Accounting and Management Information Systems
Vol. 11, No. 2, pp. 187–190, 2012

COMMENTS ON "THE USE OF ACCOUNTING INFORMATION BY FINANCIAL ANALYSTS IN EMERGENT MARKETS: THE CASE OF ROMANIA"

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Financial analysts use different models and heuristics for reaching an investment decision. They look into which models worked better in the past, analyze the current set of information and try to adjust and extrapolate them in the foreseeable future. All financial models are tools, and the experience, intuition and non-financial information are also paramount ingredients to successful investment process.

When using accounting information for forecasting, investors and financial analysts are concerned with the aspects such as the power of forecasts, the purpose of the financial information and the additional information required to support the investment decision.

According to Davidson (2009), advocates of classical economics believe that free markets are efficient. In a classical efficient market it is presumed that there are large numbers of rational decision makers who, before making a purchase or sales decision, collect and analyze reliable information on both the probability of events that have already occurred and on the probability of events that will occur in the future. In an efficient market, it is assumed that this important information about the past and the future is available to all decision makers.

The assumption that the economy is governed by an ergodic stochastic process means that the future path of the economy is already predetermined and cannot be changed by human action today. Astronomers insist that the future path of the planets around the sun and the moon around the earth has been predetermined since the moment of the Big Bang beginning of the universe. Nothing humans can do can change the predetermined path of these heavenly bodies. This "Big Bang" astronomy theory means that the "hard science" of astronomy relies on the ergodic axiom. Consequently by using past measurements of the speed and direction of heavenly bodies by

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observations, astronomical scientists can accurately predict the time (usually within seconds) of when the next solar eclipse will be observable on the earth.

The economist John Maynard Keynes on the other hand specifically argued that the uncertainty of the economic future cannot be resolved by looking at statistical patterns of the past. Keynes's believed that today's economic decisions regarding spending, saving and investment decisions depend on individuals' subjective degree of belief regarding possible future events.

The classical ergodic axiom which assumes that the future is known and can be calculated as the statistical shadow of the past was one of the most important classical assertions that Keynes rejected. Instead Keynes argued that when crucial economic decisions had to be made, decision makers could not merely assume that the future can be reduced to quantifiable risks calculated from already existing market data.

The economic developments of the past four years strengthened the financial roots of Keynesian economics and made the extrapolation of past performance, especially when analyzed based on accounting information much more difficult. Ionaşcu and Ionaşcu (2012) also conclude that "the Romanian financial analysts rely more on fundamental analysis, trying to anticipate companies' future performance, rather than using trends and extrapolating past results. These results are to be expected, taking into account the low level of development of the local capital market, and the documented inefficiency of technical analysis on emerging markets".

We fully agree with the authors' conclusions, these being supported by our experience with financial analysts' reports that place limited reliability of past results of stocks listed on Romanian stock exchanges. Our consideration is that this is due to factors such as low liquidity of the Romanian capital markets that translate into higher volatility due to one-off larger transactions. For example, the improvements in liquidity in 2011 at the Bucharest Stock Exchange owed almost exclusively to block trading in Property Fund shares that attracted major international institutional investors to Romanian stock exchanges, the listing of such a fund being a one-off event. Also, the relatively limited size of the Romanian capital markets makes it more vulnerable to volatility due to external regional events, such as the Greek sovereign crises.

General purpose financial reports are not designed *to show* the value of a reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors *to estimate* the value of the reporting entity. To a large extent, financial reports are based on estimates, judgments, and models rather than exact depictions. That estimate can be a faithful representation if the reporting entity has applied properly an appropriate process, described properly the estimate, and explained any uncertainties that significantly affect the estimate. However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. If there is no alternative representation that is more faithful, that estimate may provide the best available information. This "best available information" is the one that financial analysts must use, correlate and adapt in order to make their own estimate for value of the companies and price targets for a certain time horizon.

As noted by Ionaşcu and Ionaşcu (2012), "the predictive information provided by IFRS reporting seems to be much more appreciated by more active brokerage companies […], while those following Romanian companies seem to welcome fair value measurements […]. On the other hand, analysts following foreign companies tend to consider the link between accounting and taxation as the major risk". This conclusion is in line with our experience in Romania, as most analysts are interested for their fundamental analysis in the more extensive disclosures that IFRS is requiring companies to provide as compared to the Romanian accounting standards. Financial statements prepared in accordance with Romanian accounting standards are focused mainly on form rather than on substance and favor historical cost information over fair value these being due to the fact that the Romanian accounting records have been perceived as serving primarily as basis for calculation of taxes and distributable profits and responding mainly to the needs of fiscal authorities.

We noticed in practice that the analysts of banks that are familiar with the provisions of Romanian accounting standards and require additional information from companies as part of their review of statutory financial statements in order to reach their investment decisions. We also noticed that the banks' analysts tend to prefer IFRS in their analysis, being considered a more reliable accounting framework and providing for much better disclosures on capital and risk management, including analysis of sensitivity of financial results to market variables such as interest and exchange rates and commodity prices, as well as disclosure of critical judgments applied by management and key sources of estimation uncertainty in preparation of financial statements.

Ionaşcu and Ionaşcu (2012) notice that analysts and investors rank very high the "IFRS requirements for extensive disclosures" (ranked second after "comparability"). This is in line with our experience that investors focus on forward-looking information, while the accounting information is mainly focused on backward looking information. In the KPMG Publication *Better Business Reporting: Enhancing Financial Reporting* there are plenty of examples of how an organization can make better disclosures, for example capital financial risk management disclosures, and additional reporting in order to make business reports and financial information meaningful for investors.

The yearly KPMG International publication *Focus on transparency – trends in the presentation of financial statements and disclosure of information by European banks*, which is analyzing the differences between how the major European banks are reacting to the continuing market conditions, is a very good practice example of the power of comparability of IFRS financial information.

As a concluding remark, we noticed the practice of the financial analysts in Romania to use simpler mathematical models based on accounting records to sustain their investment decisions and the great emphasis is placed on qualitative information due to the characteristics of the Romanian financial reporting system, the characteristics of Romanian society (including contracts enforcement practices) and the complexity of forecasting in nowadays highly uncertain environment. This conclusion is in line with the ones reached by the study of Ionaşcu and Ionaşcu (2012), which adds real value in understanding the methods employed in practice by financial analysts.

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