance sheet items. Understanding earnings and cash flows potentially requires a deep understanding of their components and the conditions under which they have been generated. Previous research provides little insight into these details. Moreover, while the usage of interim and annual reports has been observed to differ, a more granular understanding needs to be gained of when information is used and what information is used. Such knowledge should contribute to the discussion of how to design and produce useful information.
3. Our approach

There are significant methodological challenges involved in trying to capture complex and interdependent processes such as real world information use (e.g. Schipper 1991). To mitigate the risk that answers “provide little real insight into what the respondents use in practice” (Breton and Taffler 2001, p. 92), we wanted interviewees to frame their comments in the context of their actual use of a specific financial report.

In order to facilitate access to actual users of specific financial reports, six listed public companies were enrolled. These companies, which belonged to various manufacturing and service industries, were all listed on the Nasdaq OMX Stockholm exchange. Each had a market capitalization in excess of 25 billion SEK in the spring of 2013 (=3 billion EUR). We refer to these companies as: ComponentCo, ConsumerCo, InvestmentCo, ManuCo, ProductCo and ServiceCo.

Owing to a combined consideration of identification and access possibilities, and the need to delimit the study, we chose to focus on professional equity and credit market actors. Most notably, this excluded journalists, day traders and non-professional investors. In collaboration with each company’s investor relations function, a list of current equity and credit sell-side and buy-side analysts as well as portfolio managers was constructed. An explicit goal was to include interviewees across a range of different categories and with varying geographic location. The listed individuals were subsequently approached with requests for interviews. In several cases, the initial contact was taken by the company in question.

A total of 40 individuals were interviewed. Between 4 and 11 interviews were made for each company. Seventeen interviewees were with representatives for investors, while the remaining were sell-side equity or credit information intermediaries. An even mix of national (Swedish) and international interviewees was achieved (see Table 1). All interviewees were experienced users of financial reports, having spent at least two years and often more than a decade following the case company.

Seven contacted individuals declined to participate in the study. Two cited corporate policy, two lack of time and three provided no justification. An additional ten individuals indicated a willingness to participate, but it was not possible to schedule an interview within the project time frame.

All interviews were made in face-to-face meetings. Twenty-seven interviews were undertaken by a team of two of the three researchers, working in different constellations. The remaining thirteen interviews were all performed by a single researcher midway through the data collection process.

Each interview was structured using a common interview guide, which was formulated based on previous findings in the extant literature and more topically delimited interview-based studies of capital market actors’ views on decision useful accounting information (e.g. PwC 2010). The interview guide (see Appendix 1) was used in a semi-structured manner, in order to both ensure coverage of common themes and facilitate presence in the interview situation (see Kreiner and Mourtisen 2005). Small changes in wording were made where necessary to reflect the particular role of the interviewee.
In each interview we sought to perform a retrospective process tracing (Klein et al. 2010). The interviewee was given a physical copy of each financial report. Beginning with the interim report, (s)he was requested to describe his/her physical location at the time of the report’s release and then move forward in time. Based on the response, follow-on questions were then posed about the details of specific activities and to elicit an account of subsequent activities related to information search and use. For example, a response that the first thing to look at was profit could prompt a question such as: “So, where in the quarterly report did you look to find the profit figure?” Following a response of page 1, a subsequent question could be: “OK, you looked at quarterly profits on page 1. Which profit line do you look at?”

The focus of each interview was thus on letting the interviewee articulate their process of using the most recent interim\(^\text{17}\) and annual report for the company that had provided the name of the interviewee. In 36 of 40 interviews the interim reports used was for the first quarter of 2013. Two of the interviews referred to the interim report for the second quarter and two to the third quarter. All interviews referred to the annual report for 2012. Each interviewee was also asked about their interaction with other parties within and outside the organization. For example, with team members, other colleagues such as internal traders, external clients and information service providers. However, interviewees were not asked about what actions they took in relation to the information. This is in line with the present study’s delimitation to probing the process of financial reporting information search and use.

Interviews varied in length between 45 minutes and 120 minutes, with an average of approximately 75 minutes. On completion, each interview was professionally transcribed. Interviews were subsequently reviewed in a series of group meetings in relation to the analytical constructs and categories outlined in the empirical sections that follow. Interviewees were requested to review the direct quotes used in the present report. A smaller number requested minor changes in wording, which did not materially influence the substance of the quotations in question. One individual asked that all direct quotes be removed.

\(^{17}\) At the time of this study all case companies provided quarterly interim reports prepared in accordance with IAS 34.
4. The situated process of using financial reports

In this section we report on how the interviewees characterized their process of using financial reports. We found that the use of financial reports was shaped by contextual factors such as the overarching purpose of using the information and the availability of resources. Different actors perceived varying degrees of time pressure, which fundamentally influenced their use of financial reports. However, we also found that time pressure appeared to be a near universal circumstance and that all of the interviewed capital actors used various strategies to deal with time pressure.

4.1 Information use is shaped by context

A range of situational circumstances appeared to shape the manner in which interviewees used financial reports. Many of these circumstances were a consequence of the interviewees undertaking their work in a particular organizational setting. All interviewees also had an ongoing relationship with the reporting entity and its financial reports. In other words, their use of financial reporting information was situated in a context of familiarity with the reporting entity.

Overarching purpose shaped information use

Unsurprisingly, differences in the type and timing of required outputs shaped the use of financial reports as well as other information. For example, while sell-side equity analysts were expected to provide rapid reactions to new information (e.g. interim reports), several fund-managers commented that they typically did not act on new information due to a long investment horizon and/or lack of sufficient liquidity. One credit rating analyst similarly reflected that he was less sensitive to information in interim reports because his output was more long-term:

We don't change the credit rating every quarter like equity analysts. [Those] guys react immediately, once there's a quarter earnings they do a recommendation...when we assign an investment grade rating, like in the case of [ConsumerCo], we tend to take a two to five year horizon. Then, for me, a bad quarter doesn't mean I'm going to downgrade, unless there is a liquidity crunch. In that case, of course, it's a big problem but typically I'm not reacting to a quarter (Credit Rating)

Available resources shaped information use

Availability of resources for information search and analysis also influenced how information was used. As one sell-side credit analyst noted: “If we had endless resources, then we could follow all companies to support our customers” (Sell-side Credit).

Access to resources related, to a large extent, to the organizational setting. Notably, we found considerable differences in the number of companies covered by each interviewee.
While all interviewed sell-side equity analysts covered a relatively limited and stable set of companies, interviewed credit analysts were less specialized. We were also told that the set of companies followed by a sell-side credit analyst could change, depending for example on how many and which companies were issuing new bonds. Furthermore, while a company generally only has one type of listed share, a company may have issued several different bonds. In contrast to equity market actors, credit analysts also differentiated between coverage of primary and secondary markets.

Buy-side interviews also revealed large differences in the number of companies covered. For example, while one fund manager reported having more than 60 companies in the portfolio, another only had 20–30 companies. Similarly, while some buy-side analysts followed many companies, others were more specialized.

In addition to the number of companies covered, interviewees also referred to having additional firms in their investment universe. For example one sell-side equity analyst explained that he was the lead analyst on seven companies, co-lead on an additional 13 companies and was “looking” at one hundred companies (Sell-side Equity Analyst). In contrast, a buy-side equity analyst referred to having “a universe of around three hundred and fifty, three hundred and sixty stocks worldwide” (Buy-side Equity Analyst).

Unsurprisingly, buy-side actors with more generalist roles indicated that they did not have the possibility to undertake detailed analysis of individual company reports. As discussed further below, they described relying on in-house buy-side analysts and/or external information intermediaries to undertake such analysis.

Availability of time shaped information use

The effect of differences in organizational purpose and availability of resources was clearly reflected in how interviewees characterized the time pressure on their use of financial reports.

Sell-side equity analysts universally described a tight schedule for responding to the release of new information such as interim reports. With some minor variations, this group of interviewees described that they needed to provide an analysis within three time horizons: within minutes of the release of an interim report, after an hour and after one day. Certain investors and buy-side analysts also described a short window of analysis and action at the time of the release of interim reports. (See Section 5.1 for more detail.) Sometimes, we were told, the inherent challenge of quickly evaluating the interim report was exacerbated by the fact that multiple companies may release reports concurrently. Interviewees reflected that it was difficult to avoid such clashes. Although analysts tended to be organized by industry, they followed different sets of companies. Similarly, investors routinely had investments in several companies across different industries.

In contrast to the time pressure expressed by sell-side analysts, interviewees working for investors with limited ability to shift holdings and/or investors with a longer investment horizon generally did not express the same type of time pressure in relation to the release of specific financial reports. Nevertheless, these interviewees also emphasized that time was an important constraint which required them to prioritize their activities:
I have 75 companies in my portfolio, and should closely follow at least another 30... The most important decision I make each day is what I should do with the few hours I have (Buy-side Equity Manager)

In short, time was the single most common source of constraint in information use articulated in our interviews.

4.2 Strategies for using financial reports

Interviewees’ accounts for how they use financial reports suggested that capital market actors used a combination of strategies to manage the time constraints in their use of financial reports. These included focusing on a pre-determined and limited set of data points, digging deeper to probe deviations and, for buy-side actors, delegating information search and analysis to information intermediaries.

Focusing on a select set of data based on a company thesis

All but one interviewee referred to having a company thesis which both directed information search and provided an interpretative frame for the information that was found. Interviewees referred to such a company thesis in terms of unique reasons to hold (or divest) a company. In part, the company thesis was related to how a company was viewed in comparison to the ‘market view’:

[U]ltimately what really matters is that you’ve got an equity story and the equity story is a function of your understanding as to where everybody else is going to be wrong and earnings are going to surprise (Sell-side Equity Analyst)

[Y]ou need to make an investment case to buy this stock or sell this stock.... [T]here are several reasons to buy the stock but one of them could be valuation.[but] I would say in the current market, valuation is not enough so you need to think about other issues that can have the stock to outperform or the share price to increase. It could be earnings, like I think there are potential upsides to margins because management will implement restructuring and restructuring actions which are not discounted into the consensus forecast. You need to have something which is different from what is discounted today in the share price. If it’s positive you would be a buyer, if it’s negative you would be a seller but really where you differ from what is currently known by the market and if you think that the market will turn more positive on the stock you have to be a buyer (Sell-side Equity Analyst)

A company thesis can thus be likened to a cognitive model of the company’s prospects and issues. As such it identifies the specific drivers for an investment in the company. Interviewees indicated that once such a thesis was established, information that was linked to thesis-based drivers was prioritized. Several interviewees described how they purposefully searched for specific data in both interim and annual reports which they had identified a priori as the most relevant for that specific company. As one sell-side analyst recounted:

So take [ManuCo]. For them it is the order book because that is the most forward-looking information that gets reported. That is usually not on page 1. But then you know “I have to look at orders”. And so you flip frenetically and you find it (Sell-side Equity Analyst)

---

18 One interviewee acknowledged the notion of having a thesis, but stated that in practice it boiled down to “simply [identifying] good companies” (Buy-side Equity Manager).
19 Interviewees used various terms, sometimes interchangeably. Examples include investment thesis, or investment case, as well as a company, or equity story.
Although most interviewees referred to a company-specific thesis, several interviewees also described having a number of overarching issues which directed their interest towards particular information and shaped their interpretation of this data. One interviewee referred to this in terms of having both a thesis for the company and for the industry. For example, at the time of this study, a number of interviewees spoke of under-absorption of fixed costs as being in focus because many companies were reducing production levels. Interviewees noted that such overarching issues changed over time.

The characteristics of a company’s operations were, unsurprisingly, a core component of the company thesis. However, interviewees also discussed the importance of company management, both for formulating a company thesis and for assessing information provided by the firm:

So I’m trying to find good companies with franchises that are going to be around one hundred years from now, and with people that are appropriately managing their assets…. [It’s necessary because…what do I have to go on? I have the reports, I have the history of the company and I have my dealings with the IR and the management team from time to time. If ever there were instances of inconsistencies…if they said this year, it’s all about focusing on internal growth in 2012 and then I saw them do five big acquisitions I would lose faith (Buy-side Equity Manager)

I want to understand management strategy, business and financial objectives and risk tolerance. I find interesting information in the annual report and sometimes in the quarterly reports, however nothing replaces the regular conversation with the management…. I’d rather have responsible management than one hundred pages of report. This is a soft factor and occasionally you may be wrong in a judgment there, but on average it’s much more important how top management behaves than what they have on paper in a quarterly report (Credit Rating)

The importance of management, both for the interpretation of reported numbers and as an additional source of information, is discussed further below.

**Forming expectations and focusing on deviations**

Most interviewees also described a process whereby they form expectations of key parameters prior to new information being released to the market and then searching for deviations from these forecasts:

Yes, you are comparing what they reported with what you have in your model, i.e. I’m expecting them to pay a billion of interest if they report more, they report less I will try to understand why…. I have my own estimates, I have consensus for revenue, EBITDA, EBIT, net, EPS, CAPEX and cash. And that helps me, for instance, going down in the P&L. If my estimates for operating profit are three per cent ahead, my estimates for EPS are ten per cent below, I have to understand that between, i.e. in taxes or interest, people are assuming different numbers than mine. Am I wrong? Are they wrong? So you try and compare your numbers with other people (Buy-side Equity Analyst)
As indicated by the preceding quote, interviewees acknowledged that forecasts were not made in isolation. Rather, expectations were attributed to a combined consideration of individual analysis and estimates of market consensus:

You have your own forecast. And then it is important to know how that forecast compares to consensus. I communicate that internally and to our largest customers, that ‘I think that consensus hasn’t taken into consideration X’. I may be below consensus and then say that ‘I think that many have not considered that things are looking a bit worse’. And then customers may say that ‘No, we are thinking that if the company reports in line with consensus, then the share price will go up’. So that’s why there is talk of whispering figures (Sell-side Equity Analyst)

Certain interviewees, notably buy-side actors with long investment horizons, said that if there were no significant deviations from forecasts of key line items, then a more detailed reading of a report could wait:

There is too much to do during two weeks so then I just look like this [holds up first page of interim report in front of face] ‘Yeah, ok or confirmatory report’. And then it might be one or two weeks before I go back and fix my forecast (Buy-side Equity Analyst)

However, interviewees from all categories echoed the sentiment that a deviation from forecasts was an important trigger for further analysis.

Focusing on a select set of data based on valuation models and spreadsheets

A clear majority of the interviewees also told us that their use of financial reporting information was directed in part towards updating their spreadsheets with various items from the financial reports. The level of detail in the models varied considerably. Sell-side analysts tended to describe more elaborated models requiring more data points to be updated. However, only a minority of all interviewees expressed a view similar to that of one sell-side analyst who stated:

We use every single number from the three statements in the annual report, quite a lot from the notes and every scrap of detail on the breakdown of segments by region, product, end market, etc. in the models (Sell-side Equity Analyst)

On the opposite end of the scale, one portfolio manager characterized the model used in his organization as very simple:

Our model...we have a very simple excel model where we enter our forecasts of sales and margins and this gives us an EPS measure (Buy-side Equity Manager)

Using several, complementary sources of information

The experienced users interviewed in this study did not use information provided in the financial statements and related notes in isolation. For example, interviewees frequently talked about information provided in the non-regulated parts of the reports, particularly in management commentary (including outlook statements).

---

20 Most interviewees used some kind of estimate of market consensus provided by an information service provider such as FactSet or Bloombergs. However, several interviewees also reflected about the limitations in knowing the market’s ‘true’ consensus.
As previously mentioned, company management was also an important source of information. Interviewees frequently referred to complementary verbal information provided by company representatives in conjunction with releasing interim reports. For most sell-side analysts, listening to the conference call, and asking questions during them, was a routine complement to the written report. Buy-side actors also described using conference calls as a source of information. One buy-side fund manager explained that these could be more important than reading a specific financial report:

I think it is almost more important to listen to the conference call or, it is often more important to listen, or if I have time I think it is good to listen to the call before I meet company representatives (Buy-side Equity Manager)

Interviewees noted that conference calls provided an opportunity to ask questions and gave the opportunity to re-interpret information based on the answers given. In particular, interviewees noted that verbal communication about management outlook could provide more granular input to forecasting. For example, when asked if there had been anything particularly interesting in the recent Q1 report, one interviewee specifically referred to the conference call:

[T]wo things. One is that, both he and [the CEO] now said, which they wouldn’t even discuss three months ago, that is [X] will happen relatively soon. That is what we call the mother of all problems and it is important for the future. And the other thing that the CFO specifically, but only in the call, when he got the questions, now I mention something that you may not be aware of, but [ProductCo] has made huge investments in [geographic region]. And that has cost a lot of money. And the question that [the CFO] also, is sort of ‘when will this pain end?’. And this time, during the call [the CFO] said that: ‘[deleted]’ And this he didn’t say before (Sell-side Equity Analyst)

For the experienced user of information issued by a known company within an analyzed industry or sector, changes over time in the form and content of information could also become visible and important:

[I]f I look at an equivalent American company, let’s say [X], their CEO gets up every quarter and he gives you almost a specific number for what he thinks his growth rate is, certainly for the next quarter anyway but recently, he has historically given an annual figure, at least for the market growth or if not, even a medium term market growth figure and he’ll say: ‘The market’s growing X per cent over the short term... but over the long term we expect to see the market grow Y per cent’. Those types of comments are extremely helpful for a shareholder, for an investor at least to evaluate whether, you know, their estimates compare to what the management’s view of the world is (Buy-side Equity Analyst)

The conference call was also characterized as a means for the company to direct attention to particular items in the financial report. This was considered useful as a support for prioritizing among the significant amount of information, which was necessary due to the perceived time pressure:

There’s never too much information... I remember reading that somebody did a study where they looked at the increase in annual filing size versus stock performance and there was significant negative correlation but you know I think this is where the companies have an opportunity to give us the details for brevity’s sake in a press release or conference call (Sell-side Equity Analyst)
A draw-back with these calls, however, was that they required additional time.
For example, one buy-side portfolio manager admitted to rarely listening in on calls,
because they “take too much time” (Buy-side Equity Manager), preferring instead to
skim the reports and transcripts from the calls. Another interviewee similarly com-
mented on the widespread use of such transcripts:

We look at more than the company will realize, analysts and investors look at the trans-
cripts of conference calls…we look at the irrational exuberance and the shares can go
down, just to look at the wording. [And] we look at the same wording as well, when it
comes to outlook [and] when it comes to companies discussions of trends so those are
also reports in our view, every quarter there are transcripts that you can go back through
over many, many, years and you can see the language of the CEO, CFO on things like pri-
cing, volumes, market outlook. I’m not sure how aware companies are, how much we use
those transcripts (Sell-side Equity Analyst)

In addition to the ‘push’ communication provided by scheduled conference calls,
many interviewees considered it of particular importance to make direct contact
with the company. One important channel for ‘pull’ communication was a dedicated
phone call.

One interviewee indicated that, unless a conference call was conveniently scheduled,
sell-side analysts would routinely call the company asking “What does the report
really say?” (Sell-side Equity Analyst). Another sell-side analyst divulged his practice
of calling the company “the second [the interim report] hits Bloomberg” in order to
be the first person “to ask for everything I know is not in [the interim report]” (Sell-
side Equity Analyst).

Buy-side analysts and fund managers also spoke of management meetings as a further
channel for ‘pull’ communication. Such meetings were typically held at least once a
year and were characterized as an opportunity to sit and ask broader questions about
outlook, in particular.

Delegating information search and analysis

All interviewees spoke of how their own work took place in on-going interac-
tion with other capital market actors. For example, at the time of an interim report
release, buy-side interviewees referred to extensive and intensive information dissemi-
nation via chat and text messages from numerous21 sell-side analysts:

As soon as the report is on the screen there will be chat comments - better, worse or in
line and what it is that is good. Then there will be a little more extensive mails, so if the
report is published an hour before the market opens I have enough time to analyze the
report before the market opens (Buy-side Equity Manager)

It was clear that sell-side analysts’ reports formed an important source of informa-
tion for many buy-side actors. For many, the need to delegate information search and
analysis to sell-side analysts was regarded as a necessary and cost-effective prioritiza-
tion of time. As one generalist fund manager explained:

---

21 The number of sell-side analysts following a particular company varied considerably. However, interviewees commonly
referred to 20–30 analysts following the same company.
When we looked at how we work, we asked whether we’d ever made money by having calculated our own DCF value…And I thought the answer was no, and while we were not completely in agreement in the group, it liberated an hour of my day…But there are advantages in doing your own calculations, of course, like you get a better feel for the consensus estimates but it just takes too long when you’re alone as compared to what your get out of it (Buy-side Equity Manager)

In a similar vein, a more niched fund manager described how the relative value of in-house analysis was much less for companies with significant sell-side analyst coverage. The same interviewee described that developing forecasts was a step-wise process, based on the successive build-up of a position in the company that justified the work:

[O]n small and mid-caps we have our own income statements…[F]rom what I’m seeing from the last six years, that’s where we get performance….The big companies usually are covered by twenty plus analysts so the added value we can create by building our own model is limited, so we don’t have our own spreadsheets…[W]e may start without an income statement, we start to take a small position, if we like the company, increase the position, and at a later stage we might start to have our own spreadsheet and estimates (Buy-side Equity Manager)

Buy-side interviewees with more generalist roles indicated that they did not have the possibility to undertake detailed analysis of individual company reports. Instead they reported relying on in-house (buy-side) and/or sell-side analysts. In some instances, references were also made to using specialist in-house analysts, focused for example on management remuneration or corporate social responsibility issues.

However, the delegation of analysis work to sell-side analysts was not unqualified; buy-side analysts and fund managers were also experienced users of sell-side reports. Thus, several interviewees described that they paid particular attention to reports from a sub-set of analysts for whom they had gained confidence over time:

I think I probably only have four or five sell-side relationships that I use regularly and trust their output…Unfortunately, I’ll get emails from a whole lot, but there will be four or five that I will seek out to make sure I have understood what their view is…Because I’ve got three hundred and fifty companies to look at and it’s a lot of information and I’m hoping that if there is something in here that one of my four or five trusted advisors from the sell-side will have picked up on it (Buy-side Equity Analyst)

Different actors appeared to rely on other actors to a various degrees. For example, one buy-side analyst characterized sell-side analysts as providing a useful sense check on his analysis:

I’ll get on the phone with an analyst for ten minutes and just say ‘You know, anything interesting that’s struck you? What’s your main take away here? What’s the best that you saw in the written numbers, what’s the worst that you saw in the numbers?’…It’s really about making sure, I guess ticking a box, because some of these analysts are actually good, and they will catch things that I haven’t caught (Buy-side Equity Analyst)

Others rely more heavily on them to pick up and out what is important and doing the ‘digging’:
In the past we did more modelling, when we were more staff. Nowadays I do not model anything on my own, I use the sell-side analysts to do the counting (Buy-side Equity Manager).

I mostly speak with specialist clients...and you might get a prompt from a client to look into something. And so I look and get back to them: ‘yeah, it’s a problem in the US which will influence margins negatively and could spill over to the European margins’. This client might not care at all about my recommendation, since he evidently does his own analysis. I mean otherwise he wouldn’t be interested in what he’s asking about (Sell-side Equity Analyst).

Because of the reliance of the capital market on sell-side analysts’ analyses, one fund manager somewhat provocatively referred to them as sanitation workers:

We do not dig that deep in financial reports. Sometimes we have questions, but then sell-side analysts always dig and they are much better at accounting than we are and they usually know the companies in much more detail than we and then we just look at 2 or 3 analysts to see what they make of it if no one has commented it - then it is cool - good! And if the company has “fooled” everyone, well sorry, we’re in that boat too.... OCI? No, that’s not something we spend a lot of time on – if some company is misusing it, then we hope that the sanitation workers - the auditors or the analysts – find it. Because they’re much better at this than we are, so why should we spend a lot of time on it? (Buy-side Equity Manager)

4.3 Concluding comments

Several recent reviews and commentaries have emphasized that much remains unknown about how financial reports are actually used by capital market actors. This study, which is based on interviews with experienced professional users about their actual use of specific financial reports, highlights two common characteristics of these users. First, these users search and use financial reporting information in any single report in relation to prior knowledge and pre-determined expectations. Second, their usage of financial reports is characterized by time pressure. Although the degree of perceived time pressure varies, we observed a set of common strategies for dealing with time pressure. This included establishing a company thesis identifying a select set of key data points, formulating explicit expectations in the form of forecasts for these items and initially focusing on information helping to explain any deviations from these forecasts.

These findings suggest that the decision-usefulness imperative requires preparers, in particular, to be sensitive to what the current theses of capital market actors are. While this might be seen to suggest that what is decision-useful information is entity, user and time specific, our interviews also indicate that information that explains changes and the impact of different factors is considered useful because it facilitates the (re)formulation of both general and specific expectations (the company thesis and the line item forecasts).

Our findings also suggest that, although some capital market actors may not have time to perform detailed analysis of all existing and potential investments, they routinely rely on the analysis of information intermediaries (sell-side analysts), who do perform such detailed analyses. In short, the information that is presently made available through existing disclosure and presentation practices is thus used by experienced users. In the following two sections, we elaborate further on how capital market actors use interim and annual reports and what information in these reports is used.
5. Financial reports in the hands of capital market actors

In this section we report more in detail on how the interviewees characterized their process of using interim and annual reports. Most interviewees attributed the interim reports a significant role. They were eagerly awaited and, once released, they were quickly and purposefully devoured. In contrast, the annual reports were attributed a more varied role. Although characterized as less important by most interviewees, the interviewees nevertheless used the annual reports systematically for three different purposes: 1) updating specific metrics not found in interim reports, 2) as a general update and 3) as a reference book. In addition, the interviewees spoke of having relied extensively on annual reports when first getting to know the company.

5.1 Interim reports

The release of an interim report was actively awaited

With few exceptions, all interviewees not only said that they had read the most recent interim report from the relevant case company but also that they routinely read interim reports from the company on a timely basis. Furthermore, most interviewees described that they had actively awaited the report and attended to it as soon as it was released, even if this was in the middle of the night (due to time zone differences). Some buy-side actors, who stated that they did not immediately attend to an interim report, nevertheless expressed the intention to read it on the same day as it was released:

> It depends on where I am...when [the report] comes and, to a certain extent on, naturally, if it is extra important, if I have made investments or not...Generally I usually read the reports on the day, but sometimes it happens...there can be 20 reports and we may have customer meetings and company meetings and then maybe I don’t have time to read all... Then it might be in the evening, or the day after, but I try to read them soon
> (Buy-side Equity Manager)

Sell-side equity and credit analysts justified their interest in the interim report with a widespread expectation that they should rapidly pass on relevant information to internal traders and external customers:

> So you sit in front of the screen. Always at your desk and then it comes to sort of satisfying different interests. There are those speculative traders ... they need to know, in principle, within minutes: Was this better or worse? (Sell-side Equity Analyst)

> Typically within minutes after a results release, we publish our initial impressions on our Bloomberg chat (Sell-side Credit)

> [The interim report] comes out at eight in the morning, and at eight fifteen I need to talk at the morning meeting about the results (Sell-side Equity Analyst)
Some of the buy-side interviewees who talked about actively awaiting interim reports motivated this in terms of the information contained within potentially triggering action:

**OK, I see the numbers flash by. OK, they made X. That was a little worse than expected. I see the stock price move. I try to form a quick view about why. Is it reasonable? Is it an overreaction in any dimension? Can I make money on this movement? So that, and it is rather common that I act on some figure thinking that the stock price movement is wrong... And then, when you've done this, let's say 10 minute analysis, which I try to do directly when the report is released, if you see there's money to be made -maybe you've talked to some persons and so on - either you act or you don't act (Buy-side Equity Manager)**

One interviewee, however, argued that even with a timing/trading business model, there was no need to be at the office/in front of the screens as the information is released:

*It's usually about seven thirty before I get into the office. I will have had my first emails from sell-side analysts with their first take on the information. They vary in their quality, but at least I will have a quick sense of what the consensus view on the results were and then I can basically spend the next fifteen, twenty minutes skimming through this before the market opens to get a sense as to whether consensus has picked up by and large the key items I was looking for, you know I thought were controversial (Buy-side Equity Analyst)*

Other buy-side interviewees suggested that it was not really motivated to pay this timely attention to interim reports. A prominent reason was that it would not be in line with the company’s business model to make money on timing/trading:

*I want to be at work and in front of the computer, but it's not essential. It's too late to act due to liquidity and our investment philosophy, but I want to work as if it were essential. I don't want to miss anything (that's talked about) (Buy-side Equity Analyst)*

Some interviewees suggested that interim reports were generally more important for equity investors (and their intermediaries). However, our interviews with credit side representatives do not quite confirm this view; all talked extensively about using interim reports.

... because they provide an update

Many of the interviewees talked about the interim reports as containing new information to the market. More specifically interim reports were seen to provide an update about recent developments. This information was used to assess if these developments affected their general or specific expectations (the company thesis and the line item forecasts):

*It's April now. Why is it so important to know how things went on average between January and March? ... Then I explain: Naturally only to the extent that the last quarter is to be extrapolated into the future (Sell-side Equity Analyst)*

*I have an investment thesis. In [ProductCo], much of it is that the earnings are too low and that the margins are depressed for transitory reasons. If this is true, over time I should just see these issues going away...If this is true, then data points should come in that are consistent with my story...So at the end, when I look at the numbers, I basically have to decide: Is my thesis on track? Is my thesis challenged? Or is it maybe even better than I had expected? (Buy-side Equity Analyst)*
Interim reports are read with a clear purpose under time constraints

In line with this, many interviewees described how they routinely read interim reports with a clear purpose, more or less immediately searching for predetermined and specific information deemed relevant for the specific company at that specific point in time:

It’s part of the thesis which we as a firm have built up for [ProductCo]. The key drivers of that thesis have been around the growth rate in [BusinessSegment] and the margin improvement in [BusinessSegment] as well as the potential margin improvements in a [related business segment] (Buy-side Equity Analyst)

If I look at the first page [of InvestmentCo's interim report], I read the summary paragraph of text and glance only at net debt. And then I jump immediately to the unlisted holdings [to check my estimates] (Sell-side Equity Analyst)

As already noted in Section 4, the purposeful reading of an interim report routinely takes place under time pressure. Thus, although interim reports are generally only used by the experienced user during a short period of time, this usage is preceded by significant preparation. This preparation includes establishing and maintaining a company thesis and making forecasts for key metrics. One interviewee compared reporting periods to exam weeks, and interim reports to exam questions. For this interviewee, it was the point in time when it would be revealed if he had “done his homework”.

...taking in information stepwise

Sell-side analysts in particular, but also other actors, recurrently described an iterative process of using interim reports to source relevant information. In other words, interim reports were rarely read from beginning to end or in one sweep.

In an initial step, interviewees spoke about comparing reported numbers for specific metrics with their own forecasts and estimates of market consensus:

Basically, I have a spreadsheet where I have the numbers that matter, what they were last year. So I compare year on year sequentially, quarter on quarter... That’s a spreadsheet that every quarter I just roll over, and typically I go through it and then punch in the numbers on my spreadsheet and I have it there (Buy-side Equity Analyst)

The first thing I do – which might take like 10 minutes - is a deviation table, that is just numbers, I just take all forecasts - my forecast, market consensus forecasts - and then I say: “This is what they report”. And it’s just about punching in the numbers and pushing out an email. And then all customers have that and they say: “OK, so this is looking a little worse”. Usually I do not have any comments, I might just write “orders were better, operating earnings were stable” – I mean very short hand (Sell-side Equity Analyst)

In this context, interviewees often referred to looking at the first page of the interim reports, as this contained the data they were seeking. If this was not the case, they described quickly turning to wherever the relevant data could be found. Often, this would be in the narrative sections, especially in the section(s) on segments. In this first phase, the experienced users we interviewed were not generally looking in the financial statements or in the notes. One notable exception was the statement of cash flows, which several interviewees told us they turned to in order to find information about changes in working capital, capital expenditures and amortizations and depreciations.
I quickly turn to page [X], all analysts do: What cash flows have they produced? And if the cash flow is different from the earnings, then numerous questions arise. So that is included in the 5-minute analysis (Sell-side Equity Analyst)

This first wave of attention, which was generally estimated to last only a few minutes, was followed by efforts to understand the reported numbers. For users with more elaborate spreadsheets, this included updating as much of the data as the interim report allowed.

As noted in Section 4, interviewees told us that they tended to focus on the unexpected. A common objective was to evaluate whether the causes of these deviations could be expected to be transitory or persistent. The latter could require that their company thesis and/or forecasts needed to be revised.

In line with this objective, many interviewees expressed favorable sentiments when the reporting companies identified, explained and quantified how different factors affected reported numbers. Several interviewees spoke especially about the usefulness of a ‘bridge’ explaining the difference between the outcomes of two periods in terms of the effects of acquisitions, foreign exchange and so on:

If you asked me for just one thing that I think everybody would quite like to see, which a lot of the car companies are doing, is something called an EBIT bridge...basically a bridge where you see the volume impact, the mix impact, the price impact, FX, raw materials, production, over- and under-absorption and cost savings (Sell-side Equity Analyst)

In their efforts to probe the underlying drivers of reported numbers, the interviewees highlighted the usefulness of verbal communication provided in conference calls, as well as the opportunity of asking questions during these calls. The contents of calls could prompt further analysis and change interpretations of financial reporting information. For buy-side actors, various sell-side comments and reports could have the same effect.

In general, interviewees told us that they tended to focus on forward-looking information such as outlook statements and orders, in addition to revenue (sales) and operating income measures. However, the order in which specific data points was sought varied. For example, while one interviewee indicated that organic growth in revenue was one of the first metrics he sought out, another said that he tended to look first at outlook statements and a third said that he focused first on gross margins. Some interviewees also emphasized that their focus depended on the specific circumstances at the time of the release of the report. This relates back to the notion of an established company (and industry) thesis being dynamic:

As an example, last week when [another company] reported, what was it, [x] % under consensus on EBIT, I got a call from someone asking me if I didn't agree that they should've issued a profit warning because the stock will crash and I said "No I think the price will go up", because orders were so good. So it depends. Perhaps in three quarters, then the orders won’t be important and the earnings will. So you've got to have that figured (Sell-side Equity Analyst)

Several interviewees also included cash flow information in the set of information that received immediate attention. Others included this information in the set of information which received attention somewhat later. This expanded information set could also include net debt and other data points that needed to be entered into the specific user’s spreadsheets.
5.2 Annual reports

Views on, and the described use of, the annual reports were more diverse than for the interim reports. A smaller number of buy-side interviewees expressed more interest in the annual report than the interim reports:

I find the annual [report] much more important to me than the quarterlies. They give you highlights and pictures...I use them for trends or things that are happening and again I think [ComponentCo] is a fine example of telling me what as an investor I need to know to be able to follow trends. You know, they give me the rolling twelve months, they put it in a way that shows me how it's occurred (Buy-side Equity Manager)

Yes [the annual report] plays a bigger role...because, first, it gives a significantly more descriptive information about the company. You get a significantly better understanding of the business risk and trends...In an interim report it can look very dark one quarter and very good the next. What matters for us is between years, because we're after the default risk: is default becoming more likely or less likely compared to how things looked last year or two years ago? And if things are looking worse? What are they doing? You don't get that from an interim report, it's about the big strategies, the big picture you find in the annual report (Buy-side Credit)

Most interviewees, however, argued that the annual report from the case company was not as important for them as the interim reports were. This was because they had already developed a company thesis and because they had read the interim reports. In line with this, interviewees noted that the importance of the annual report varied with the quality of the interim reporting. Simply put: the better the interim reports, the less important the annual reports. Their lower interest in the annual reports was thus suggested to be a consequence of their general satisfaction with the case companies' interim reporting.

Nevertheless, the interviewees’ responses also suggested that they used annual reports for three different purposes: 1) updating specific metrics not found in interim reports, 2) as a general update and 3) as a reference book. In addition, the interviewees spoke of having relied extensively on annual reports when they were first getting to know the company.

(a) Annual reports as a source of information not found in interim reports

Many interviewees told us that they regularly used the annual reports to update specific data points in their spreadsheets which were not available in the interim reporting. For this reason, several interviewees told us that they actively awaited the release of the annual report, although not with the same urgency as the interim reports:

It’s quite rare that I’ll take an annual report on the day it comes out and go through it straight away because these normally come out some time after the Q4 report. It usually takes me a month or two to get through all the annual reports (Sell-side Equity Analyst)

For [ProductCo] specifically and some of my other companies, the pension, the off balance sheet issues. I don’t remember if this is an issue for [ProductCo] specifically but, you know, a lot of companies will give kind of summary balance sheet metrics, but then they give the supporting data underneath it. Even if I’m not modeling it I want to capture it in my model because over time there might be some informational value and understanding kind of the
composition of the fixed assets or something like that. So, I think the main function of the annual report, it's the back fill information that the company doesn't give us in the press releases (Sell-side Equity Analyst)

I know the numbers I'm looking for in that report, in the press release you don't have all the details, all the information you can get but when the [annual] report is released I have some lines I need to update to have a more complete balance sheet for instance. I will go to the annual report once it's been published...so I have a few figures I'm looking for (Sell-side Equity Analyst)

While detailed information on, for example provisions, amortizations and deprecia-
tions and expenses by nature were thus awaited, interviewees were not generally dis-
satisfied with receiving this information on an annual basis. One exception was if there were significant changes that merited explanation:

If there's a sudden drop or sharp rise in an important item like cash flow or debt, then I would expect the company to provide detail about this change, put something in writing, at least a line or something just to flag the main changes (Credit Rating)

Yes because the quarterly reports are usually focused on the sales and the operating profit - where is the company going? How the balance sheet looks is not a pressing issue on a quarterly basis. It is about seeing where is the company going? What's the growth in sales? That's the important issue. And, in a cyclical business, each quarter could be the start of a new trend (Sell-side Equity Analyst)

Our interviews thus indicated that, at least for some capital market actors, timeliness means different things for different items of information.

As with the interim reports, some interviewees indicated that their interest in specific figures in the annual report could shift depending on the development of their company or industry thesis. For example, one interviewee said that in the past he had been very interested in the annual report because it had provided additional information in relation to restructuring provisions, something which he did not perceive as important for the specific company at the time of the interview. Another made a similar point noting that in a particular context, he might have reason to access detailed information of accounts receivables.

Another reason for why the annual report was considered important was given by one credit rating analyst, who told us that part of the role attributed to annual reports derive from the fact that these, in contrast to most interim reports, are audited:

We're not auditors, you know, we don't assess if a company tells the truth or not in its statements. We have to rely on the auditor's statement, it's actually a pre-requisite for us to rate the company. It needs to have audited accounts for us to make a forward-look-
ing credit rating...I think for us the annual report is very important, as I said, because of the auditor's statement. We always read the auditor's statement to see whether there has been anything that's been flagged (Credit Rating)

However, not all interviewees said that they use the annual report to source data, arguing that “there should be nothing in here which I would need to update to my model” (Buy-side Equity Analyst).
(b) Annual reports provide a general update about the company

Numerous interviewees spoke about skimming through the annual report around the time of its release, with the general purpose of ensuring that nothing had changed with the company:

It can be a good way of updating yourself, if your perception of the company is correct, for example when it comes to foreign exchange exposure... Or flip through it and skim the text to see if it still the company that I have in mind, if anything is changing (Buy-side Equity Analyst)

The bits that are of interest to me is just the letter from the CEO just to make sure there's no change of tone, change of pace, that I haven't missed anything from the messaging of the company which is different... By the time the annual report comes out I've had all that data already so apart from as a sense check to read through the commentary I think that's really all I read the annual report for (Buy-side Equity Analyst)

Many interviewees described a habit of skimming the narrative sections of the annual report in particular, searching for comments on the company's outlook or any new information:

I don't read all the stuff at the front but I skim through it to see if there's something interesting. For example, there is sometimes more information on a certain region, so I do skim the front of the report (Sell-side Equity Analyst)

One interviewee particularly noted that the annual report normally preceded the first interim report, thus also offering the possibility of new information. Another made the point that whether or not he paid attention to these sections depended on his perception of the information content of previous such comments.

In addition, many interviewees told us that they would also look through the notes to the financial statements. Again, they described being on the look-out for things that were not in line with what they would expect and could thus suggest that their company thesis and/or specific forecasts needed adjustment. In this context, any large change seemed to be particularly eye-catching:

You have a few things you look at, like provisions and then you try to check if there is anything big that has changed during the year. Because you do have a history and if there are big changes you try to understand why and where it is coming from (Sell-side Equity Analyst)

Two interviewees articulated that part of the reason they would skim this information, was that it was available, and provided an additional opportunity to look for potential problems and prospects:

I look at this as well, as I said, from a timing sensitivity perspective it's not really that crucial. Usually there's very little incremental information that's out there and part of me reading that in the footnotes is not because I think it can really give me an edge, I just don't want to be in a situation where something blows up and for no reason I didn't see footnote seventeen which basically made it quite clear that here's a big yellow flag that I ignored (Buy-side Equity Analyst)
I’m guilty to this ‘What if someone else finds something?’ And that makes one, as soon as [the annual report] is out you want to look at it, not because I will change…but I don’t want to learn that anyone else found something and have the traders shout ‘What the hell, our competition is sending out that…!’ So I try, as soon as it is out to skim through it, I will skip things like the sustainability report and focus on things that I believe can affect earnings or forecasts (Sell-side Equity Analyst)

(c) Annual reports as reference books

Many interviewees also spoke about referring to annual reports for information on an ad hoc basis after their release, for example when trying to understand something particular such as developments in a particular region or of a specific cost item. The usefulness of information provided in an annual report could thus become evident several years after its release, when it might serve to put current developments or specific events into a historical perspective of previous communication and activities:

Suddenly there might be big changes in [foreign currency rates] and then you go and have a look because the company presents a sensitivity analysis! So you can see...so there’s a wealth of information that I might not care about right now, but at a later stage, so I use this as a reference book (Sell-side Equity Analyst)

And sometimes you might find something a year or two later. Or it could be an acquisition where you don’t understand what’s been going on and you want to check the historical information (Sell-side Equity Analyst)

While the reason behind the search for a particular type of information could be company-specific, interviews indicated that there is usually particular matters of general interest. Recent examples included management remuneration and, in view of changes in IAS 19 Employee Benefits, pension obligations. To find this information, interviewees generally referred to searching in the notes to the financial statements as this was widely considered to be the source of potentially ‘new’ information in the annual report.

Many interviewees also told us that they generally used annual reports as a key source of information – i.e. reference book – when they are first getting to know a company and building their company thesis:

I read it almost entirely when I started looking at the stock (Buy-side Equity Analyst)

If I were to invest in [a company name], for example, then I want to read the annual report (Buy-side Equity Manager)

...the first-time reader would be glad to know a bit more about the business, the manufacturing, the footprint, the strategy, you know a view about the world. This is not my case, I know the business, I know the strategy (Sell-side Equity Analyst)

Because of the selection criteria of our interviewees, however, no interviewee had used the relevant annual report for this purpose. Indeed, for most interviewees, a considerable amount of time (ten years or more) had passed since they had performed this activity for the company in question. Their comments, however, suggested a deeper meaning to the common suggestion that annual reports serve as marketing document used to attract new capital providers.
5.3 Concluding comments

Previous research has consistently found that capital market actors rank both annual and interim reports highly as sources of information. Indeed, in many studies annual reports have been ranked higher than interim reports. Our findings elaborate on this understanding by indicating that annual and interim reports play different roles for different capital market actors.

First, our findings suggest that the information contained in annual reports is perceived to be imperative when a potential capital provider (or an intermediary) is first getting to know a company (i.e. an investment alternative). For these users, decision-useful information is information that helps them establish a company thesis.

Second, for experienced users, i.e. users with an established company thesis, the annual report plays other and more secondary roles. Indeed, most of our interviewees expressed greater interest in the interim report because it provided them with timely updates of the reporting entity’s development. For these users, decision-useful information was that which helped them corroborate or reject their company thesis as well as specific line item forecasts.

Most of the time, the financial reporting information in the interim reports was sufficient for these purposes. If this was not the case, then one route was to wait for updated information in the next annual report. In general, the interviewees did not express dissatisfaction with only being able to update certain figures on an annual basis. This distinction of timeliness, between information that is useful on an interim versus annual basis, is not currently reflected in the Conceptual Framework. One might argue, however, that such a notion could be the basis for different disclosure requirements in interim reports compared to annual reports.

Having found that the annual and interim reports are used differently by capital market actors, we now turn to the use – and perceived usefulness – of specific data points in these reports.
6. What financial reporting information is used?

In Section 4.2 we described how interviewees told us that they focused on a pre-selected and delimited set of information which was identified as particularly relevant by their company thesis and forecasts. While there were some variations in which information interviewees identified as core, the observed variations were not radical and seemed to be primarily about order and emphasis.

In this section we account for what financial reporting information interviewees told us that they used in the financial reports, structured by reference to the three primary financial statements. In general, interviewees did not refer to looking for, or using, information in the statement of other comprehensive income. However, as this statement has received particular attention in the current debate, we also include a section elaborating on interviewees’ comments relating to information in this statement.

6.1 The statement of profit or loss

Understanding the quality of operating income...

Many interviewees mentioned sales and/or operating income as one of the first data points to be identified and compared with own and the market expectations. Most interviewees explicitly mentioned that they looked for this information on the first page of the interim reports.

A simple comparison of reported sales and/or operating income with forecasts was thus an important first step in the process of information search and use. However, the interviewees emphasized the need to understand the reported number (outcome) in conjunction with other information:

Well first off everything is looked at in conjunction with other things, so if you ask me very specifically I would very specifically tell you gross margins but there is no single data point, it’s generally thinking about it as a mosaic and so therefore, in my view, if I can understand what’s happening with gross margins and what is driving it about and then obviously what falls down to the operating line that gives me perspective as to how the business is doing (Buy-side Equity Analyst)

Several interviewees spoke explicitly about wanting to understand the quality of the revenue/operating income. In this context ‘quality’ seemed to translate to ‘sustainability’ and to be related to the objective of forecasting the future. To understand the sustainability of sales and/or operating income, interviewees highlighted the need to evaluate several dimensions.

22 Financial reporting information is here used in a narrow sense. Management commentary (e.g. outlook statements) are not included.
...by differentiating between different segments and regions...

One such dimension was the source of revenue and/or operating income:

You can’t make sense of the gross margin that [ProductCo] is reporting for the group unless you know the sales for the different segments. I know that, so the first thing I will do is start with finding them, the business areas. Because then I see immediately that [one segment] was stronger than I had expected compared to another segment and then, everything else unchanged, the gross margin should be up. So then I know the background before I look at the group results, the group income statement (Sell-side Equity Analyst)

This time it was [one region] that was good and everything else was a bit under expectation...and then you think: What is the quality of this outcome? It could be that you think that how [the region] is doing is the most important thing, and then that’s fine. But say it was a different region that had an outstanding performance and everything else was junk, well then I would think: Yes, but next quarter that region will be down...because it’s a market that is less stable and then the quality is lower (Buy-side Equity Analyst)

As indicated by these quotes, interviewees were not just interested in revenue/operating income for the various segments identified by the reporting entity. They also frequently referred to geographic location, both in terms of countries and regions.

...and the impact of different factors...

A second dimension concerned the impact of factors on reported numbers, such as currency rates, acquisitions/divestments and volume and price mix. Companies that provided quantified ‘bridges’ explaining the difference between the number for one period and another period in terms of acquisitions, foreign exchange and so on were commended. If this was not provided, it was often on the interviewees’ wish-lists:

One of our irritating jobs is to figure out the currency impact to sales and EBIT, Product Co group the divisional FX and acquisition to sales. ..... I would like to see a normal bridge for sales and EBIT by group and division which always breaks out FX and acquisition impacts to sales and EBIT. Also I would like to see the slide given re: 3Q every quarter with the key FX transaction impacts by currency (Sell-side Equity Analyst)

The interviews suggested several reasons for why such ‘bridges’ were useful. One reason that interviewees gave was that it helped them understand operating leverage (the change in income relative to the change in sales). A second reason was that it helped them to separate out the effects of organic growth, something many interviewees expressed a particular wish to understand. One interviewee linked this issue back to operational leverage, by suggesting that organic growth contributed to fixed costs, while acquired growth usually only came at additional costs. Another interviewee commented that acquired growth was usually not considered to be of the same ‘quality’ – i.e. ‘sustainability’ – as organic growth:

...the best way to grow in a business is to be positioned in a growing market. It is difficult to grow in a market that isn’t growing. Then you have to take market shares from you competition and you need to, all of the time to be better and have lower prices and what not. Whatever the case, it is very hard. The competition is harder. So if you can show that you have growth in your business, it might mean that the market is growing and that makes things easier for everyone (Buy-side Equity Manager)
A further reason for why interviewees sought information about organic growth was linked to the way key metrics were forecasted. Interviewees told us that their models tended to be based on organic growth expectations per segment, with effects of foreign exchange and/or changes in structure added separately:

When I model the company I start with revenues. I forecast organic growth per division and add in FX and known acquisitions. At the EBITA line, I forecast margin per division. The sum of these forecasts gets me to group revenue and EBITA estimates (Sell-side Equity Analyst)

In order to forecast organic growth, interviewees also indicated a desire to understand the effects of volumes and prices. This information was less frequently provided. Although difficult to obtain, it was perceived as useful as it was seen to allow for a more detailed analysis and hence more informed forecasting:

Most companies don’t give you the effect of volume and price. Because it is difficult. So most companies give you organic growth. And then they will tell you...yes it can be off the record, something about price, but it can be very difficult because the mix (effect) can be good. Today you rarely get at price-increase in [x]business for a specific product. Instead you make a new better product and then you have a higher price, or usually it can be a new product at the same price but with lower costs (Sell-side Equity Analyst)

Interviewees also generally spoke about wanting to understand the impact of the aforementioned factors on a regional and/or segmental level. Comments ranged from wanting to compare the development of sales and EBIT on a regional/segmental basis, to actively requesting a bridge on segmental level:

For volume, price and mix I call IR and they are helpful...Usually I’m rushing to get three numbers for [number deleted] divisions plus the group, so I’m rushing to get [number deleted] numbers out of them. In order to then be able to say what pricing has done, which is key for margins, I need to know the exact numbers with decimal point. Others sort of guess from the statement they say price mix was favourable but I want to be able to say no volume was plus [X point X], price was [Y point Y] and mix was [Z point Z]. Only then and with 40 quarters of back history mapped against the peers am I in a better position to have an intellectual discussion with investors, about the true performance of the business. So, yes I want to know immediately the breakdown of the revenue bridge. Ideally, they’d publish it. I would also like the million SEK impact at the EBIT level for each division’s bridge...So I want to know immediately the breakdown of the revenue bridge. I've sent [IR at company] a presentation as to how I think they should do this...which is bridging revenues by division and bridging EBIT, because they have this bridge that they talk about behind the scenes with FX and raw materials and savings. I'd love to see the whole thing laid out, because that's how I think and model so for me the whole day is about filling in all those numbers to make sure that I've got my history correct, because I build my models off history (Sell-side Equity Analyst)

The need for a longer-term view was echoed by other interviewees who also lamented not only a general lack of information on organic growth, but especially a lack of such information on a time-series basis.
...and adjusting for items affecting comparability...

A third dimension of the quality of sales and operating income concerns the effect of items affecting comparability. In line with normative literature on valuation, interviewees expressed an objective to form a judgment on likely (normal) future levels:

What people want to know is what is a sustainable performance, the results you show, what matters is what is sustainable if you show the reporting number but you cannot ascertain the sustainability of this number, it’s meaningless, I mean you don’t really care. That’s why we state one-offs, it’s not for valuation, it’s just to find out what is sustainable and that’s the basis on which I build my forecast (Sell-side Equity Analyst)

Again, any such information was actively sought at both an aggregate and segment level. In contrast to information on organic growth, however, interviewees seemed quite satisfied with the way the case companies disclosed information on items affecting comparability and there was almost no talk about how such items were presented in the financial statements. One reason for this may be that the interviews suggested that this information was picked up from the summary first page(s) of the interim reports.

Nevertheless the interviewees also suggested three problem areas with items affecting comparability. One is the risk of confusion with several measures:

So generalist portfolio managers that look at twelve different sectors. They see sell-side commentary, operating margins are this and if you don’t know where to look you can’t reconcile them because the sell-side reports’ operating margins for the [a segment] are [x] per cent yet [the company’s] reported numbers are [y] per cent, so you know, where’s this difference coming from? I think that’s not helpful. If you put this information up there with the reconciliation of how that is, it’s really helpful (Buy-side Equity Analyst)

Another is the problem of knowing what to regard as items affecting comparability and not, restructuring items often being commented as ambivalent in this regard:

Restructuring is a way of life for most companies. I’ll often strip it out for analysis purposes to see what the underlying trend is but I won’t treat it as being a genuine one-off because it’s money you’ve chosen to spend on the business (Sell-side Equity Analyst)

I never take them (restructuring charges) away. I always.. in [ComponentCo] they are part of ordinary earnings (Sell-side Equity Analyst)

A related concern was that of misuse by the company. While certain interviewees said that they calculate their own adjusted measures, these were in minority. One said it depended on his trust in management:

My first take is to accept their classification, I will do that... It depends on which company it is. Now I know ConsumerCo, I know how they think and what they do, I trust that that figure is clean. Nowadays. This wasn’t the case a couple of years ago...Then there could always be something else...There may still be, something small, but nothing large. It’s rarely anything large (Sell-side Equity Analyst)

---

23 Different expressions were used by different interviewees. Many used “IACs”, but others used “one offs”, “non-recurring”, “unusual”, or “exceptional” items.
Most said, however, that they made do with keeping an eye on what was being treated as items affecting comparability by the reporting entity:

If one looks at a ten-year-summary and note that there are one-offs each year and that they are about this size, then I can definitely add a comment in my spreadsheet: ‘There seems to be an average of one-offs of one percent on the margin’... Maybe for a normalized margin I would take that into consideration, but I wouldn’t have an opinion on the one-offs for the last period, not really (Buy-side Equity Manager)

I would double check, obviously I would check it is clean, that there’s not some funnies in it (Buy-side Equity Analyst)

And, sometimes, considering operating expenses...

While all interviewees talked about revenue and operating income, there was much was less talk about the intervening component: the operating expenses. There also seemed to be large differences in how the interviewees related to information about these expenses.

These differences were partly related to the characteristics of the reporting entity, the interviewee and other specific facts and circumstances. For example, the interviews suggested that cost information will be probed in cases of (large downward) movements in gross and/or operating margin and if cost-cutting was a key tenant of the current company thesis. Indeed, detailed information on cost structures was mentioned in several interviews as an example of the type of information users would look up in the annual report from time to time.

In discussions of the reporting of operating expenses the focus is often on whether these should be present by function or by type. The interviews did not indicate a clear preference for any format. While some interviewees did suggest a preference for expenses by type, others did not express a preference, suggesting that both formats may be useful.

We believe that these variations in preferences are, at least in part, related to differences in company theses and differences in perceptions of which type of information is useful for forecasting future operating income:

I like the breakdown of raw materials in the annual. It’s very important here because it’s a [monetary amount], [X] times EBIT, so a [Y] % movement in your raw material bill doubles or zeros your profitability. What would be very helpful would be to provide the cost breakdown (raw mats, depreciation, wages, etc.) and the raw material split of costs for each quarter (Sell-side Equity Analyst)

We also note that some interviews emphasized that the usefulness of information on cost structure is limited if it is only provided at the group level. Again this is because models used for forecasting are generally structured around segments and/or regions.

Lack of comparability in terms of how different companies classify expenses was another reason mentioned for why interviewees did not probe operating expenses:
Everyone has a different definition of the cost structure. Some will give you R&D and depreciation, almost everyone will give you that, and some will give you raw material costs, but some won’t give you any details on that so the cost structure of the company…. Because our job is to compare companies with each other, you don’t analyze ComponentCo on its own, we look at its close competitors or the [X] industry, we put ComponentCo in a context and… I think for cost structure there is a lot of difference in terms of reporting (Sell-side Equity Analyst)

…but seldom financial items and tax expense

Interviewees generally did not pay much attention to items below operating income in the statement of profit or loss. In part this was justified based on perceptions that such items are not generally possible to forecasts:

Tax is an item where you are completely on your own. For tax rates it is completely impossible to have another view that the company. It’s kind of strange, actually, it is a big and important expense item, but you can’t say anything about it (Buy-side Equity Analyst)

Many interviewees said that they thus limit themselves to entering reported figures in their spreadsheets. Some suggested, however, that it would be useful if companies provided guidance on these items.

…or management compensation

Another expense related item that received some attention in some interviews was management compensation. One buy-side interviewee said that these issues were looked upon by a special governance function. One sell-side actor, on the other hand, used this as an example where he had recently looked into annual reports for more detailed information. In this case, he had ended up calling the company for additional details. Other views ranged from “completely uninteresting” to something that received attention:

English annual reports have an endless amount of pages on management compensation which are completely uninteresting, almost all the time (Buy-side Equity Manager)

One thing on the annual report, that I guess, maybe not part of the footnote disclosure but in terms of the corporate governance and the remuneration of the management is something that I’m focused on. I do believe that incentives work and it would be nice if management’s incentives are aligned with our incentives which, as I said, is not the case with ProductCo unfortunately (Buy-side Equity Analyst)

One interviewee suggested that one reasons for why management compensation received less attention was that management compensation schemes tended to be of less importance in Swedish companies.

6.2 The statement of other comprehensive income

Most interviewees did not refer to looking for, or using, information in the statement of other comprehensive income (OCI). If this was the case, we often choose to ask specifically about the use of information in this statement. Most interviewees then told us that they did not make use of any OCI information. At the most, they might have looked at it. Some said that they might have dug deeper if the reported numbers had been material. Only a few suggested that they included OCI items in their spreadsheets.
A lasting impression is that the interviewees seemed much less familiar with this financial statement, although not all were as open about it as these two interviewees:

I must admit that I feel like a question-mark when I look at it (Buy-side Equity Manager)

I would say I read it. I wouldn’t say, confidently, that I understand many of the line items. I guess I understand the changes in the currency translation adjustments, but say things like, adjustments for amounts transferred to initial carrying amount of hedged items, I can make an educated guess but specifically what it means... (Buy-side Equity Analyst)

Other interviews suggested a more complex situation, where different causes combine:

I guess I have to admit that I do not focus on OCI, because we come back to it all being about me wanting to have something to base forecasts on really, and I feel that I do not need OCI for that, ..... since I do not need it honestly I’m not entirely updated on each item here. I know the translation differences and I know that OK it won’t have any big effect on my forecasts, really. Cash flow hedges, they may affect the future, but I solve it through talking with the company and asking about it to get a feel for what I should base my estimates on and so on (Sell-side Equity Analyst)

It is very hard to interpret....because we don’t know, now [ProductCo] tries to be very transparent about how they hedge, but it is extremely difficult to judge. Why? Because it is not as if [ProductCo] enters into a contract today to hedge a delivery they hope to receive payment for a year from now. In line with their policy they will not hedge everything when they sign a contract. Instead they will hedge X % each month so that means that this information is rather difficult to interpret, because it is not as if [ProductCo] will make money based on what the rates were at (Sell-side Equity Analyst)

These quotations suggest that forecastability is a key characteristic of usefulness. In the statement of other comprehensive income, an area of particular concern is the impact of hedging activities.

6.3 The statement of cash flows

In general, the interviewees did not talk about cash flows to the same extent as they talked about income. Nevertheless, most interviewees did indicate that they regularly, and at an early stage, look through the statement of cash flows to ascertain that the income was being translated to cash flows. Cash flows would thus seem to be another dimension of gauging the quality of reported income:

I like to evolve to the cash flow statement, look at stuff like working capital, CAPEX and finally balance sheet and cash flow generation which is the acid test of everything that has been reported above (Buy-side Equity Analyst)

Then I look at the free cash flow and the free cash flow relative to their net income. I’m not that interested in free cash flow to EBIT, it’s a pointless number, free cash flow should be compared to net income and, I look at that conversion....So first EBIT number, then it’s the cash flow, working capital components, etc. etc. (Buy-side Equity Analyst)

They show inventories, you need to look at the cash flow, we take the cash flow before investment, before financing, the free cash flow. Cash flow matters, especially for companies like [ComponentCo], because cash flow will give you some feel about the quality of
numbers. Has [ComponentCo] over-produced or under-produced over the period? That can have an impact on the P&L performance so it gives a feel about the quality of the results (Sell-side Equity Analyst)

Some interviewees also motivated this focus in terms of cash flows being ‘hard’, actually occurring, events which made them more reliable and less susceptible to manipulation:

If it deviates too much from the reported income or the cash flows last year, then you will study the line items in the cash flow statement... but that is after looking at the income ..... But it can be interesting to, (because) sometimes the company can choose, on specific instances, to change things to make a situation look better (Buy-side Equity Analyst)

And then, actually, the most important number, that is almost, the most important table is this, yes the cash flow table more or less. Income that is accounting, how you choose to depreciate things... (Buy-side Equity Manager)

Two related motivations were that cash flows should be comparable between companies and that it was cash flows that were of ultimate interest:

Often I will look at free cash flow across companies to, you know, try and bring some consistency given that the accounting rules exclude certain things depending if it’s IFRS or GAAP. Ultimately I care about the free cash flow that’s generated and how the management team deploys it (Buy-side Equity Analyst)

A peculiarity when it comes to cash flows is that interviewees told us that generally they would look for information in the actual cash flow statement. One reason for this could be that cash flow metrics were less common on the first summary page(s) of interim reports. However, our interviews suggested that another reason was that interviewees were interested in understanding cash conversion, rather than specific metrics.

In line with what might be expected, the interviews suggested a focus on cash flows from operations. In particular, interviewees often referred to looking at changes in working capital and expressed preferences for companies detailing changes in inventories, accounts receivables and payables etc. rather than just providing a net change in working capital:

Yes, I prefer to know if it is inventories or receivables because that has a different interpretation. Inventories is a lot about work in progress, i.e. deferred revenues, that’s gone up, so that might explain some of the weak sales [in the previous quarter] (Sell-side Equity Analyst)

Investments, it is not like they are the same each quarter. I don’t look at that instead you look, foremost, at net cash flow from operations, and then you see that in the case of [ComponentCo]: “It’s gone down from X to Y, not good!” And it is mainly changes in working capital, which remain on a high level! But then, you know, when a company is expanding rapidly, you build inventory for the next quarter and then you can accept - in a period of growth - that cash flow is lower than earnings. And vice versa when sales are falling. And in this case sales are not growing. So then the question becomes: “Why so much working capital?” And the [ComponentCo] might say: “We expect to sell this, we didn’t get it out in Q1 so inventories are high.” But this might have pushed up earnings for Q1, so for
the next quarter you may have cash flows, but maybe lower margins, so you’ve got to look at these items together, all within 5 minutes (Sell-side Equity Analyst)

Something which is important to me, the working capital, I need to see a breakdown of what’s trade working capital and what’s not and I need to see what receivables are trade related and what payables are trade related, they don’t give that breakdown except in the annual, I’d like to see that in the quarterly, I’d like to see that reflected in the cash flow statement as well. They net off a lot of items in the quarterly cash flow so it’s just they have to give a net figure for, they have other operating capital employed line so trade receivables and they’ve got other operating capital employed line, I’d like to see that more broken up so I’d like to see movements in payables, receivables, um, pre-payments, I want a real detailed breakdown, it’s so important for a company like this which is low margin but very large revenues and it has very large billings which go through the books so the working capital is crucial (Buy-side Equity Analyst)

Another focal point in the statement of cash flows was depreciations/amortizations and investments (prior to acquisitions, if these were significant). These measures seemed to be used as a health test of the company thesis. If a company capitalized a lot of development expenditures, the cash flow effects of such expenditures were also mentioned as a point of interest in the statement of cash flows.

A few interviewees, all of them on the credit side, stand out in that they expressed a greater interest in cash flows than in income:

As a credit analyst, I mostly look at the cash flow statement and balance sheet to assess whether a company can repay its debt maturities with internal cash flow. The income statement is useful to assess the ability of the company to service debt but we don’t look too much at the income statement, because we’re more interested in cash flow from operations.... So the main headline numbers that I look at are the regions, and then I look at the cash flow (Credit Rating)

Credit side interviewees also talked about checking and updating an established set of credit metrics based on cash flow measures. However, again interviewees emphasized that the company thesis will direct the focus of attention:

The cash flow statement is among the most important things I look at. We generally do not worry too much about liquidity for an investment-grade rated company. However I could be worried if I saw large cash flow volatility quarter on quarter. As a credit analyst, I prefer to see a company generating stable recurring cash flow through the year....But it really depends where the company’s standing. For example [ConsumerCo] is highly rated, so usually we don’t have so much concern about liquidity or about potential huge cash flow problems or anything. So, for [ConsumerCo] I’m more interested in how the business is doing because that’s the main driver of the rating but for other companies who have a very risky rating then I would look immediately at the cash flow section or liquidity or if there’s any problems with refinancing covenants (Credit Rating)

It depends on what kind of company it is. [ServiceCo] is an investment grade company.... If you look at a company in distress or a high yield company, you look at other key ratios. Traditionally – and this is very much inspired by the rating institutes’ set – I look at how cash flows in relation to debt. Funds from operations through debt is a typical investment-grade ratio. For [another company], I would look at free operating cash flow (Sell-side Credit)
6.4 The statement of financial position

In general the interviews suggested a relative less focus on items relating to the statement of financial position. One interviewee explained this in terms of balance sheet items generally not being key drivers for a company thesis:

It varies. [ConsumerCo] is not a balance sheet company, although many other companies are. … It is seldom that the stock moves because of something happening on the balance sheet. What happens on the balance sheet rarely affects the price of shares. … It is possibly because it churns so quickly, 4 or 5 times, so the margins are much more important for profits (Sell-side Equity Analyst)

In general, however, many interviewees mentioned keeping an eye on one item related to the balance sheet: net debt. This was tracked to make sure that there were no major and unexpected changes:

[The balance sheet] comes...second. You tend to be fixated at the net debt, I mean credit side people look, the equity market, if you want to do an EV-valuation, then net debt is what matters (Buy-side Equity Analyst)

Yes, you look at net-debt directly, to get the EV. So net debt, pension liabilities and inventory, you look at that (Sell-side Equity Analyst)

In general, interviewees did not turn to the statement of financial position for this figure. One reason was that the case companies generally reported a net debt figure in the first summary page of the interim reports or in the following narrative sections. A second reason was that it was generally not possible to determine net debt based on the information in the interim or even annual reports:

Most companies are quite good at telling you what net debt is, but some don’t do it very clearly and then you have to sit and check the balance sheet and sum it up yourself and look in the notes...It is important information and it would be so simple if they would only write what net debt is (Buy-side Equity Manager)

[ComponentCo] specifies its net debt quite well. In fact, most companies do nowadays. You can’t determine the interest-bearing net debt from the balance sheet, but in a table on page [X], they specify what is debt, long and short, pension liabilities, financial assets and so on (Sell-side Credit)

Credit side interviewees, however, said that they generally try to calculate their own net debt figure based on established practices of credit rating agencies using the available information.

6.5 Concluding comments

In line with previous literature, our findings suggest that both sell-side and buy-side actors use information in financial reports to understand the quality of income as a basis for making forecasts about the future. In line with Barker and Imam (2008), our findings highlight that such quality is a multifaceted concept. Specifically, our interviews indicated that interviewees sought to ascertain the quality of reported earnings by (1) differentiating earnings growth in different segments and regions, (2) considering the impact of organic growth and (3) evaluating the impact of items affecting comparability.
Our findings raise a number of questions and have several implications for the understanding of what constitutes decision-useful information. Because of the focus on understanding the quality of reported income, interviewees were interested in disaggregated information relating to earnings, both for segments and regions. A striking observation is that interviewees seemed less concerned with presentation issues than with whether or not the information was disclosed (transparency). In relation to expenses, however, some concerns were raised about a perceived lack of comparability of classifications, which was seen to reduce the comparability and hence usefulness of this information.

The interviews also indicated a strong focus on operating income. Items below operating income, including OCI, appeared to receive considerable less attention. This could be taken to suggest that such information is less relevant. Our interviewees explained that these items were perceived to be hard to forecast. Forecastability might thus be a qualitative characteristic of usefulness.

A further dimension of understanding the quality of income related to cash conversion. This would explain why most interviewees told us that they looked at the actual statement of cash flows, focusing e.g. on changes in working capital. Another common focus area in the cash flow statement was depreciations/amortizations. These findings indicate that experienced users find information that is available in an indirect cash flow statement to be useful. No interviewee indicated that they would have preferred a direct statement of cash flow.

With the exception of changes in working capital – which were considered through the statement of cash flows – the interviewees expressed less interest in reported assets, liabilities and equity (i.e. the statement of financial position). One suggested reason for this is that such items had not been identified as key drivers in the interviewees’ company theses. Nevertheless, both equity and credit side interviewees expressed an interest in keeping an eye on the reporting entities’ net debt. Interviewees indicated that they found disclosure of net debt to be useful and indicated that a more standardized metric could be useful.
7. Conclusions and implications

In this section we summarize our findings and draw conclusions based on these results. One purpose in doing so is to stimulate debate about the possible implications of this study. We acknowledge that further studies and broader considerations which are outside the scope of the present study must also inform the on-going discussions and future actions of preparers, standard setters and other actors.

We begin with a discussion of our conclusions in relation to the debate on the problem of financial reporting practices: Is it a problem of information overload or information inadequacy? We then focus on what our findings suggest about what is perceived as decision useful financial reporting. In a third section we focus on our conclusions with regard to the use of interim and annual reports. Finally, we close this section and the report with a brief comment with regard to the debate on the decision usefulness versus stewardship objectives of financial reporting.

First, however, a few words on the generalizability of our findings. The present study includes 40 in-depth interviews with experienced capital market actors. Of course, these individuals constitute a very small proportion of all capital market actors. Nevertheless, the similarities in views and work methods articulated by this fairly diverse group (see Section 3) provide grounds for some tentative conclusions about the actual use of financial reports by capital market actors. It must be emphasized, however, that all interviewees were both experienced professional capital market actors and individuals familiar with the reporting entities. Thus their views and behavior may differ from those of professional capital market actors reading financial reports from a specific reporting entity for the first time, and from the views and behavior of non-professional capital market actors.

7.1 Information overload and information inadequacy

This report takes its point of departure in the observation that perceptions of a significant financial reporting problem have triggered a number of initiatives to reform financial statement presentation and disclosure requirements. However, there are different understandings of what exactly it is that is problematic with present financial reporting practices. Somewhat paradoxically, some argue that present presentation and disclosure practices give rise to information overload, while others argue that the problem is one of information inadequacy. As there is a paucity of empirically-based research about the situated process of information use by capital market actors, we set out to talk to experienced users about their actual use of specific financial reports for identified reporting entities. In summary, these interviews supported neither the thesis of information overload nor that of information inadequacy.

Our interviews suggested that the interviewees did not perceive that the information provided to them was excessive and unnecessary. The general impression was instead that, in their view, “(t)here’s never too much information” (Sell-side Equity Analyst).
There are several possible explanations for why the professional capital market actors we interviewed did not experience information overload. First, all interviewees were familiar with the reporting entity. More specifically, their process of information search and use was directed by an established company thesis as well as specific line-item forecasts, based on which they could delimit and interpret the financial reporting information. Second, their information search and use was also driven by a widespread perception, especially among equity actors, that a core task was to identify and understand information not yet reflected in the present share price. Any additional information was thus perceived as a potential resource in accomplishing this task.

The interviewees did not indicate that they were constrained by information inadequacy either, at least not on a general level. In fact, they expressed a general satisfaction with the financial reporting practices of the six companies whose financial reports were used in the study. Some interviewees told us, however, that there were large variations in the information provided by listed entities and that their responses would have been different if they had been asked about the financial reports of other, often named, entities. Furthermore, almost all interviewees provided at least one suggestion for how the financial reporting practices of the case company could be changed in order to facilitate their work. However, several interviewees also explicitly and without prompting reflected that it would perhaps not be appropriate to either require or voluntarily disclose the information they desired, because of potentially adverse consequences on competitiveness.

A first high-level implication of these findings is that a better understanding of how capital market actors actually use information in financial reports is unlikely to be a panacea for those seeking to limit the scope of disclosure requirements.

A second high-level implication would seem to be that a pertinent current financial reporting problem, from a user perspective, is large variations in the quality of financial reporting disclosure practices. Finding ways to address this problem by inducing ‘low-achievers’ to improve financial reporting within the scope of existing regulation is a very different matter than developing more sophisticated financial reporting. Arguably, the former concern may be more of an enforcement issue, rather than a matter for standard setters.

Our findings concerning how actual users use information in financial reports also throw some light on the apparent contradiction between ballooning reporting requirements and practices, and the common observation that many capital market actors appear to base their decisions on cursory glances at a select few metrics in these reports. Our findings suggest that extensive preparations precede such rapid responses (i.e. the formation of a company thesis as well as explicit line-item forecasts) and that rapid evaluations are followed by subsequent waves of analysis.

Finally, our study indicates that while all capital market actors operate under some form of time pressure, the degree of perceived time pressure seems to differ between actor groups. In particular, our interviews suggested two major groups of actors. The first group consisted of a combination of buy-side actors who had the intention and opportunity to act quickly on new information and sell-side analysts. The second group consisted of buy-side actors who did not respond rapidly to new information due to organizational business model and/or portfolio strategy reasons. While it is beyond the scope of this report, we speculate that such reasons could be one explanation for recurrent empirical observations of post-earnings announcement drift.
7.2 Decision useful financial reporting information

On an overall level, the interviewees seemed to perceive financial reporting information as useful if it confirmed or rejected their company theses. One over-arching conclusion would thus be that the perception of decision usefulness depends on firm-, time- and user-specific circumstances. As a result, changed circumstances can at any time shift what is perceived to be useful information.

In the terminology of the present IASB Conceptual Framework, this conclusion can be phrased in terms of relevant information being entity-, but also user-specific. Nevertheless, one might argue that an awareness of capital markets actors’ theses and forecasts may provide guidance in the determination of which information “is capable of making a difference in the decisions made by users” (definition of relevance in the Conceptual Framework for Financial Reporting, QC 6).

In addition, our findings also support five further conclusions about what constitutes decision useful information:

1. Information about past performance is decision useful
2. Information about past cash conversion patterns is decision useful
3. Information that explains the variability of outcomes is decision useful
4. Forecastability is an enhancing characteristic of decision useful information
5. Disclosure is more important than presentation

Information about past performance and cash conversion is decision useful

Although users’ company theses may differ both between users and over time, the interviewees were primarily concerned with understanding the ‘quality’ of reported income by differentiating between growth in different segments and regions and by considering the impact of different factors on this growth. In addition, users also looked at cash conversion (see Section 6 for further detail).

Our interpretation of these findings is that information about past financial performance and past cash conversion patterns, rather than existing resources and claims on those resources, are used as a primary basis for making predictions of the amount, timing and risk of future net cash inflows.

This is consistent with previous research (see e.g. Cascino et al. 2013, pp. 25–26). It is also consistent with how forecasting of future cash flows is normally taught, i.e. by projecting future financial statements (e.g. Koller et al. 2010). In this context, information about key drivers for performance as well as cash conversion patterns (e.g. the impact of working capital changes and investment activities) are important. It is also in this context that information about resources and claims on those resources becomes relevant.

The suggestion that a general primacy is attributed to the statements of profit and loss and cash flows is not trivial. At present the IASB’s Conceptual Framework states that users “need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources” (OB 4).

---

24 Financial reporting information is here used in a narrow sense. Management commentary, including outlook statements, is not included.
Cash flows are not mentioned.\textsuperscript{25} While the present formulation could be taken to imply primacy to the statement of financial position, the discussion paper on possible changes to the Conceptual Framework published by the IASB in July 2013 suggests that no financial statement should have primacy over other statements (IASB’s DP/2013/1, paragraph 7.31).

The suggestion that information in the indirect cash flow statement is found to be decision useful may also be significant, both in terms the IASB’s agenda and on a standard level. On an entity-specific level, the understanding that capital market actors use the cash flow statements and in what manner, may provide incentives for (re-)considering the emphasis and granularity of these statements, particularly as regards the information on changes in working capital.

\textbf{Information that explains the variability of outcomes is decision useful}

The described practice of making detailed forecasts for key metrics (Section 4.2) highlights the importance of information that explains the variability of these figures in terms of the impact of different components, as well as the impact of various factors (Section 6). For example, linked to the general primacy of understanding past performance, we found that interviewees expressed a strong desire for disaggregated information about performance for segments and geographical regions, as well as for ‘bridges’ that explain the impact of factors such as currency rates and acquisitions/divestments. Such information is perceived to contribute both to the accuracy of forecasts and to users’ understanding of why reported outcomes deviate from forecasts (which is then perceived to inform future forecasts). We heard many of the interviewed users explain how they sought to understand the persistence of any changes, i.e. the implications for future forecasts. Users also tended to base their forecasting models on organic growth expectations per segment and/or region, with effects of currency rates and structure added separately. This practice arguably drives the widespread desire for disaggregated information and for ‘bridges’ explaining variations in reported outcomes over time. While these findings have potential implications for a future framework or standard for disclosures, they could also be taken as indication of the value of voluntary disclosures.

\textbf{Forecastability is an enhancing characteristic of decision useful information}

We understand the observed lack of interest in items lower down in the statement of profit or loss (Section 6.1) and in the statement of other comprehensive income (Section 6.2) in terms of these items being perceived as too difficult to forecast. One interpretation of this might be that the users in this study lacked information which adequately explained the variability of these items. Another interpretation is that the forecastability of different items varies.

The latter interpretation suggests, in turn, that forecastability may be an enhancing characteristic of decision useful financial reporting information. Although further work and thought is obviously required, this suggestion might have implications for measurement issues. More specifically we note that fair value measurement potential increases variability and decreases forecastability of reported income.

\textsuperscript{25} That information about cash flows during a period is also useful is articulated later on (see IASB Conceptual Framework, OB 20).
Disclosure is more important than presentation

Our finding that the interviewees primarily search and use financial reporting information to compare outcomes to company specific forecasts, to derive a deeper understanding of why reported outcomes deviate from such forecast and to make new forecasts, suggest that transparency is a key concern. While this confirms the primacy of relevance over comparability in the IASB’s Conceptual Framework, it also suggests that disclosure issues are more important than presentation issues (and that transparency is more important than standardization). We note, for example, that users told us that they would tend to look either in the (unregulated) management commentary or the notes to the financial statements once they had identified the outcome for their particular key metrics. Information from line items in the financial statements was typically only reviewed in the process of updating spreadsheets. These spreadsheets were, in turn, based on and adapted to the format used by the specific entity.

For standard setters like the IASB, these findings suggest that matters of disclosure could generally take precedence over presentation issues such as the format of the primary financial statements and the order of notes to the financial statements. The prior observation that users seem to find information in an indirect cash flow statement as useful, however, nuances this overarching conclusion. Furthermore, we also note that this conclusion may be contingent on the interviewees’ perception of an existing sufficient level of comparability having been achieved. As previously noted, interviewees did not perceive this to be a universal characteristic of current financial reporting practices. For example, some interviewees indicated that a lack of standardization made an analysis of cost structures less meaningful and some also suggested that it might be desirable to develop a standardized metric for net debt. The preceding conclusion may also be driven by the fact that all interviewees were established users of financial reports from the specific reporting entities. In other words, they had an established company thesis and had pre-formulated expectations about the entities’ future developments.

7.3 Timing of financial reporting: interim and annual reports

In contrast to previous research, which tends to rank annual reports higher than interim reports, most of our interviewees focused on the use of interim reports. We believe that the findings described in Section 5 contribute to previous research by indicating that interim and annual reports play different roles for different users.

As already noted, a key characteristic of the interviewees was that they were all familiar with the reporting entities. An important reason for focusing on the interim reports was that they were perceived to provide timely updates of the entity’s recent performance. This provided cues as to whether the company was ‘on track’ with previously formed expectations. It is relevant to note that interviewees were interested in interim reports, irrespective of whether or not there was an intention or an ability to act on new information. Annual reports, meanwhile, were typically used to source information not available on an interim basis, or as a general update and source of pertinent information in response to other, ad hoc, events.

The primacy of the interim reports for the interviewed users comes with two modifications. First, the interviewees generally emphasized that the interim reports of the case companies were of high quality. This suggests that the better the interims, the less
important the annual reports. Second, the interviewees also emphasized the important role of the annual reports when first getting to know the company and developing a company thesis. Furthermore, as already noted, annual reports were identified as the key source of information in the light of other events triggering search for information/a potential revision of a company thesis.

These findings raise several important policy issues. A first issue concerns the requirement for interim reporting. In the current public debate, particularly in Sweden, various parties have argued in favor of de-emphasizing or even removing interim reporting. One purpose with taking such measures has been to increase public listings by decreasing the resources required for financial reporting. A further purpose has been to address concerns of short-termism. Our finding that interviewees valued interim reports – irrespective of their intention to act immediately on this new information or not – nuances this view.

Second, despite their importance, interims have received fairly little attention by standard setters like the IASB. In this context we think it important to highlight that the interviewees seemed to perceive frequent updating more useful for some items than for others, i.e. that the quality of ‘timeliness’ is different for different types of items. We also note that most interviewees told us that they primarily focused their attention on the first page(s) of the interim reports (the summary and management commentary).

Third, the different functions of interim and annual reports for different user groups have, to our knowledge, not been emphasized in the extant literature. For new users (i.e. potential new capital providers or new intermediaries), the annual report was seen to contribute to building a company thesis. For established users (i.e. existing or past capital providers and established intermediaries), the annual report was primarily characterized as a reference book, a comprehensive set of information that was available if and when needed. These findings suggest that while the contents of an annual report might not appear to be immediately useful, the ‘useful life’ of this financial report can extend far into the future.

7.4 Decision-usefulness vs stewardship

A recent revision of the objective section of IASB’s Conceptual Framework (2006–2010) triggered a fierce debate about the relationship between the decision usefulness and stewardship (or accountability or contracting) objectives of financial reporting. To a large extent this discussion seems to hinge on whether or not the two objectives are contradictory, supporting different accounting solutions.

While our interviews provide some insight into the role of users’ perception of management for investment decisions, they do not address stewardship decisions. However, in the context of this debate, it is interesting to highlight the conclusion that capital market actors desire information explaining (the variability of) past performance (including e.g. the impact of various factors) when making capital allocation decisions. This is contrary to the widespread assumption that investment decisions require future oriented information/information on future cash flows, while stewardship decisions require information on past transactions and events (e.g. Cascino et al. 2013, p. 19).
8. References


Appendix 1: Interview guide

This interview guide was used to interview both equity and credit sell-side analysts, buy-side analysts and investors. The wording of starred questions (*) were adapted, depending on role of the specific interviewee.

1. Work setting
   - How long have you served in your current role?
   - Briefly, could you describe your role?
     - Number of companies analyzed/in portfolio?
     - What is the intended output of your work?
   - Do you work with a group of colleagues with similar roles?
     - How many?
     - Do other individuals follow the same companies/manage the same portfolio?
   - Briefly, could you characterize the strategy/profile of your company/portfolio?
     - For example sector or geographic specialization, analytical approach and so on

2. Your use of financial information - all questions posed in relation to identified company.

2.1 Use of interim reports
The most recent interim report was released [insert date]
   - Where were you located when the report was released?
   - What did you do just prior to the report release?
   - What did you do first once the report was released?
     - What information did you look for?
     - Where is it found in the report?
     - What did you do with this information?
   - What did you do second once the report was released?
     - What information did you look for?
     - Where is it found in the report?
     - What did you do with this information?

Iteration of question until no additional activities undertaken.

   - Was there anything of particular interest that you anticipated in advance of this report? What, if anything, did you do differently because of this interest?
   - Was there anything of particular interest that you identified in this report? What, if anything, did you do differently because of this interest?
   - Do you use all interim reports from [insert company] here?
   - Do you use interim reports from [insert company] the same as other companies you follow?
• Are there any special characteristics of [insert company’s] financial reporting information content or structure that influences your work? Please describe.
• What, if anything, would facilitate your use of [insert company’s] interim reports?

2.2 Use of annual report
• How would you characterize your use of the annual report, as compared to the interim report? Please describe
  – How would you characterize your use of the primary financial statements?
  – How would you characterize your use of the notes?
  – How would you characterize your use of the qualitative information preceding the financial information?

The most recent annual report was released [insert date]
• Where were you located when the report was released?
• What did you do just prior to the report release?
• What did you do first once the report was released?
  – What information did you look for? Where is it found in the report? What did you do with this information?
• What did you do second once the report was released?
  – What information did you look for? Where is it found in the report? What did you do with this information?

Iteration of question until no additional activities undertaken.
• Was there anything of particular interest that you anticipated in advance of this report? What, if anything, did you do differently because of this interest?
• Was there anything of particular interest that you identified in this report? What, if anything, did you do differently because of this interest?
• Do you use all annual reports from [Company] in the same manner?
• Do you use an annual report from [Company] in the same manner as annual reports from other companies you follow?
• Are there any special characteristics of [Company’s] annual report’s content or structure that influences your work? Please describe.
• What, if anything, would facilitate your use of [Company’s] annual report?

3. Conclusion
• In your opinion, is your use of financial information from [Company] similar or different from other individuals in similar roles at other organizations?
• Is there anything else regarding [Company’s] reporting of financial information that you would like to add?
• Is there anything else regarding the standards for reporting of financial information that you would like to add?
• May we contact you via email for approval of use of any direct quotes?
• Would you like to receive a copy of our final report?
Decision usefulness explored

An investigation of capital market actors’ use of financial reports