PERCEPTIONS OF PERFORMANCE: THE REACTIONS OF ANALYSTS AND INSTITUTIONAL INVESTORS TO FRS 3

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ABSTRACT

This paper explores the reactions of analysts and institutional investors to FRS 3 Reporting Financial Performance. Such reactions are elicited through an analysis of submissions to the Accounting Standards Board concerning FRED 1 (on which FRS 3 is based), a review of reactions to FRS 3 in the financial media and by way of a series of interviews with analysts and institutional investors. Those interviewed were generally supportive of FRS 3. The research finds little support among those interviewed for the arguments made by user groups and others during the development of FRS 3. Based on the discussions with analysts and institutional investors, and other research in the area, the paper argues that, although EPS is an important component of the language of such users, it is not the only word in their vocabulary.

INTRODUCTION

This paper explores the reaction of institutional investors and analysts to FRS 3 *Reporting Financial Performance* (ASB, 1992). The paper commences by describing the main requirements of FRS 3 and FRED 1, *The Structure of Financial Statements – Reporting Financial Performance* (ASB, 1991), which formed the basis of FRS 3. The

ASB's objectives as set out in FRS 3 and elsewhere are also discussed. The research approach adopted is then outlined. Submissions regarding FRED 1 and the published reactions of analysts and institutional investors to FRS 3 are analysed. The results of a series of interviews with institutional investors and analysts on the subject of FRS 3 in the light of some of the assertions made in the submissions to FRED 1 concerning investor behaviour are presented and explored. The paper concludes with a discussion of the main findings of the research. These findings are considered in the light of the objectives of the standard and the reactions to its main requirements during its development.

FRS 3 – REPORTING FINANCIAL PERFORMANCE

The development of FRS 3

FRS 3 was issued in October 1992. The standard was preceded by a discussion draft, *The Structure of Financial Statements: Reporting Financial Performance* and FRED 1 *Reporting Financial Performance* (ASB, 1991). Three hundred and forty potentially interested parties were circulated with the discussion draft. Among them were the Hundred Group, the Confederation of British Industry (CBI), analysts and accountancy firms (Irvine, 1991). The consultation period was four weeks. Seventy-five responses were received. Because of the limited response to the discussion draft and the limited period allowed for response, this paper does not propose to review responses to the discussion draft. Furthermore, the ASB noted in FRS 3 (ASB, 1992, p. 51) that the support received at the discussion stage led to few changes between the discussion draft and FRED 1. FRED 1 was issued in December 1991. Comments were invited by March 1992. These comments are examined in this paper.

The requirements of FRS 3

FRS 3 introduced a number of changes to the manner in which the performance of reporting entities is portrayed in financial statements. The format of the profit and loss account should be layered 'to highlight a number of important components of financial performance' (ASB, 1992, p. 3). These components include: the results of continuing operations (including the results of acquisitions); the results of discontinued operations; profits or losses on the sale or termination of an operation; costs of a fundamental reorganisation or restructuring; profits or losses on the disposal of fixed assets; and, extraordinary items.

FRS 3 also introduced a new primary statement, the Statement of Total Recognised Gains and Losses (STRGL). The ASB comments that the STRGL 'enables users to consider all recognised gains and losses of a reporting entity in assessing its overall performance' (ASB, 1992, p. 5). A number of additional disclosures were introduced. These include the note of historical cost profits and losses, and the reconciliation of movements in shareholders' funds.

FRS 3 amends SSAP 3 *Earnings per share* (ASC, 1974) and replaces SSAP 6 *Extraordinary Items and Prior Year Adjustments* (ASC, 1986). The earnings figure used in the calculation of EPS under FRS 3 is the profit attributable to equity shareholders of the reporting entity, after minority interest, extraordinary items, preference dividends and other appropriations in respect of preference shares. This differs from the EPS defined by paragraph 10 of SSAP 3, where EPS was calculated before extraordinary items. Other EPS figures may be disclosed where appropriate. The standard's definition of extraordinary items requires that they possess 'a high degree of abnormality' and that they arise from events or transactions falling outside the ordinary activities of the reporting entity and which are not expected to recur. The instance of extraordinary items is expected to be rare mainly because of a narrow definition of ordinary activities (ASB, 1992, p. 8).

The standard differs from FRED 1 (ASB, 1991) in a number of respects. FRED 1 proposed that expenditure incurred for the benefit of future periods (revenue investments) should be disclosed. This proposal did not become part of FRS 3, however, as it 'failed to attract support' (ASB, 1992, p. 54). Other changes included an extension in FRS 3 of the number of exceptional items required to be disclosed on the face of the profit and loss account, and the introduction of the reconciliation of movements in shareholders' funds.

The objectives of FRS 3

The ASB's objective in issuing FRS 3 was to assist users 'in understanding the performance achieved by an entity in a period, and to assist them in forming a basis for their assessment of future results and cash flows' (ASB, 1992, p. 7). The first element of this objective reflects the hope that users will avoid 'a blinkered focus on single performance indicators' (Barker, 1993, p. 14). The ASB comments in FRS 3 (p. 51) that 'certain totals in the profit and loss account, such as profit before tax and earnings per share, have been used too simplistically' and that 'the performance of a complex organisation cannot be summarised in a single number'. By requiring a layered format to the profit and loss account and certain additional disclosures, the standard requires that reporting entities highlight various important components of financial performance and that variations in reported EPS will 'demand more explanation' (ASB, 1992, p. 52). This objective seems to extend the objective of accounting standards beyond that of standardising accounting practice and of contributing to financial statements which will give a true and fair view of a reporting entity's performance. It appears to regard accounting standards as instruments of change, changing the focus of the users of financial statements. Whether this kind of objective is appropriate in general is beyond the scope of this paper. The need for it in the context of reporting performance will, however, be assessed.

The second element of the ASB's objective aims to provide information concerning future performance. This is consistent with the ASB's comment in its exposure draft of the Statement of Principles that accounting information should have predictive value. Predictive value is enhanced, it is argued (ASB, 1995, p. 103), by distinguishing between gains that will continue into the future (for example, from continuing operations) and those which will not (for example, from discontinued operations).

THE RESEARCH APPROACH

Data were collected from three sources:

- By analysing responses to FRED 1 received by the ASB
- By reviewing published reaction to FRS 3 in the accounting media and elsewhere
- By interviewing analysts and institutional investors.

This replicates the approach of Weetman, Collins and Davie (1994). Interviews took place in July 1995. Several follow-up interviews were conducted in January 1996. FRS 3 was effective in respect of financial statements relating to accounting periods ending on or after 22 June 1993. This particular time was therefore seen as opportune to obtain initial reactions to a new standard which was effective for at least one reporting period.

Seven analysts and five fund managers drawn from eight different financial institutions participated in the research. This compares with 20 participants, 11 fund managers and nine analysts, in Weetman et al. (1994 and 1996) and 15 in Day (1986). Of the analysts, three were in-house analysts of an institutional investor. The remaining four were brokers' analysts.

The participants included five qualified accountants and four members of the Institute of Investment Management and Research (IIMR). Three had post-graduate qualifications in the area of investment and treasury. All were directly involved in equity analysis or the management of funds which included equities.

Approximately half of those interviewed were senior analysts or fund managers in their organisations. The other half specialised in particular industry or client sectors. All had more than three years experience, with the exception of two who had joined their organisations approximately a year previously. One of the latter is a qualified chartered accountant, the other a business graduate who specialised in accounting. Therefore, all the participants worked in the area of analysis, fund management or accounting for a time before and after the introduction of FRS 3.

Structured interviews were used in this research. The same questions were asked of each interviewee in the same order. They were first asked their position within the firm and their experience in the analysis of financial statements. They were then invited to outline their approach in forming a perception of the performance of a reporting entity. The contribution of FRS 3 to this approach was then discussed. Finally, specific questions were asked concerning the main changes in financial statements introduced by FRS 3. In this way, the questions moved from the general to the particular and allowed for unprompted reaction to FRS 3 followed by reaction to its specific requirements. The average length of the interviews was 25 minutes. Interviews were tape-recorded and subsequently transcribed for analysis.

Limitations of the research approach

The research approach has a number of limitations. Qualitative research is subjective and does not lend itself to statistical analysis or extrapolations to larger populations (Chisnall, 1986, p. 146). Those interviewed were not picked at random but were selected on the basis of personal contacts and on their willingness to participate. Those who responded to the ASB on FRED 1 and, subsequently, FRS 3 are self-selected. Furthermore, it is not clear whether the qualifications of those interviewed are representative of the investment community as a whole. For these reasons, the views expressed are not representative of all analysts and institutional investors. Furthermore, statistical analysis of the interviews was not carried out because, as a result of these limitations, such analysis lacks meaning and may be misleading.

The potential also exists in the case of the interviews for interviewer bias. Interviewer bias is most likely to occur during informal conversational interviews, when questions are not predetermined, and least likely, according to Day (1986), when protocol analysis is used. According to McCracken (1988, p. 22) 'every qualitative interview is, potentially, a Pandora's box. Every qualitative researcher is, potentially, the hapless victim of a shapeless inquiry'. He continues to say, however, that this may be avoided by adopting structured interview techniques (as were used in this research).

REACTIONS TO FRS 3

Responses to FRED 1 – Comments submitted to the ASB

Responses to FRED 1 were received from 101 organisations and individuals, two of whom did not wish to comment as they felt the proposals were not relevant to their organisations. Of the comments received only five came from analysts, institutional investors or their representative organisations. This research seeks to redress the absence of responses to FRS 3 from this sector by seeking out the views of analysts and institutional investors.

Reactions to FRED 1 by parties other than analysts and institutional investors will also be briefly discussed. These reactions are of interest in the context of this paper as several assertions were made regarding the effect of the application of FRED 1's proposals on users, including analysts and institutional investors. As well as discussing the reactions of analysts and institutional investors to FRS 3, a by-product of this research is to assess the assertions made concerning users during the development of the standard.

Table 1 classifies the responses to FRED 1. Each submission was independently read and categorised by the researchers and each classification of the submissions was confirmed and cross-checked independently. Submissions were classified by applying a judgment of the overall opinion on a scale of 1 to 5. Representative organisations include representatives of reporting entities (for example, the Confederation of British Industry) and accountancy bodies. Representatives of analysts and institutional investors are included among analysts and institutional investors. This process of classification is similar to that pursued by Weetman et al. (1994 and 1996) and Tutticci, Dunstan and Holmes (1994).

A chi-square test (as performed by Tutticci et al. (1994) and Weetman et al. (1996) and assuming all underlying populations are equal) confirmed a significant difference between the origins of response at a 99% level of confidence with nearly half the responses emanating from finance directors. This is consistent with the findings of, for example, Coombes and Stokes (1985), Morris (1986) and Tutticci et al. (1994). No significant difference (Kruskal-Wallis One-Way ANOVA) was found between the opinions of the different categories of respondent with the proposals of the FRED (with a few exceptions discussed below). These statistical findings should, however, be treated with caution given the relatively limited responses, the potential for response bias and the assumptions underlying such findings.

Table 1: Opinions of respondents categorised

	Categories (see below) 1	2	3	4	5	6	TOTAL
Finance directors	5	24	10	8	1	–	48
Representative organisations	5	8	5	2	–	–	20
Accountancy firms	3	6	9	–	–	–	18
Mixed views	2	2	1	–	–	1	6
Affiliation not clear	–	1	–	–	–	1	2
	15	41	25	10	1	2	94
Analysts and institutional investors	1	2	2	–	–	–	5
Total	**16**	**43**	**27**	**10**	**1**	**2**	**99***

* 101 less two that had no comments

Categories:

1 Support for proposals with minor comments
2 General support but with concerns over particular areas
3 General support but with substantial reservations
4 Severe reservations with principles
5 Objections to proposals
6 No comments on content but disappointed with style of FRED

Reactions to FRED 1 by parties other than analysts and institutional investors

Of the 94 substantive comments received from parties other than analysts and institutional investors, 81 supported the main proposals. Sixty-six of these, while supporting the general direction of the FRED, expressed concern over particular areas or had substantial reservations regarding the proposals. Only 11, primarily from finance directors of UK public companies, severely criticised the proposals of FRED 1.

Most comment appealed to logic. Arguments were based on the view that the standard would lead to misleading, meaningless or confusing information. Criticism focused on the increased complexity of the annual accounts, apparently in the belief that users would be confused and misled. Many of these comments related to how users might react to financial statements resulting from FRS 3. These hypothetical user reactions then became a vehicle of criticism. Economic consequences were discussed mainly in the context of the disclosure of revenue investment.

Sixty-four of the respondents were concerned that financial statements were becoming too complex or confusing. Of these, 24 felt that a P&L analysed between discontinued, continuing and acquired operations would be too complex. Ten were concerned about the number of primary statements (where some seemed to view the note of historical cost profits and losses as a primary statement).

A further 11 believed that users would be confused rather than enlightened by the disclosure of more than one EPS figure. The severest criticism came from the finance director of Dawson International Plc commenting that 'the acceptance by [the] ASB that a company's results cannot be encapsulated in a single number, such as earnings per share, is in my view an admission of defeat'. He was also concerned that the resulting financial statements 'will not be interpretable by anyone other than a specialist in accounting matters'. The fear was also expressed by 10 of the respondents that attention might shift to profit before exceptional items and/or discontinued operations. Thus the focus on single performance indicators would resurface in another form. The ASB responded to this potential problem in FRS 3 by narrowing the definition of discontinued operations and amending the requirement regarding exceptional items.

Thirteen of the respondents expressed the view that the revenue investment proposals would be of little value to users. Others commented on the subjectivity and potentially detrimental economic consequences of such disclosures. Analysts and institutional investors did not criticise the revenue investment disclosure. In fact, the ASB commented (ASB, 1992, p. 54) that the proposal that revenue investment should be disclosed received support from users at the discussion draft stage. The disclosure did not survive in FRS 3 but the ASB indicated that it should be discussed in the Operating and Financial Review.

Reactions from analysts and institutional investors

Of 99 comments received by the ASB on FRED 1, only five came from the investment community. Among those were the Institutional Fund Managers' Association (IFMA), the Society of Investment Analysts (SIA, now IIMR) and David Damant (chairman of the IIMR's EPS sub-committee, who responded on behalf of Map Securities). The other responses were from individual investors who expressed a personal view of the FRED.

The IFMA was supportive of FRED 1 and welcomed the ASB's efforts to curb the abuses that were associated with financial reporting. In a short letter, IFMA expressed concern about the increased complexity of the P&L and the potential for discontinued operations to be abused in the same way that extraordinary items were in the past.

The SIA expressed its general support for the ASB's proposals. It suggested that as the FRS 3 EPS figure was 'all-inclusive' it should be renamed 'net income per share'. It recommended that additional information be disclosed (including details of disposals and acquisitions) so that maintainable earnings could be calculated. The SIA expressed confidence that analysts would not focus solely on the FRS 3 EPS figure but would look at all the data provided, including that contained in the notes.

Damant's (1993) comments were very much in line with the SIA's. He reiterated that the EPS figure required by FRS 3 should be called net income per share. He noted that if the word 'earnings' was dropped 'the analytical element in the whole debate would be sharply reduced if not removed altogether and the inclusion of all items, including all extraordinary items, would no longer be a fault – indeed it would be necessary'.

Published reaction to FRS 3

Although analysts did not react in great numbers to FRED 1, there was significant reaction to FRS 3. Most of the comments were directed at the increased volatility of the new EPS figure. Two investment houses, James Capel and Hoare Govett, issued reports criticising the changes introduced by FRS 3. James Capel (in Irvine, 1993a) warned that without a stable earnings figure there would be a lack of comparability and consistency because different entities would use different measures of performance.

The report issued by Hoare Govett, subtitled *Tweedie: Descent into Chaos,* was more critical:

> Before Tweedie earnings could be discussed and compared using a common tongue; after Tweedie . . . we have an earnings Babel with the accounting authorities, companies, broking firms and institutions all advancing varying interpretations of earnings (Ireland, Rae, Workman and Brezeskwinski, 1993, p. 1).

While admitting that the ASB had greatly improved disclosures in financial statements, they continued 'Tweedie has successfully, and usefully, attacked a cancer in the P&L, but has damagingly killed off the P&L in the process' (Ireland et al., 1993, p. 2). They also felt that allowing the publication of additional EPS figures would be a 'recipe for chaos' leading to a 'free-for-all, where there are so many legitimised definitions of earnings, that anomalies become less visible' (p. 6). Despite Tweedie's best efforts, they concluded, investors would still look at EPS, and for this purpose the FRS 3 figure was worse than the old figure. They suggested that cash flow and dividend paying ability would become more important when comparing companies after the application of FRS 3.

Tweedie's suggested approach to the measurement of performance was for analysts to take a 'pencil out and recalculate . . . there is actually more information now, as well as everything there was before – so what's the problem?' (Irvine, 1993a, p. 9). Adrian Fitzgerald of NatWest Securities agreed; he believed that analysts had been given a broader range of information as a result of FRS 3 and were presented with 'greatly superior tools with which to ply their trade' (Fitzgerald, 1993, p. 95). He admitted that the FRS 3 EPS figure is volatile and of limited value for assessing performance. He believed that what analysts must do is develop their own measures of performance and argued that 'Professional analysts can only benefit . . . They should look to make effective and maximum use of the opportunities being presented' (p. 95). Contending that what was necessary was an estimate of maintainable earnings, he argued that the additional information provided by

FRS 3 makes this possible. Calculating maintainable earnings, Fitzgerald commented, is nothing new for analysts. This was always necessary if reasonable forecasts were to be formulated.

The IIMR, the successor to the SIA, issued a Statement of Investment Practice No. 1, *The Definition of IIMR Headline Earnings* (IIMR, 1993). The IIMR agreed with the ASB's view that the performance of an entity cannot be encapsulated in one earnings figure. The Institute continued to say, however, that there are advantages to providing a clear earnings figure that would have common usage. Two earnings figures are identified. Each has a different role. One is a figure indicating maintainable earnings to assist the forecasting of future performance, while the other is a headline earnings figure summarising results from trading on a basis that could be used for comparison between entities.

The IIMR suggested that the headline earnings figure should be disclosed along with the FRS EPS. Users need an 'unambiguous reference point' (IIMR, 1993, p. 6). (This view is contradicted by Lev (1974) in its very phraseology. He describes EPS as an 'ambiguous measure of performance' (p. 18).) The FRS 3 earnings number, the IIMR argues, is not 'appropriate' as '"earnings" itself has the aura of its original and indeed its present essence, of reflecting the ongoing capacity of the company to generate wealth from its operations' (IIMR, 1993, p. 8).

A similar argument regarding comparability of trading performance was made by Bradfield (an analyst who was a member of the ASB) in his dissent from FRS 3. He observes that shareholders attach a different importance to each of the components of profit, with profit from trading having most significance in assessing performance. The FRS, he argues, conflicts with the objectives of comparability and understandability as 'users will be left without a single indicator of whether the entity has done well or badly' (ASB, 1992, p. 49).

Tweedie is reported as pleased (in Irvine, 1993b) that the IIMR EPS is very different to the SSAP 6 EPS, pointing out that it is only calculable because of the additional information provided by FRS 3. He adds, 'We've always said that it is up to the user to say what he wants, and now at last we know' (Irvine, 1993b, p. 11). In order that we may know more, particularly in an Irish context, a series of interviews was carried out with analysts and institutional investors. Having considered written reactions to FRS 3, the interview responses of a set of users will be discussed to obtain a broader picture of the perceptions of the information presented as a result of the application of FRS 3.

Interviews with analysts and institutional investors

The responses of the interviewees to a general question concerning FRS 3 focused on the changed definition of EPS, the curtailment of extraordinary items and the distinction between continuing and discontinued operations required on the face of the profit and loss account. In contrast, analysts and analyst organisations in their published reaction to FRS 3 focused almost exclusively on the changed definition of EPS. The discussion that follows will focus on the main changes introduced by FRS 3 (as defined by the ASB in the Standard) but will begin with the changed definition of EPS.

Most of those interviewed did not feel that the changed definition of EPS would affect their approach to the analysis of performance. A frequent comment was that they would "still have to recalculate [their] own . . . you want a feel for the underlying trend". An analyst commented that "nobody really uses the FRS EPS, but adjusted EPS". Little concern was expressed regarding the inconsistency and volatility of EPS. A common theme was that there were different layers of profit. Different levels of importance would be attached to each depending on the context and aims of the shareholder. This reflected Bradfield's comments concerning the differing significance of earnings numbers. In general, the basis on which EPS might be calculated in the financial statements did not seem to concern any of those interviewed.

A minority of those interviewed was aware of the IIMR EPS. They did not view it as informative. One analyst commented that he had not seen it disclosed. There was little consensus with respect to whether more than one earnings number should be made available. One participant observed that "four or five different EPS figures confuses a lot of people". Several others, however, mentioned the existence of two measures of EPS, "the FRS earnings figure and also some kind of underlying earnings".

Only one of the analysts interviewed commented on the usefulness of the STRGL. Others commented that they "rarely look at it" and that it contained "no additional information". Where it was used, the disclosure of foreign exchange differences and revaluations were seen as useful. The STRGL gives "a more transparent view", according to a fund manager. As the research was carried out in a relatively early period of the application of FRS 3, there is potentially a learning effect that would lead to greater understanding (and perhaps use) of the STRGL as time passes.

Most of those interviewed felt that the layered format to the profit and loss account was "more useful" than the pre-FRS 3 format as "it makes things more transparent." The most frequent comment was that the layered format "helps in making forecasts: you know what's not going to be there next year".

The most positive reaction to FRS 3 focused on the distinction between continuing and discontinued activities, which was perceived as enhancing the predictive value of accounting information. None of those interviewed reacted negatively to this change. A fund manager observed that "the truth is you would actually adjust for that [element of profit] to the extent you don't expect it to happen again . . . what type of profit did they make?" A consistent theme of the discussion was that there are different types or layers of profit: "a company is more complex than just one number".

Several mentioned the need to identify organic growth: "organic growth is what gives you EPS" and "if organic growth is a curve going upward [that] is very exciting". Another observed that "a lot of growth from Irish plcs comes from acquisitions" and that the distinction between growth achieved by acquisition and other means is useful in that context. On the other hand, a fund manager noted that while it would be "very difficult . . . to get a measure of consistent earnings without [such a] split, management can give you these figures when you're talking to them".

One response by a participant to the ASB's objective that reporting entities 'highlight a range of important components of financial performance' (ASB, 1993, p. 7) was "what else should we focus on?" Another felt that "EPS will always be important". An analyst agreed that "people tend to become overly focused on EPS but usually these people are the companies themselves rather than the market". The same analyst commented that EPS "probably is the best measure of the performance of most companies".

Others disagreed. A fund manager noted that "there is no one measure that is of total use to anybody" but that FRS 3 had "broken the detail out in a more thorough and disciplined way". An analyst commented that "there are a huge number of factors that go into your decisions as to whether you like the company or not and I would think that, for most analysts, the [P/E] multiple is only one of those factors . . . If you felt that a company was growing, you tolerated a high multiple".

A fund manager thought that "EPS will always be used as a yardstick [as it is] the only one [measure] that really recognises the underlying earnings of a company". He went on to say that "the true test of a business is if it can grow and give you cash at the same time". Commenting that the P/E ratio is a "distorting measure" which can be used "really superficially", one analyst commented that "there is a huge degree of consensus that it is a useful measure." Cash flow per share, however, "is more reliable than EPS". Another mentioned the need to reconcile profits and cash and to assess the ability of profits to generate cash as "if they are not the same over time there is something wrong".

Most other interviewees agreed that cash flow will now become "the most important measure" in the financial statements as FRS 3 had made EPS "less useful". Similarly another analyst commented that "still people want a single measure. That is now more likely to be cash flow per share". This reflects the concern of several respondents to FRED 1 that attention would shift from one performance measure to another, given the application of FRS 3.

Cash flow was mentioned by several other participants as an objective measure of performance; "earnings are still subjective . . . it is very hard to hide anything in cash flow". However, they differed regarding the definition of cash flow that might be used as a measure of performance. Some found "FRS 1 cash flow easy enough to interpret." Another commented that "what I mean by that (cash flow) is the profit after tax and after dividends with depreciation added back and capital expenditure deducted. That indicates the amount of capital the company has to grow for future years". This measure of performance, traditionally termed free cash flow, is described by Williams (1980, p. 15), a former Chairman of the Securities and Exchange Commission, as an 'even more sophisticated – and . . . informative – analytical tool' than EPS.

The participants differed, then, as regards the importance of EPS as a measure of performance. However, those differences do not seem to arise from the requirements of FRS 3 *per se* but from differing approaches to the analysis of performance. On the other hand, the apparent lack of concern regarding the definition of EPS would seem to be contradicted by the view, for example, that EPS "will always be used as a yardstick".

A pervading sense was that:

- There is a market 'out there' which may act differently from the way the participants might act
- "The market is looking years down the road"
- "The market will reward a company that looks to the long-term"
- "The market doesn't look at cash flow"
- "The market still looks at the bottom line".

While FRS 3 was viewed positively by the individuals participating in this research, they were more sceptical about 'the market'.

EXPLORATIONS OF THE CONSTRUCTION OF PERCEPTIONS OF PERFORMANCE

The discussion that follows is concerned with the assumptions of FRS 3 and the assertions of several commentators (Cheney, 1971; Tweedie in Littlejohn, 1992; Barker, 1993; Ó hÓgartaigh, 1994) and respondents to FRED 1 that the focus of analysts and institutional investors is a narrow one. In particular, it discusses whether the information that is used by analysts and institutional investors in constructing their perception of a company's performance is exclusively, or almost exclusively, the EPS number.

The alleged focus on single performance indicators

Earnings growth was identified by seven of the participants as the key measure of performance. However, only one identified EPS growth *alone* in this context. Another commented that steady EPS growth is 'vital'. A number of participants mentioned the importance of the 'quality of earnings', in particular 'sustainable earnings rather than accounting earnings', in assessing the performance of reporting entities. Other factors mentioned by those interviewed as influencing perceptions of performance are cash flows, cash profits, cash flows per share, future intentions, 'strength of the balance sheet', the quality of management, the company's position in its markets and its performance relative to other companies in the same sector. Only one participant assessed the state of the economy, the industry and the position of the company within the industry (as suggested by, for example, Foster, 1986). Of particular importance in that regard, he said, is the position of the company's share price relative to the rest of the industry. Those interviewed expressed the desire for more widespread disclosure of segmental information, market share and margins. These disclosures, it was felt, would assist in the consideration of wider influences on performance.

Several participants commented that an assessment of performance depends on the type of company and the motivation for the investment. Asset backing, for example, was seen as important in assessing financial institutions. Another, who invested for private individuals, mentioned the importance of dividend potential and the attractiveness of equities relative to bonds and other investment opportunities.

There was little evidence in the interview responses to support the assertions that analysts or fund managers focus *exclusively* on single performance indicators. There was an awareness of the subjectivity of profits. There was also a very strong feeling that there were layers of profit of different quality, that profit might mean different things to different people and that different uses might be made of those different layers. These findings suggest that FRS 3 provides information compatible with the existing decision behaviour of the users in question rather than changing it, supporting Tweedie's view (in Littlejohn, 1992) that FRS 3 enables rather than restricts by providing more information to users. The findings do not support the assertions of the IIMR and others that the application of FRS 3 would result in measures of performance that are ambiguous and of limited value.

EPS appears to be part of the language of analysts. Hoare Govett warned that the introduction by FRS 3 of a different EPS number introduced 'an earnings Babel' (Ireland et al., 1993, p. 1). The IIMR (1993, p. 6) expresses the need for an 'unambiguous reference point' for users of financial statements. Frishkoff (1981, p. 42), in a comprehensive review of research in the area, concludes that 'of the performance indicators, EPS has been most preferred'. However, he goes on to say (p. 42) that 'instances of simplistic abuses of EPS by 'the great unwashed' are completely anecdotal'. A 'preferred' performance indicator is not necessarily the only one used. The desire for a definition of earnings which will be commonly understood does not mean that there is only one word in the language of analysts and other users.

Opportunities of the research

Belkaoui, Kahl and Peyrard (1971), Ferris, Hiramatsu and Kimoto (1990) and Capstaff (1991) found cross-national differences in analyst perceptions. The interviews were set in an Irish context. The Irish investment community is small. As one fund manager noted, it is led by respected individuals in certain sectors. In that sense, the Irish market is no different from others (as described by, for example, Foster, 1986, p. 274). Its size, however, might render the leadership by certain individuals more marked. It was observed by those interviewed that the Irish investment market may have particular needs as large Irish companies appear to have different patterns of growth (for example, by acquisitions overseas) than those in other countries. There appears therefore to be an opportunity for research specific to the Irish context. This research might include not only reaction to FRS 3 from a wider community but might set out to describe the 'ecology' and decision processes of the Irish investment community compared with other countries or markets.

While the summer of 1995 was seen as an opportune time to assess initial reactions to FRS 3, users may become accustomed to the effects of FRS 3 over a longer period. The STRGL, in particular, was little used. Its significance, and more subtle aspects of the standard such as the definition of operations, may be 'learnt' over time. This may offer an opportunity for research on learning effects in the context of a standard such as FRS 3.

CONCLUDING COMMENTS

This research set out to explore the reactions of analysts and institutional investors to FRS 3. Those reactions took a variety of forms: submissions regarding FRED 1, reactions to FRS 3 and interviews with selected analysts and fund managers. The nature of the research and its limitations do not form a basis for broad conclusions that can claim to represent the behaviour or reactions of all users.

Through FRS 3, the ASB aims to highlight a number of important components of performance. The concern was expressed by several respondents to FRED 1 that users would simply focus on another performance indicator. There was evidence to support this concern. Some of those interviewed cling to EPS as a measure of performance. Others always focused on cash flow. The attention of others has been drawn anew to cash flows or 'cash flow per share'. This focus did not exclude wider considerations such as economic prospects and competitive position.

Those interviewed were generally positive with regard to FRS 3. The standard was viewed as strengthening in particular the predictive value of financial statements. The introduction of a layered profit and loss account appears to accord with a view that profits have layers of quality. There was little support for the views of some respondents to FRED 1 that FRS 3 would be less user-friendly or that the provision for different performance measures would be confusing. The common view appeared to be, furthermore, that profits are not homogeneous. Evidence was not found to support the view that, as the IIMR argued, 'earnings' has an aura which is commonly shared.

NOTES

[1] The views expressed in this paper are shared by the co-author (a trainee chartered accountant) and not necessarily by Coopers and Lybrand.

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