Stockholm School of Economics
Department of Accounting
Bachelor of Science in Business and Economics
Presented 30th of May 2017

# How do sell-side equity research analysts evaluate items affecting comparability?

*An interview-based study of sell-side equity research analysts' view and approach to items affecting comparability*

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**Abstract**

We investigate sell-side equity research analysts' behaviour in the process of choosing whether to exclude or include items affecting comparability (IAC) in their valuation. We used a qualitative method by interviewing 16 analysts in order to understand how they adjust for IAC and potential factors influencing their approach. In line with previous research, our results show that analysts find IAC to be an ambiguous area involving a subjective decision process in order to reach higher earnings quality. We find that only a quarter of our sample selection makes own adjustments to IAC, where the most influential factor is how frequently the IAC occur. Furthermore, our study confirms previous findings suggesting that adjustments are mainly done on a case-by-case basis where the analyst evaluates each company separately.

**Acknowledgements:** We would sincerely like to thank all of the interviewees who generously took their time to share their experiences and thoughts with us. Further, we would like to show our gratitude to our supervisor Walter Schuster for the useful advice and guidance. Finally, we would like to thank the four members of our mentoring group for their ongoing feedback and valuable insights both during and after our sessions.

**Key words:** Items affecting comparability (IAC), Non-recurring items, Equity research analysts, Earnings quality
**Supervisor:** Walter Schuster
**Course Director:** Stina Skogsvik

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# 1. Introduction

## 1.1 Background

Over the years, numerous studies have been investigating the concept of earnings quality. There is no common definition of earnings quality, however, earnings of high quality can be perceived as earnings that can be more accurately forecasted in the future (Barker and Imam, 2008). One dimension of earnings quality is that earnings that are recurring are considered to be of higher quality. Here, the concept of items affecting comparability, hereafter referred to as IAC, plays an important role. IAC correspond to the adjustments made by companies when they find items to be "non-recurring" or "unusual", thereby relevant to be excluded in order to show core performance (Bhattacharya et al., 2003).

In a study, conducted by Barker and Imam (2008), sell-side equity research analysts, hereafter referred to as analysts, emphasised their focus on understanding core earnings to achieve earnings of high quality. Indeed, one of the most important inputs in analysts forecasting and valuation modelling is earnings, thus analysts' view and process of interpreting earnings quality are central. Orens and Lybaert (2007) express that analysts have been of high interest for researchers due to their work when analysing, interpreting, and dismissing financial information of listed firms to capital markets participants. As a result, analysts decrease the information asymmetry between companies and investors through their work. Interestingly, literature has shown that earnings quality is negatively associated with information asymmetry, implying that information asymmetry impacts the ability to predict recurring earnings (Bhattacharya et al., 2003; Francis et al., 2004; Salerno, 2014).

Previous researchers have identified a literature gap related to the limited insight in analysts' decision processes (Schipper, 1991; Ramnath et al., 2008; Beyer et al., 2010). More specifically, the gap refers to what information analysts use, and how the information is used; a decision process that has been illustrated as a "black box" by Bradshaw (2011). Indeed, Bradshaw suggests that most previous research on the topic has focused on examining correlations between inputs, outputs and conditioning variables to understand the analysis process but has not fully captured the entire decision process. The chosen process to study is the one of how analysts evaluate IAC.

Understanding analysts' decision process should be of particular importance for the practitioners operating in the financial markets. First and foremost, managers of public

companies should be familiar with the information that analysts use and put emphasis on in their valuation process, in order for companies to communicate the appropriate information. Secondly, investors often rely on analysts' reports due to limited capabilities and time, thus investors should be well aware of the reasoning of analysts. Finally, regulators are keen to understand the flow of information that enables a functional and liquid market, and analysts have an important role in this flow of information (Bradshaw, 2011).

### 1.2 Purpose and research question

The purpose of this thesis is to investigate the process undertaken by analysts to reach the decision of including or excluding IAC in their valuation. With respect to this, the research question reads as the following:

> *How do sell-side equity research analysts evaluate items affecting comparability?*

As our thesis aims at giving a broad understanding of how analysts view IAC it will also include thoughts given by interviewees on important aspects that they take into consideration with regards to IAC. More specifically, this includes analysts' general opinion on how companies report IAC as well as the sources they use to extract information about IAC.

### 1.3 Contribution

Three main contributions with our study have been identified. Firstly, we seek, through an interview-based study with sell-side equity research analysts, to contribute to a behavioural oriented understanding of how users of accounting information interpret IAC. Secondly, our findings are done in a Swedish setting, where only a limited number of previous studies have been documented. The majority of the research on IAC is based on US data and due to significant differences between US GAAP and IFRS, the findings are not fully applicable in a European setting. Finally, the inputs from our interviewees might contribute to the ongoing discussions on how IAC should be reported by companies according to regulations and standard setters.

### 1.4 Delimitations

The study will only include sell-side equity research analysts and thereby exclude investment bank analysts, private equity analysts, other financial analysts and non-professionals. Furthermore, there are different types of equity analysts: either sell-side or buy-side. Typically, buy-side analysts are employed by asset managers and their main task is to provide investment recommendations to internal portfolio managers. In contrast, sell-side analysts are employed by brokerage firms where their research and recommendations are used both internally, for the firm's sales and trading desks, and to external clients. A delimitation has been drawn in regards of the nature of the organisation by excluding buy-side analysts. This choice has been motivated by the fact that we performed a document study prior to our interviews, analysing equity research reports in order to map out the reporting of IAC. Indeed, this would not have been possible if our sample included buy-side analysts, as their work is not as accessible. Among our sample of analysts we aimed at speaking with specialists, who cover fewer companies as opposed to generalists. Specialists have more in-depth knowledge of the companies they cover and therefore they are thought to be better informed about IAC.

Due to practical reasons, the study will focus on analysts based in the Stockholm region. However, most of the equity research departments in Stockholm are operating on an international level. Further, many of the companies covered by analysts are Swedish firms with an international presence. As a result, one can expect some similarities with how analysts in other European countries, regulated by IFRS, take IAC into consideration.

Finally, we will not focus on examining how we believe IAC should be regulated, since it is a very complex area to study within the framework of this thesis. However, in order to contribute to the ongoing discussion of the reporting of IAC we aim to include a part which expresses how analysts wish IAC to be reported.

## 2. Theory and previous research

*In the following section we will provide an overview of previous research made on analysts and IAC. Firstly, a definition of IAC as well as an explanation of the role and purpose of sell-side equity research analysts will be given as a foundation for our analysis. Thereafter, in sections 2.3 and 2.4 previous behaviouristic studies related to our research question will be outlined.*

### 2.1 Defining items affecting comparability

International Financial Reporting Standards (IFRS), followed by all listed Swedish companies, only have a few requirements on what should be incorporated under the presentation of the income statement. It is regulated by the International Accounting Standard (IAS) 1 Presentation of Financial Statements, in the paragraphs IAS §82 and §82A, that the statement of profit and loss should contain five items, and that the other comprehensive income should contain two items. If choosing to report additional line items, then headings and subtotals shall be presented on the face of the income statement when such presentation is relevant to an understanding of the entity's financial performance, according to IAS §85. Moreover, entities are prohibited under IAS §87 from classifying any item as extraordinary, see Appendix 1: IAS 1 §82, §82A, §85 and §87 for further details (IFRS, 2017). Companies can therefore choose to report non-IFRS measures, also called alternative performance measures (APM). The European Market and Securities Authority (ESMA), who gives out recommendations that are followed by all listed European companies, advocate companies on new guidelines for APM reporting. As of July 2016, companies are advised to give details on what adjustments have been made when adjusted key ratios are reported (ESMA, 2016).

IAC arise as a result of the adjustments companies make when reporting APM. The adjustments, which can both be of a positive or a negative nature, are made when companies find it relevant to exclude items in order to show underlying financial performance. A survey of 2,800 financial statements from the UK, France and Germany, made by PwC in 2007, explored the presentation of income under IFRS. They found that companies use a variety of ways to present income measures that exclude certain non-recurring items in the financial statements, see Table 1. below (PwC, 2007).

**TABLE 1.**
**Terms companies use for income measures excluding certain non-recurring items**

| | |
|---|---|
| - Result excluding exceptional items | - Result before specific items |
| - Result before non-recurring items | - Normalised result |
| - Result before significant items | - Underlying result |
| - Result before special items | - Current operating result |

*Source: "Presentation of income under IFRS: flexibility and consistency explored" by PwC, 2007*

### 2.2 The role and purpose of sell-side equity research analysts

Sell-side equity research analysts' main task is to analyse and interpret data on listed companies in order to create investment recommendations. These recommendations mostly come in a written format. Their written recommendations, also known as equity research reports, often include a qualitative and quantitative analysis of the company, and the recommendations are often made on a twelve-month horizon. The reports are not subject to any reporting regulations and as a consequence one can only expect that analysts include the most relevant and important information to justify their recommendations (Abdolmohammadi et al., 2006). Pinho et al. (2013) define analysts' work as the following:

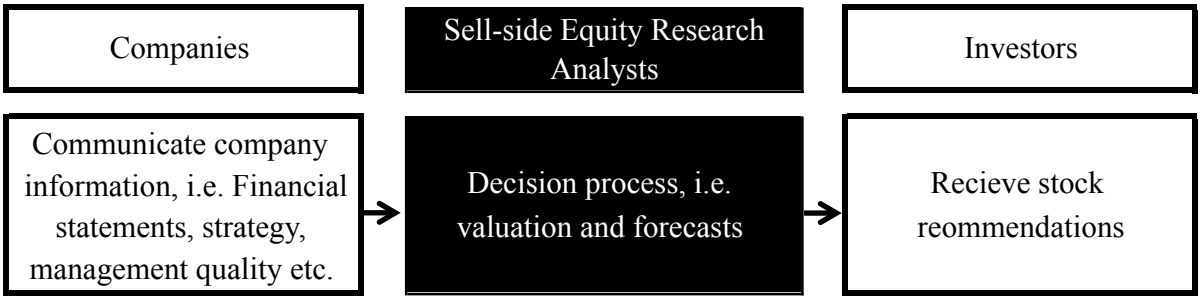
> *"Sell side analysts conduct company research, searching and gathering financial and non-financial information on a company from both private and public channels, analyse and interpret this information using models and heuristics, forecast firms future earnings, cash flows and growth rates while also issuing reports on companies with a recommendation to buy, hold or sell the stock."* (Pinho et al., 2013, p. 631)

As mentioned earlier, analysts are often employed by a brokerage firm and their recommendations are used both for internal and external purpose. External clients include institutional investors and buy-side equity analysts from insurance companies, pension funds and hedge funds among others. An analyst must be able to communicate and persuade these clients to trade in order to generate commissions for the brokerage firm (Cheng et al., 2006).

In Figure 1., seen below, the aforementioned "black box", referring to the uncovered decision process of analysts, is visualised. The figure both shows the analysts' role as information

intermediaries as well as how the stock recommendation is the result of the decision process of analysts and is based on the input received from companies. Since the analysts' conclusions and recommendations are conveyed to investors, company management, clients and other market participants it is of importance that they always strive to arrive at the correct valuation, hence implying them to partially be critical towards company information (Bradshaw, 2011).

**FIGURE 1.**
**The information processing of sell-side equity research analysts**




In the process of creating investment recommendations, Orens and Lybaert (2007) state that analysts fulfil two important functions; providing investors with reliable information and firm monitoring. Firstly, in their study from 2007, Orens and Lybaert highlight how analysts help investors to sort out reliable and relevant information by transforming the large amount of public information available. Thus, investors must rely on analysts to keep them updated with appropriate information. Secondly, firm monitoring is an important function as analysts reduce information asymmetry between company management and shareholders in their process of assessing companies.

## 2.3 Analysts' approach to IAC

### 2.3.1 General opinion on IAC

In a survey from 2014, PwC interviewed 85 international investment professionals from the buy-side, sell-side and rating agencies in order to understand what they find useful and not in APM reporting. The results show that 85% of investment professionals would like to see management's view of what is "underlying" or "core" to the company (PwC, 2014). In

addition, one of the main findings of the interviews held with analysts and other users by the US Financial Accounting Standard Board (FASB) was that adjusted, "normalised" or "operating" earnings are some of the key measures that they commonly use (FASB, 2002). This is in line with the findings of Barker and Imam (2008), who conducted both a qualitative study interviewing 35 sell-side analysts from European brokerage firms, and a quantitative analysis on 98 equity research reports. They found that the market puts more emphasis on adjusted earnings figures, where IAC have been excluded, than reported earnings. In other words, several analysts strive to focus on core earnings, to achieve earnings of high quality (Barker and Imam, 2008).

Many researchers have emphasised the difficulties for analysts to understand companies' definitions of IAC and thereby how to reach earnings quality. In a study conducted by Hjelström et al (2014a) 40 sell-side, buy-side and credit rating analysts were interviewed, and the interviewees commented that the earnings quality is indeed affected by IAC. Further, the analysts brought up three problem areas with IAC. Firstly, they highlighted the confusion created by the use of several measures by companies. Secondly, they identified the problem of judgement in what to be regarded as IAC. Finally, the analysts expressed a concern of companies misusing IAC.

IAC is often commented upon with regards to the concepts of comparability and consistency that are considered as two dimensions of earnings quality. Consistency refers to analysts' capability to compare the reporting within a company over time while comparability refers to the reporting of companies in a manner that enables comparison between sectors. In the previously mentioned report by PwC from 2014, consistency was stated as key for analysts. This is because they partly extrapolate their forecasts from historical performance, of which they create a trend. In addition, in Hjelström et al.'s (2014a) study, interviewees addressed their concern regarding both the consistency and comparability in how firms report. Due to analysts' desire to maintain consistency in their reporting, they find it frustrating whenever companies change the way of presenting their earnings figures. One example of a change would be if a company that previously has been reporting their results on a business unit basis changes to a geographical basis.

In the aforementioned study made by PwC (2014), analysts were interviewed regarding their opinion of how they ideally would like firms to report IAC. One of the findings highlighted

that 95% of the analysts would prefer management teams to provide clearer descriptions of which IAC they have excluded when calculating their adjusted earnings figures. More specifically, analysts revealed that they commonly want better information on segment reporting from companies. This can be explained by the fact that most intrinsic valuation models are built from the segment and up; hence it would be beneficial for analyst to receive that information (PwC 2014). In addition, Hjelström et al. (2014a) found that analysts were quite satisfied with the ways companies disclose information on IAC yet still emphasising that they seek information on a segment level.

### 2.3.2 Information sources used for IAC

Previous research differs in the findings of which information sources analysts consider to be the most valuable. Graham et al. (2002) conducted a survey, with 34 financial analysts across 18 sectors, to investigate how analysts use financial information and determine earnings quality. All respondents answered that they use public financial company information when performing company valuation, from which they will construct adjusted earnings figures. The respondents ranked the income statement as the most important and useful source of information, followed by the balance sheet and the cash flow statement. Out of the 15 different information sources included in the survey, "consensus earnings forecasts" was the least used source.

In contrast to Graham's study, a combined survey and interview-based study by Brown et al. (2015) highlights the importance of other sources of information. Rather than public financial company information, Brown et al. (2015) found that private communication, including contact with the investor relation (IR) department and company's management, to be a more useful input in the process of understanding the quality and persistence of earnings. The majority of the analysts included in the survey stated that they have direct contact, more than five times a year, with the CFO or CEO of the companies they cover. In follow-up interview questions regarding company contact, it is revealed that some analysts actually avoid asking questions in public conference calls. Instead they listen to the questions being discussed and ask their own questions in private conversations where they check assumptions in their models and gain insight in other areas such as IAC (Brown et al., 2015). On a similar note, Barker (2000) conducted a study with both participant observations and interviews with 32 UK-based analysts, in which he found that the analysts highlight the value of private

communication with companies, explaining that it is one of the central sources of information where they ask questions regarding IAC.

## 2.4 Analysts' adjustments of IAC

### 2.4.1 Own adjustments versus following company guidance

Ecker et al. (2015) studied 16,748 firm-year observations of analysts' earnings adjustments from 1999 to 2012 covering 1,744 listed companies from 19 EU countries. They found that the median number of adjustments an analyst makes is 3.36, ranging from one to eleven. Most commonly these adjustments are exclusions, hence excluding costs items from the company's income. Moreover, Ecker et al. (2015) argue that analysts will make more, and larger, adjustments if they perceive the reported earnings quality to be poor (Ecker et al., 2015). Hjelström et al. (2014b) further emphasise that the majority of their interviewees said that they follow the adjustments provided by the companies, only a few form their own adjustments. In contrast, Barker (2000) investigated analysts' use of earnings, and addressed the multiple definitions of normalised earnings. He found that most analysts have their own version of normalised earnings and report earnings after making own adjustments to them. When Barker asked the analysts what they include in their normalised earnings, all of the interviewed analysts said they include recurring items and 75% of them said they exclude non-recurring items.

Several previous researchers have emphasised that adjusted values done by analysts are of greater value (Bradshaw and Sloan, 2002; Bhattacharya et al., 2003; Brown and Sivakumar, 2003; Graham et al., 2015). For example, Brown and Sivakumar (2003) argue that valuation measures provided by managers and analysts are more value relevant than valuation measures provided by the database Standard & Poor's Compustat, which provides financial, statistical and market information on global companies. This is consistent with the findings of Bradshaw and Sloan (2002) and Bhattacharya et al. (2003), indicating that analysts believe adjusted earnings are a better measure of a company's sustainable profitability. Moreover, according to Graham et al. (2015) analysts view an adjusted earnings figure constructed by the analyst to be the most important figure to include when evaluating companies (see Appendix 2: Table 1. Items regarded as being the most important to analysts in evaluating companies).

### 2.4.2 Own adjustments related to the frequency of IAC

Hjelström et al. (2014a) address the issue that some companies report IAC, of similar sizes and nature, repeatedly every year. When there is a frequent reporting of IAC, by the same company, the analysts face the challenge of judging whether the item is recurring or non-recurring. In line with this view, Barker (2004) criticises the practice of excluding earnings items that are non-recurring, non-operating or outside management's control. To start, he addresses the subjectivity of deciding what is recurrent and not. This subjectivity creates room for questioning how frequently the item must occur in order to be considered as recurring. Further, he explains that there exists no objective way to "draw the line" between what is operating and non-operating (Barker, 2004). This has lead to a concern among analysts to whether the exclusion of these items is being misused by companies (Barker, 2000; Hjelström et al., 2014a).

### 2.4.3 Valuation and reporting of IAC

Several previous studies have been made on which valuation models analysts use when valuing a company (Barker and Imam, 2008; Hjelström et al., 2014a). Two different types of valuation methods can be distinguished. On one hand, intrinsic valuation models built by analysts, such as discounted cash flow (DCF) and return on invested capital (ROIC). On the other hand, market-based analysis ratios such as price/earnings (P/E) and EV/EBIT[1] are used. In finance theory, DCF is privileged as the base for valuation, however, studies suggest that the PE multiple is the dominating and preferred valuation model by analysts while the DCF is the second most used valuation model (Barker and Imam, 2008; Hjelström et al., 2014a). Regardless of the valuation method chosen by the analyst, IAC can be included. The adjusted EBIT measure can be used in both DCFs and multiple valuation models. IAC is reflected in the sense that both adjusted and unadjusted values are presented by the analyst in his or hers report; for example EBIT, EPS[2] and P/E can be presented in the forms of adjusted and unadjusted.

Furthermore, analysts cover companies both from a long-term value creation perspective and a short-term trading perspective. In the short run, analysts aim at reaching a valuation as accurate as possible. This implies the importance of forecasting the correct IAC, since this

[1] Enterprise Value / Earnings Before Interest Taxes.
[2] Earnings Per Share.

otherwise is a common reason for arriving at the wrong forecast. However, over a longer time frame, if a company frequently presents the same IAC analysts will at some point consider it as recurring, and thus lower the earnings forecasts.

A great deal of previous research gives prominence to the correlation between earnings recurrence and a high multiple. According to a commentary written by Schipper and Vincent (2003), if earnings are persistent, they will be recognised as sustainable, thus receiving a larger valuation multiple from the analysts. They describe that persistent earnings, i.e. recurring earnings, are connected to stronger investor responses, hence being more attractive. In addition, Ohlson (1995) and Graham (2002) emphasise that a higher multiple will be attached to a company that has a greater persistence in their earnings, thus reaching higher earnings quality.

### 2.4.4 Adjustments made for specific items

Even if there is a common view of adjusted earnings being a preferred earnings figure, there are mixed answers of which items to include or exclude. For example, changes in interest rates may be considered as a clear external event, however, management can control the use of financial instrument and the company's exposure to such external factors (Barker, 2004).

Several studies highlight the ambiguity surrounding restructuring costs (Barker, 2000; Barker and Imam, 2008; Hjelström et al., 2014a). Hjelström et al. (2014a) emphasise in their study that restructuring items are often being commented as ambivalent in the regard of IAC. Furthermore, in Barker's study (2000), restructuring costs were sometimes considered as IAC by some analysts, while it was viewed as a part of the ongoing business by others; depending on the company and its history of restructuring costs (Barker, 2000). In a later study made by Barker and Imam (2008) they confirmed Barker's previous findings regarding restructuring costs. Indeed, the items perceived as the most unsure items to include or exclude by analysts are restructuring costs, operating expenses and exceptional items (highlighted in grey in Table 2.), which can be explained by their regularity, inherent with a subjective determination. Table 2. below summarises the interviewees responses on adjustments made to reported earnings.

**TABLE 2.**
**Earnings adjustments made by analysts**

| Item to include or exclude in adjusted earnings | Include | Exclude | Depends/ Unsure |
|---|---|---|---|
| Depreciation | 35 | 0 | 0 |
| Interest expenses | 33 | 1 | 1 |
| Pension (service cost) | 32 | 3 | 0 |
| Pension (interest cost) | 31 | 4 | 0 |
| R&D expenses | 29 | 4 | 2 |
| Stock compensation | 21 | 8 | 6 |
| Operating expenses (one-off) | 14 | 9 | 6 |
| Provisions for future cash outflows | 13 | 8 | 6 |
| Restructuring costs | 10 | 11 | 14 |
| Gains or losses on financial assets | 6 | 22 | 7 |
| Impairment losses on fixed assets | 6 | 28 | 1 |
| Revaluation gains on fixed assets | 6 | 24 | 5 |
| Discountinued activities | 4 | 23 | 8 |
| Impairment of goodwill | 4 | 27 | 4 |
| Amortisation of goodwill | 3 | 28 | 4 |
| Gains or losses on asset disposals | 2 | 23 | 10 |
| Exceptional items | 1 | 16 | 18 |

*Source: "Analysts' perceptions of 'earnings quality'" by Barker and Imam, 2008*

Gu and Chen (2004) examine the rationale behind analysts' selective inclusion and exclusion of non-recurring items. They highlight that the inclusion and exclusion decision is made on a case-by-case basis rather than a category-by-category basis, where the latter would be to always adjust for a specific type of item regardless of the firm in question. In practice the appropriate treatment of transitory components of earnings is a matter of professional judgement.

### 2.4.5 Adjustments made for company specific characteristics

Previous research highlights that in the decision process of excluding or including IAC the analyst's choice is firm specific (Doyle et al., 2003; Barker, 2004; Barth et al. 2009; Christensen et al., 2011). For instance, Barker (2004) reveals that the inclusion of IAC will vary from company-to-company as well as from sector-to-sector. He argues that a particular item can be viewed as operating for one company while being non-operating for another; instead the decision whether the item is an IAC depends of the company's business model. This implies that there is no objective method of how to be consistent within a sector.

Individual analysts may disagree concerning the appropriate treatment of a given non-recurring item, and treat it differently. In line with this idea, Schipper and Vincent (2003) explain in their commentary that the ability to predict earnings is related to a company's business model. They highlight that it is often more difficult to forecast the earnings of cyclical and capital-intensive companies, due to the nature of their underlying business.

# 3. Methodology

*A mixed method has been applied: both a document study and an interview study have been conducted. This section will begin by describing the research design of these two methods. Thereafter, the process of how the data was collected will be explained in more detail; including how the sample was delimited, how the initial contact took place, and more deeply on how the interviews were conducted and which interview technique was used. Finally, the procedure behind how the data was analysed and coded will be covered.*

## 3.1 Choice of methods

Mixed methods were used implying that both qualitative and quantitative data were collected (Bansal and Corley, 2011). Prior to conducting the interview study, it was argued to be valuable to perform a document study. The last mentioned study was found appropriate in order to gain an understanding of how the IAC landscape looks like to ensure that IAC is presented in equity research reports.

### 3.1.1 The document study

We started to approach the subject of our thesis by thoroughly screening equity research reports. Conducting this document study was motivated since it would be important to detect, at an early stage, if there were some equity departments which did not include adjusted earnings measures in any of their given reports. As a first step, the document study was made in order to confirm that analysts present IAC in their equity reports, which was confirmed. As a second step, we aimed at understanding if the presentation of IAC in equity research reports differed between sectors. This was made in order to make a decision whether to focus on only one sector, or make a cross-sectional study, which will be further developed under section 3.2.2.

### 3.1.2 The interview study

The chosen method is an interview study, focusing on answering how and why analysts include or exclude IAC in their analysis process. We aim to provide an explanatory and descriptive understanding of the phenomena, and therefore we found it appropriate to include interviews with several analysts, in order to allow the identification of important themes and patterns. Moreover, an abductive approach has been chosen as the study involves an interplay between existing theory and empirical data. More specifically, the study aims to answer the research question with both existing research as well as searching for complementary findings through the interviews.

## 3.2 Data Collection

### 3.2.1 Data collection of the document study

The data collection started with screening the database Thomson Reuter for all of the available equity research reports on the companies listed on the OMX Stockholm 30 index, on the Nasdaq Stockholm stock exchange in February 2017. A total of 80 equity research reports were collected and scrutinised. Four major equity research departments were represented among our sample. However, the representation was not equal, in average there were 2.5 reports per company. Even if reports from all the equity departments within our sample could not be collected we did not find it problematic, as the intention with the document study was to confirm the use of IAC. In addition, equity research reports from a couple of other international equity research departments were also available on the database. Nevertheless, these were not selected due to the fact that their analysts are not positioned in Sweden. Moreover, in order to get the most updated view on IAC reporting, the most recently published equity research reports available were collected, more specifically from the beginning of the year 2017, ranging from the 8$^{th}$ of January to the 18$^{th}$ of February.

### 3.2.2 Delimitation of the selected sample

The study is limited to equity research departments present in Stockholm due to practical reasons in terms of geographic accessibility. Further, a discussion followed on how to make sure that the selected interviewees covered companies that actually report IAC. As a result from the document study it was found that the majority of the equity research reports include adjusted values or a line for IAC in all sectors. A choice was made upon if the study should

be limited to analysts covering one sector only or whether analysts should be selected regardless of their sector coverage. Worth mentioning, analysts most often cover only one sector. In this matter, it was decided that the selected sample would be too small if only aiming for Stockholm-based analysts covering one specific sector. Moreover, it was found interesting to uncover any potential differences on how analysts approach IAC across different sectors. More details on the analysts' background and coverage will be provided in section 4.1 under empirical findings.

### 3.2.3 Initial contact

The names of the interviewees were found in two ways, either through the accessed equity research reports, where the author's contact details always are included, or on company websites. The latter refers to listed companies websites and not the equity research departments' websites. More specifically the majority of the listed companies communicate the contact details of the analysts covering them under the investor sector in a sub-category often named "analyst coverage" or "analyst and estimates".

The interviews followed a funnel shaped approach meaning that the intended subject of the interview was stated in the initial contact. The motives behind informing the analyst that the interview would be about IAC were that it was expected to receive a higher acceptance ratio as well as providing the analysts with an opportunity to decline the interview if they would feel they have had too little exposure to IAC. The initial contact was made by e-mail where the companies were approached with a request for interviews. In the cases when no response was received, the contact was followed up by a phone call. In total, 15 companies were contacted whereof three did not result in interviews. One of the approached companies does no longer have equity research as a part of their business and the other two did not respond to the e-mails and phone calls. Among the twelve participating companies, two individuals recommended us to contact their colleagues; one could not schedule the interview within the time frame of this thesis and one felt too inexperienced to be able to contribute (i.e. less than one year of practice as an analyst).

### 3.2.4 Interview context

In order to create a balanced analysis, one interview was held with each participating company, apart from one company were two interviews were carried out. As the equity

research department in question (Company I) is one of the largest players and each interviewed analyst cover different sectors, it was judged to not interfere with the validity of the study. The majority of the interviews were held with one employee, only two interviews were held with two respectively three employees. The two later mentioned interviews were the result of a choice made by the interviewee to ask their colleagues to join them.

To increase the comparability of the interviews we aimed to conduct all in face-to-face meetings, however, four out of 13 interviews were held over the phone as the interviewees preferred it as they thought it would be more time efficient. The face-to-face meetings mostly took place at the local offices of the interviewees yet three interviews were conducted on outside premises as a consequence of the analysts' wish. Furthermore, all interviews were performed by both authors of this thesis during a period ranging from the 21st of March 2017 to the 11th of April 2017 (see Appendix 3: Table 2. Interview sample details). The length of the interviews varied between 30 and 60 minutes, with an average of approximately 40 minutes. The shorter interviews were those made over the phone, in which we chose to let only one person be the primary interviewer in order to avoid interference when asking the questions.

### 3.2.5 Interview technique

All of the interviews were structured using an interview guide that was created prior to the interviews (see Appendix 4: The interview guide). The interview guide was used in a semi-structured manner as it allows to be more interactive and to have new perspectives and ideas to be brought up during the interview while still covering relevant themes. Moreover, one of the advantages of this structure is that it allows control questions to be asked (Yin, 2014). According to Brinkmann and Kvale (2009) these clarifying questions allow the participants to develop their reasoning, thereby providing more in-depth answers.

Furthermore, Brinkmann and Kvale (2009) suggest that all interviews should start with a short introduction of the interviewers and an explanation of the purpose of the interview. This approach was adopted, as we believed it would be an appropriate way to make the analysts feel more comfortable and relaxed; hence making them speak more freely about their experiences and feelings (Brinkmann and Kvale, 2009). Moreover, before starting each interview the interviewees were guaranteed anonymity and allocated codenames, minimising

the risk of dishonesty and thereby increasing the study's validity. After the introduction part, all interviews began with open questions about the analyst's role and background. Then, questions on IAC were introduced. All questions were asked to the entire sample to make the empirics comparable. Further, while following the interview guide, interesting aspects were also explored if being raised by the interviewees. Finally, many of the interviews included discussions on specific companies; however, only public company information has been included to avoid enclosing any sensitive information, which could make the analysts feel uncomfortable.

### 3.3 Data analysis and coding

On completion, each interview was transcribed within one day after the interview and formed the main empirical source. Spoken language expressions and pauses were included in the transcripts, as Olsson and Sörensen (2007) suggest is the appropriate method when transcribing. However, these have been removed in the included citations in order to make the quotes more readable and exclude any personal expressions, hence securing the analyst's anonymity. Furthermore, Brinkmann and Kvale (2009) argue that it could be viewed as unethical to include these since it can create a less serious impression. One individual asked not to be recorded in order to be able to speak more deliberately about the subject. Instead, detailed notes were taken. All quotes were translated from Swedish to English and thereafter interviewees were requested to review and approve the direct quotes used in the present report. All of the selected quotes included in the empirical findings section were approved; only minor changes were adopted upon the request from the analysts. However, none of these modifications involved any changes to the meaning of the quote.

After all of the interviews were transcribed, they were coded after a predetermined structure, separating the data after the dimensions focused on in our study. Coding has been used as a method in order to connect the empirics to the research question and the theoretical contribution; enabling a more structured analysis (Bansal and Corley, 2011). The process was found necessary in order to find similarities and differences in the answers provided by the analysts, hence enabling us to get a more in-depth understanding of the collected data. A further benefit of coding is the importance of specifying all data points to each dimension as well as starting the reasoning and reflection process at an early stage. First, each transcript was thoroughly scrutinised for quotes and other data of particular interest, for example

contradicting statements, in order to favour a more complete and in-depth analysis where real statements are included. Secondly, we found it appropriate to structure our coding through a matrix in Excel. Each row matched one analyst, thereby having 16 rows, while each column referred to our dimensions and factors. For example, specific items mentioned during the interview constituted one row and ideal reporting another. Thirdly, patterns were searched with regards to the two major variables within our sample, being the number of years of experience of the analyst and which sector he or she cover. The choice of selecting dimensions and then looking for intergroup differences as well as within-group similarities is in line with what Eisenhardt (1989) suggests as a way to search for cross-case patterns.

# 4. Empirical findings

*To begin with, a description of the background of the interviewed analysts will be provided. Thereafter, the empirical findings of this study are presented in two parts. Firstly, we present the approach analysts have to IAC including their general opinion and sources of information used. Secondly, analysts' adjustments in regards to IAC are demonstrated.*

## 4.1 Background and context of the sample selection

16 sell-side equity research analysts were interviewed. In Table 3., information about the sectors, market size and the number of companies the analysts cover have been summarised. As seen below, the numbers of companies followed by the analysts ranged from five to a maximum of 20 companies (average being nine companies), thereby making all of them specialists rather than generalists within the field. Overall, the analysts interviewed have a broad variety of experience; ranging from close to one year of experience up to 30 years. More precisely, the average is eight years of experience while the median is four years.

**TABLE 3.**
**Sample description: analyst coverage by industries, market size and number of companies covered**

| Company | Analyst | Industries * | Market size | # of companies |
|---|---|---|---|---|
| Company A | Analyst A1 | Industrials | Large-Cap | 10 |
| | Analyst A2 | Industrials, Consumer Goods | Large-Cap, Mid-Cap | 13 |
| Company B | Analyst B | Consumer Goods | Large-Cap | 5 |
| Company C | Analyst C | Industrials, Consumer Goods | Large-Cap | 10 |
| Company D | Analyst D | Industrials | Large-Cap | 10 |
| Company E | Analyst E | Technology | Large-Cap, First North | 4 |
| Company F | Analyst F | Financials | Large-Cap | 6 |
| Company G | Analyst G | Technology | Micro-Cap | 20 |
| Company H | Analyst H | Consumer Goods, Industrials | Large-Cap | 8 |
| Company I | Analyst I1 | Consumer Goods | Mid-Cap, Small-Cap | 3 |
| | Analyst I2 | Financials | Large-Cap, Mid-Cap | 10 |
| | Analyst I3 | Strategy and Quant * | Micro-Cap | 10 |
| | Analyst I4 | Consumer Services, Industrials | Large-Cap, Small-Cap | 10 |
| Company J | Analyst J | Consumer Goods | Mainly Large-Cap | 10 - 12 |
| Company K | Analyst K | Financials | Mid-Cap | 10 |
| Company L | Analyst L | Consumer Goods | Large-Cap, Mid-Cap | 9 |

* Classified according to the 10 industries of the Industry Classification Benchmark (ICB) structure (used by OMX Nordic Exchange, First North Sweden and Nordic Growth Market) at the exception of 'Strategy and Quant'

All equity research departments are divided by sector. One of the interviewees, Analyst I3, does not cover a specific sector but instead works with strategic matters and selecting new companies to follow at the micro-cap level if finding an interesting case. Furthermore, four analysts followed two sectors. The reasons why an analyst follows companies from different sectors are either because the companies covered have natural synergies, or if analysts take over companies from previous colleagues leaving the firm. The process of deciding which companies to follow is a mix between personal interest, previous knowledge and company need. Furthermore, the two smaller equity research departments only had one analyst following each company. At the larger equity research departments there are often two analysts following the same company, one primary analyst and one secondary analyst. However, many analysts stress the fact that the primary analyst does the majority of the work in practice.

## 4.2 Analysts' approach to IAC

### 4.2.1 General opinion on IAC

Most of the interviewees agreed upon the reporting of IAC from companies to be a valuable indicator of the company's underlying business. Further, the analysts agreed that they prefer when companies disclose IAC. Although, six of the analysts brought up that the various ways of addressing and reporting IAC are rather confusing. When asking the analysts how they define IAC they explained it as being costs, or in rare cases revenues, outside the "natural business" which disturb the comparison over time. Indeed, two analysts expressed that they had never seen IAC as revenues. However, the analysts in our sample recognise that there is room for interpretation. Two quotes on the subject read:

> *"Items affecting comparability, it is mainly costs but can also be revenues, which are considered to be outside the company's core business. For example, it can be termination costs or property divestments, as long as you are not a real estate company. There is no clear definition, it is rather fluid."* (Analyst I4)

> *"I actually think it is difficult to find a definition, and to determine what is a part of the underlying business. For example, firing employees can occur from time to time, thus being viewed as an recurring item."* (Analyst G)

As mentioned earlier, companies report IAC in different ways: certain companies do not report any IAC at all, some companies report solely on a company level while others report on a business unit level. Indeed, 14 out of the 16 interviewees commented upon that there is large variation in how the covered companies report IAC. Only three of the analysts expressed a concern regarding comparability due to this matter. One of them, Analyst B, expressed a frustration regarding this incomparability between companies saying that it makes their work more complicated. Moreover, several of them emphasised the importance of consistency from year to year, since they look at historical trends when forecasting earnings. Analyst L highlights that once a company has started to report IAC it will create an inconsistency problem if they stop reporting it. The following of his quote reads:

*"If a company suddenly stops reporting these items affecting comparability, it will be more difficult for us analysts to compare over time."* (Analyst L)

Upon receiving the question whether analysts would prefer companies to report IAC differently, some analysts expressed that they want companies to be as transparent as possible by making it clear for the analysts to know what adjustments they should make. The more guidance they receive from companies, the more accurate the forecasts will be. Moreover, a couple of the interviewees stressed that they would value to always have IAC reported on a segmental level.

### 4.2.2 Information sources used for IAC

When asking the interviewees which information sources provide them with information regarding IAC all the analysts stated that they rely on public financial company information when valuing a company, mostly figures in tables. However, five analysts mentioned that some of the companies they cover comment on IAC in the qualitative part of their financial report, such as the executive summary or the notes, while not reporting any adjusted earnings figures in their tables.

The vast majority of the interviewees stated that communication with management is a valuable source of information, and that many analysts use conference calls to ask about IAC. Some analysts highlighted the importance of private communication with internal relations (IR) and top management saying that even though it will not change their fundamental view on the company it can help them arriving at a more accurate forecast of IAC. One analyst explained that even if company management cannot give you the exact details regarding IAC in a private communication, analysts could get an understanding from analysing their body language and other valuable indications. In addition, he said that it is very important to have a strong relationship to company management. He further explained that by getting to know the company and its management you will, as an analyst, have a greater insight in the business and your margins will be more precise. However, there are situations when a company has not provided the analysts with any guidance regarding an unexpected IAC, Analyst B states that:

> *"Two hours after the earnings announcement the company can announce in the conference call that the lower result is due to an extraordinary item, which we would have adjusted for. It is important that companies communicate any special costs or benefits. If not, we will arrive at the wrong forecasts."* (Analyst B)

Five of the analysts mentioned that they use sources such as Bloomberg, FactSet or the Swedish equivalent SME Direkt, in order to get an understanding of consensus view on IAC. The aforementioned databases collect and compile analysts' forecasts. The interviewees expressed that looking at consensus is especially done prior earnings releases but only as a "sanity check". In several cases when analysts are off with their forecasts, a common deviation is that the analysts have judged the size of IAC differently than consensus (i.e. the market). In contrast, Analyst H said that he avoids looking at consensus in order to not allow it to influence his own judgement and forecasts.

## 4.3 Analysts' adjustments of IAC

### 4.3.1 Own adjustments versus following company guidance

All of the interviewees highlighted that they strive to conduct estimates that reflect the company's core business. However, the analysts are not always in agreement of what adjustments are needed in order to reach it. Two distinct standpoints taken by analysts can be identified: either they make their own adjustments or they follow company guidance. Among our sample of analysts, the majority revealed that they are in between the two - they follow the company guidance in most cases but will keep in mind to question whether own adjustments are necessary. An interviewee stated:

> *"You are a bit under the company's 'violence' since they are the ones communicating what are restructuring costs and what are items affecting comparability"* (Analyst A2)

In both the extreme standpoints, three analysts rarely questioned companies' disclosed figures while four constantly kept a critical standpoint. Among the analysts who are less critical, Analyst G, expressed that if the company he follows does not report an adjusted earnings value he will not include an adjusted earnings figure in his report either. In contrast, Analyst

L stressed that even if a company does not report an adjusted earnings figure nor disclose IAC in their financial reports, he will include an adjusted earnings figure in his report based on his own adjustments. Further, the most critical analysts were the most senior among the sample (more than ten years of experience). Analyst C reflected upon the correlation between his critical standpoint and his experience, stating:

> *"In my opinion, I view all costs as ordinary. In very few situations I make exceptions, only when something very extraordinary has happened, for example an explosion somewhere. I think I have become more critical over time, in the beginning of your career you may not feel comfortable questioning the companies in the same way."* (Analyst C)

### 4.3.2 Own adjustments related to the frequency of IAC

The analyst's dilemma of excluding or including IAC in adjusted earnings figures often ends with the question: "is the item recurring or non-recurring?". If an item would be seen as too recurring, several of the analysts emphasised that they would include it in their earnings figures. In the situation of the IAC being costs, this would result in lowering the expected earnings. The analysts explained the dimension of frequency to be important to have in mind when they are aiming to understand the underlying business. Upon the discussion of frequency two analysts state:

> *"One time is no time, but if the company does it frequently it will loose the market's trust and the valuation will be punished."* (Analyst L)

> *"At some point you will get frustrated, if quarter after quarter new non-recurring costs emerge. Then, you will consider including them - it is a subjective decision you have to make."* (Analyst B)

The analysts were asked how they would act in a situation where a company reports the same IAC in several repeated quarters. All analysts stresses that it is very difficult to give an estimated threshold for the numbers of quarters that would have to pass before reacting. Nevertheless, four analysts estimated the number of quarters to be between four and 16, with an average of eight quarters. Furthermore, the company Electrolux was mentioned by six

analysts' as an example of a company which is known for having undergone a period of frequent reporting of restructuring costs as IAC. Interestingly, three of these analysts do not cover Electrolux themselves, and still mentioned it.

Moreover, Analyst I4 mentioned that it might take a while to detect if a company reports IAC frequently. He explained it saying that if the IAC appear unexpectedly on the day of the release of the interim report most analysts would probably include it immediately in their valuation and forget it until the next quarter. This can partly be explained with the analysts' expectations to release an updated report shortly after company earnings announcement; hence the time pressure can be an explanation to why no deeper analysis of the frequency of IAC is made.

### 4.3.3 Valuation and reporting of IAC

The interviewed analysts stated that there are standardised formats of how to include adjusted earnings figures in their reports. However, in the end it is up to the analysts to choose how he or she wishes to present it. The great majority of the interviewees report adjusted values. Analyst A2 stated that whenever using EV/EBIT he always used adjusted EBIT. In addition to showing adjusted earnings in the table, some analysts also write about IAC in the qualitative part of their report, highlighting the importance of being clear in their communication to investors. Analyst A1 emphasised that if something is unusual, he will make a note of this in his calculations for future references and client communication but not show it in his report. Furthermore, Analyst I4 commented upon what happens to the adjusted earnings figures reported by analysts when being interpreted by external parts. He explains that some of the databases, which present compiled earnings figures by analysts, can sometimes lack clarity in what numbers are adjusted and not.

The interviewees revealed that there is a different focus on how to include IAC in the valuation depending on the time perspective. Analyst L expressed that in the long-term there is a limited focus on IAC, this can be explained by the fact that a true IAC will be adjusted for and not extrapolated forward. However, if an IAC is recurring, as mentioned in the previous section 4.3.2, it can affect the long-term valuation. More specifically, four analysts stressed that a company that reports the same IAC on a regular basis will receive a lower future earnings valuation. In practice, this is done by including the specific recurring item, which is

reported as an IAC by companies, directly in their cost figures and thereby lowering the earnings. In the short-term, and especially prior earnings announcements, there is a stronger focus on IAC as correct forecasts are of greater importance. Analyst H stressed that if he would not include the right adjustments in his forecasts, for example prior an interim report release, the margins can be very incorrect. Upon this subject the analyst expressed:

> *"If I have not included the right adjustments prior an interim report release I can be very off. So in the short-term it is important."* (Analyst H)

#### 4.3.4 Adjustments made for specific items

When asking analysts about the most common IAC that companies report, the entire sample of analysts mentioned restructuring costs in their answers. In more details, restructuring costs were referred to as including store or plant closings and headcount reductions. However, the analysts were not in agreement whether they should adjust for this specific item or not. Indeed, restructuring costs is the item that causes the most discussions; especially in those situations when restructuring costs recur for several quarters. Three categories of analyst approaches were identified. Firstly, the four most senior analysts (over ten years of experience) were of the opinion that a restructuring cost should be a part of the ordinary business, hence they do not include it in their adjusted earnings measure. Secondly, the majority of the analysts had a less critical standpoint, suggesting that they primarily follow company guidance, but would consider making own adjustments whenever necessary. Thirdly, a minority of five analysts were unsure of how they would count for restructuring costs, and said that they would probably follow company guidance. One quote from an analyst belonging to the first category reads as following:

> *"If it is restructuring costs, that is something a company needs to do all the time, and then I do not view it as an one-off. Even if a company chooses to view something as a one-off, it does not mean I agree and will adjust for it."* (Analyst F)

Furthermore, acquisition and transaction costs were commonly mentioned as a specific IAC that the analysts encountered. In some cases these merger and acquisition (M&A) related costs were clearly of a non-recurring nature. For example, if a company that they cover would

divest a business unit this would be considered as an one-time occasion. However, five analysts reflected over the fact that it is less clear for companies that have M&A activities as a dominating part of their strategy. One analyst, which coverage includes companies within the gaming industry, expressed that M&A related costs is the most frequently reported IAC in his sector. Further, he noted the difficulties to draw the line when the M&A activities had become so recurrent that it should be viewed as a part of the gaming company's business model.

Three analysts mentioned that currency effects are specific IAC to which they place more careful attention. Even if some companies do not exclude currency effects in their adjusted earnings figures, it is important for an analyst to understand if the earnings figures may have been impacted by a positive or negative currency effect. Analyst A1 highlights that currency effects can be argued to either be a part of the operational business or appropriate to adjust for, often related to the size. The following view was shared:

> *"Another important part of the analysis is how you incorporate transactional currency effects on EBIT, which in some cases can be viewed as a non-recurring item."* (Analyst A1)

Moreover, the analysts that brought up fines and penalties were in consent in regards of how to adjust for it; these items should be excluded from the earning measure as they are considered as clear non-recurring items. Analyst D exemplifies this by saying that if a company would receive fines from illegal cartel activities he would exclude these costs as it is highly unlikely to recur. Interestingly, fines and penalties were brought up by the entire sample of interviewees that cover the financial institutions sector, more specifically, three analysts.

Finally, three analysts addressed that it is common for some companies to end up in legal claims and settlements. All of them were in consent that even if lawyer costs might not be considered to be a part of the core business, it can be a recurring cost and should therefore not be adjusted for. Although, whenever these costs are recurring many companies avoid reporting it as IAC since they know analysts will ask about them, and of course they do not wish to reveal that clients are dissatisfied with them. A quote from the interview with Analyst L, regarding how he would adjust for the aforementioned costs, reads as following:

*"Why have they been in legal disputes? Because customers have felt mistreated. Then these type of legal disputes might be something that often happens. Sure, lawyer charges are not a part of their business, but it can recur, and then it should not be excluded."* (Analyst L)

### 4.3.5 Adjustments made for company specific characteristics

The majority of the analysts in our sample addressed the broad variety in the reporting of IAC between the companies they cover, even within the same sector. Analyst F exemplifies the important differences in how the companies he covers report IAC by telling that he cannot identify a pattern within the sector he covers; one of the companies he covers rarely reports any IAC while one of the peer companies almost always does it. In contrast, the two analysts that did not agree with the discrepancy of IAC reporting between the companies they follow are both covering the consumer goods sector solely. In their opinion all companies that they cover report a balanced amount of IAC.

Eleven of the interviewed analysts follow one single sector, the majority of them said they have limited experience and knowledge whether there are certain sectors where IAC is more frequent. However, a few analysts expressed their view there was a collective understanding that it is more common within the industrial sector where restructuring costs dominates. Among them, Analyst C and Analyst D that both cover the industrial sector, were convinced that IAC were more common in their sector. They explained the rationale behind this as industrials, by nature, have a higher value-added to sales ratio in their business. This is in line with four analysts opinion, being that rather than sector, the use of IAC was linked to the "nature of the company", in other words the company's business model. More specifically, companies that operate on a project-based basis were thought to have more IAC, Analyst C explains that:

*"A large source for one-time items is from project-based businesses, hence it is more frequent for manufacturing companies but also companies such as ABB and Alfa Laval. They sell entire projects and it seems to be a part of their structure that project-based work often goes wrong. It seems to me that many companies are exiting their project business because they believe it has a too high risk profile."* (Analyst C)

# 5. Analysis

*In this section we compare the empirical findings with the previous research, with the aim to answer the research question. Our analysis is structured in the same way as our theory and empirical findings sections, being divided into two main parts. In the first part, findings on analysts' approach to IAC will be examined and in the other part, patterns of analysts' adjustments to IAC will be investigated.*

## 5.1 Analysts' approach to IAC

### 5.1.1 IAC - a complex area for analysts

Our study confirms the findings from previous research by PwC (2014), FASB (2002) and Barker and Imam (2008) saying that analysts prefer to see management's view of what is considered to be the underlying earnings. Indeed, the analysts within our sample agreed that they found it valuable when companies report IAC in order to enhance the understanding of companies' adjustments. Moreover, the problems of confusion and judgement in the process of deciding to include or exclude IAC in the valuation were a dominant topic during our interviews. These two problem areas were identified in the interview-based study of capital market actors by Hjelström et al. (2014a). Their study also discusses analysts' concern with achieving comparability when companies report IAC in various ways. Overall, this concern was not stressed to the same extent in our interviews. Only three analysts within our sample pointed out their need to treat IAC in the same way for all the companies they cover within a sector with the underlying reason being to increase comparability. One reason why our findings do not fully support Hjelström et al.'s (2014a) could be because no explicit question was asked about comparability.

Similar to the analysts in the PwC report from 2014, which stressed consistency to be a key dimension in the valuation process, our sample of analysts agreed upon this. Two main reasons for our interviewees' focus on consistency were identified. Firstly, consistency in the reporting was seen as significant in order to create a trend, which the analysts can extrapolate for future forecasts. Secondly, the analysts in our sample compare current valuation to historical valuation, as a point of reference, thus it is crucial for them to evaluate the company in a consistent manner. Indeed, if a company would change the style of financial reporting,

analysts can adjust for it themselves, however, it makes their work more difficult as they need to identify the nature of the items included and excluded for each quarter.

The satisfaction of how companies report and disclose information regarding IAC differed. On one hand, the analysts that cover companies who provide detailed information regarding their IAC were more satisfied with the companies' reporting, while on the other hand, the analysts who cover companies that provide very limited information about IAC requested more. Our findings are therefore not entirely in line with the study of Hjelström et al. (2014a) in which analysts expressed themselves to be rather satisfied with the reporting of IAC. However, the more senior analysts did not find the limited information disclosed about IAC to be as problematic. This is supported by our finding that more senior analysts make their own adjustments rather than following company guidance, discussed in more details under section 5.2.1.

Furthermore, some analysts within our sample asked for more guidance from companies regarding the reporting of IAC on a segment level. These findings are in line with the studies made by PwC in 2014, in which analysts requested more details regarding the IAC for each business unit. However, more guidance would decrease information asymmetry and allow analysts to reach earnings of higher quality by arriving at a more accurate forecast. Nevertheless, as a consequence, more information would also limit analysts' ability to add value to clients. Indeed, if all companies would be completely transparent in their reporting and forecasts, the role and purpose of analysts would become less valuable for investors.

### 5.1.2 Multiple information sources are used regarding IAC

Both the study conducted by Graham et al. (2002) and our findings show that each and every analyst primarily bases his or her valuation on public financial company information. Further, in the situations where companies disclose adjusted earnings figures in their financial reports, either in the tables or the qualitative part, the analysts within our sample find it to be a useful input for their valuation. Even if the analysts wish to make own adjustments, and not follow company guidance, this information will provide them with valuable insight of the items to their own reasoning.

Similar to Brown et al. (2015), the majority of the analysts in this study highlighted the value of having an ongoing communication with company management, especially when determining IAC. However, our results do not support Brown et al.'s (2015) findings suggesting that communication with management is the single most important information source. Indeed our interviewees expressed it to be of great importance, and it can help them arrive at more accurate IAC forecasts, although they did not rank it as the source they rely the most on when determining which adjustments to include. In addition, in line with Barker's (2000) findings, the analysts within our sample highlighted that communication with management is one of the channels where they can ask most questions regarding earnings quality and IAC.

The interviewees in our sample that looked at consensus prior to earnings announcements in the regards of IAC stated that they only do it as a "sanity check". As a result, our sample of analysts does not rely too heavily on consensus as an input source for their adjustments of IAC. These findings could be argued to be in line with previous research from Graham et al. (2002), where consensus was ranked as the least used information source (out of 15 choices).

## 5.2 Analysts' adjustments of IAC

### 5.2.1 Experience bring a more critical standpoint

Our findings are in line with the study by Hjelström et al. (2014b) where the majority of the interviewees said that they follow the adjustments provided by the companies and only a few analysts form their own adjustments. Indeed, three quarters of our sample, in most situations, follow company guidance on IAC. Our conformity with the study by Hjelström et al. (2014b) can be explained by the similarities in terms of geography and time between our two studies. More specifically, in Hjelström et al.'s (2014b) study 50% of the interviewees were Swedish analysts and their collection of empirics occurred in the year 2012 and the year 2013.

Furthermore, our empirics reveal that there is a strong correlation between the numbers of years of experience the analyst has and how critical he or she is towards companies reporting of IAC. Indeed, the four most senior analysts in our sample, having over ten years of experience, all made own adjustments to IAC. One possible reason why more experienced analysts make own adjustments is that when an analyst becomes more experienced he or she will gain more exposure to companies reporting of IAC, hence they could be considered to

faster detect recurring IAC. Another possible reason for the correlation could be that more senior analysts are more comfortable questioning company management. If younger analysts would make their own adjustments and arrive at a wrong forecast, they might find it more difficult to defend their assumptions towards their employer and clients.

Nevertheless, the finding that own adjustments are made by the more senior analysts can also be explained by the fact that there are often two analysts following the same companies within an equity research department, one primary analyst and one secondary analyst. The primary analysts of larger companies are often the more senior ones while the secondary analyst supports the primary analyst, and may cover some smaller companies himself or herself. As a consequence, more junior analysts might not be in charge of how to adjust for IAC. Indeed, the four analysts that make own adjustments are all primary analysts.

### 5.2.2 Analysts' emphasis on frequency

Previous research has addressed that analysts believe IAC to be misused by companies in some cases (Barker, 2000; Hjelström et al., 2014a). One way to misuse IAC could be to report the same item as an IAC too frequently. When asking the analysts for a threshold number of quarters they would wait before reacting to the same item being reported as IAC for each consecutive quarter, the answer was an average of two years. The fact that companies can report the same item for several quarters, before the analysts would react to the item as being repetitive, can be seen as a quite long time and give companies the possibility to misuse IAC in shorter periods. However, the analysts which more often make own adjustments than follow company guidance will have a shorter threshold than the analysts mainly following company guidance.

Moreover, the judgement of deciding to include or exclude IAC in the valuation is a common concern in the valuation process, confirmed by both the analysts that participated in our study and by Barker (2004) in his commentary. This issue is mainly related to the subjective decision made by analysts whether an item is reported too frequently in order to be excluded. Further, Barker (2004) states that there is no objective way to create a standardised approach concerning where to draw the line regarding the frequency, hence creating room for subjectivity.

### 5.2.3 IAC is discussed both in quantitative and qualitative terms

Our empirics on how analysts incorporate IAC in their valuation and how they report it is in accordance with the theory on the subject. Indeed, the analysts used both DCFs and valuation multiples. However, our interviewees rely primarily on multiple valuations, which is in line with the findings of Barker and Imam (2008) and Hjelström et al. (2014a). Moreover, all of the analysts within our sample report adjusted values in most cases, with one exception. As mentioned earlier, the only situation in which some of the analysts would not include IAC in his or her equity research report was when the covered company does not report any adjusted figures.

Moreover, the long and short-term perspectives of valuation were also reflected in the answers to our interviews. Our interviewees expressed that one of their practical ways to include IAC in the longer time frame of their valuation was by lowering the earnings forecasts. This is in line with the previous research conducted by Ohlson (1995), Graham (2002) and Schipper and Vincent (2003) who found that the recurrence of earnings is one factor that analysts takes into account as a sign of earnings quality. This further implies that if a company reports recurring earnings figure, they will be given a higher valuation multiple by analysts.

### 5.2.4 Restructuring costs - the most ambiguous item for analysts

Restructuring costs was by far the most common item brought up for discussion by the analysts in our sample. This confirms the findings of Hjelström et al. (2014a) study in which the interviewed analysts often commented on restructuring items as ambivalent in the regards of IAC. Moreover, in Barker and Imam's (2008) study of earnings adjustments made by analysts, they found that within their sample of 35 analysts, ten analysts included restructuring costs, eleven excluded them and 14 were not unsure of how to adjust for them (see Table 2. in the theory section). When comparing with our results, four analysts would include restructuring costs, five would exclude them and seven analysts said it would depend. In broad terms, our findings are relatively consistent. However, a slightly smaller share of our sample included restructuring costs in their adjustments compared to Barker and Imam's (2008) findings.

In the process of coding, we identified that at least one analyst from each of the five covered sectors, represented in our sample, mentioned transactions costs as a typical IAC; the sectors being industrials, financials, consumer goods, consumer services and technology. This implies that companies, regardless of sector and size, engage in M&A activities and report the costs related to them as IAC. However, the analysts' approach of how to adjust for the costs differed depending on the company being study and its business strategy. Analyst I4 stated that transaction costs could be a clear IAC for some companies, if engaging in M&A activities very seldom. In contrast, if a company would have M&A activity as a large part of their business strategy, he explained that analysts might become less willing to exclude it, since it can be viewed as a part of the ongoing business. These findings are in line with Gu and Chen (2004) who emphasised that own adjustment decisions were made on a case-by-case basis rather than a category-by-category basis.

In contrast to Gu and Chen's (2004) findings, one adjustment that was made on a categorical basis could be identified. Fines and penalties were items the analysts expressed to always exclude, as it was clearly seen as an IAC that would not occur again. Moreover, fines and penalties were brought up by all of the three analysts that cover the financial sector, independent of the market size. As all of the aforementioned analysts adjust for it in the same way, this could suggest a potential pattern of how analysts adjust for specific IAC depending on the analysts' sector coverage.

Finally, when searching for a potential pattern among our interviewees' answers, we found that currency effects and legal fees were only brought up by analysts covering either the consumer goods or the industrials sectors. Moreover, all of these analysts cover primarily companies of the large cap market size. However, even if this suggests a pattern of currency effects and legal fees to be identified in these sectors, it is important to mention that the analysts do not adjust for these items in the same way. The reason for the varying methods to adjust for currency effects and legal fees were due to the different perceptions of what is considered being a part of the ongoing business. Nevertheless, not all of the analysts within our sample that cover large cap companies within consumer goods or industrials mentioned these costs.

### 5.2.5 Adjustments based on company specific characteristics dominates

Within our sample, four analysts made own adjustments. Among these, there was no clear sector belonging, as one covers financials, one industrials, one consumer goods and, the last one, both industrials and consumer goods. As a consequence, our empirics did not provide evidence supporting that analysts covering a particular sector were more inclined to make own adjustments.

The majority of the analysts within our sample believed the reporting of IAC to be more connected to company specific factors rather than sector. This is connected to the idea that companies, within the same sector, can have different business strategies and operating activities, thus what is viewed as IAC will differ from company to company. Since analysts want to exclude items that are considered to be "unusual" or "one-time", adjustments cannot be done on a sector basis and the analyst must instead base it on company specific characteristics. Interestingly, a few analysts expressed that they believe industrials to have more IAC, where restructuring costs is the dominating item. In addition, some analysts said that they believe the reporting of IAC is connected to the nature of the company, more specifically that project-based companies would have more IAC. The aforementioned could be an explanation of why a few analysts believed industrials to have more IAC, as some of the companies within this sector are characterised by project-based work. This is in line with what Schipper and Vincent (2003) explain in their commentary where they emphasise that due to their business models it is more difficult to forecast earnings for cyclical and capital-intensive companies, two common features for companies within the sector industrials.

One a similar note, Barker (2004) addresses that the inclusion of IAC is related to the company's business model. He further explains that what is considered to be a part of the operating business for one company might not be operating for another. With regards to business models, five of the analysts within our sample brought up that transactional costs in connection to M&A activities are ambiguous IAC to evaluate. Indeed, at some point M&A activities might become a part of a company's business strategy and therefore the transactional costs should be included in the earnings figures. The choice of engaging in M&A activities can be taken by all companies, regardless of the sector in which they operate.

# 6. Conclusions

*In the following section our findings will be summarised and a discussion on their implications will be provided. Further, the validity and reliability of our study will be described. Finally, our thesis ends with suggestions on possible areas for future research.*

## 6.1 Summary and discussion

The existing research does not fully capture analysts' information processing. In order to contribute to the limited insight in analysts' behaviour and answer our research question, we aimed at analysing analysts' process of evaluating IAC. To begin with, regarding analysts general opinion on IAC, we found that analysts do find the subject rather difficult, as there is no common definition, nor clear guidance of what to include or exclude. In line with Graham et al. (2015) and Brown et al. (2015), we found that analysts primarily rely on financial company specific information and private communication, respectively, when evaluating IAC.

When investigating analysts' adjustments to IAC we found that a quarter of our sample of analysts makes own adjustments. Interestingly, previous research has emphasised that adjusted values done by analysts are of greater value (Brown and Sivakumar, 2003; Bradshaw and Sloan, 2002; Bhattacharya et al., 2003). In addition, Graham et al. (2015) study revealed that analysts viewed an adjusted earnings figure constructed by the analyst to be the most important figure to include when evaluating companies (see Appendix 2: Table 1. Items regarded as being the most important to analysts in evaluating companies). Having this in mind, we would have expected, prior to conducting the interviews, a larger share of the analysts to make their own adjustments. Furthermore, in the process of coding our empirics, we found that there was a correlation between the numbers of years of experience of the analyst and if they made own adjustments. Indeed, the four analysts in our sample who made own adjustments were also the most senior, all having more than ten years of experience in their role.

In line with Barker (2004), we found that the treatment of IAC is highly subjective. The most influential factor in making own adjustments is the frequency of the IAC. Further, we found that own adjustments made by analysts are done on a case-by-case basis, rather than category-by-category. In line with this, we did not find a clear pattern between sectors and making own

adjustments on IAC, instead, IAC is connected to the nature of company. Upon collecting the empirics, we expected to find a larger discrepancy of the adjustments made by analysts to IAC between different sectors. More generally, we were of the belief that there would be more differences between our interviewees and their approach to IAC.

We believe our results can be of interest for several groups operating in the financial markets: managers of listed firms, investors and regulators. First and foremost, it could be beneficial for managers to be aware of what information analysts would prefer to receive regarding IAC. Our results show that if companies want to match analysts' view on ideal reporting of IAC, they could disclose information about IAC on a business unit level. Secondly, we would expect the reasoning and information processing of analysts to be of interest for investors since they rely on analysts' investment recommendations. Finally, regulators might find the study useful since they have an important role in managing what information companies disclose. From another perspective, we are under the impression that our results could be of interest for all sell-side equity research analysts in order for them to reflect on their decision process and standpoint towards IAC. To conclude, we hope that our study is a step towards uncovering parts of the decision process of analysts, which still is largely hidden in a "black box".

### 6.2 Validity and reliability of the study

Arguably, there is a correlation between the sample size and the validity of the study. On one hand, a smaller sample allows the researchers to fully investigate the participants' answers in more depth; however, it does limit the opportunity to create statistically important findings. In order to increase the validity of this thesis one could have included a larger selection sample. On a similar note, we are aware that this study might not represent the general opinion of all analysts. Nevertheless, as there exist consistency in the views of the analysts, these might prove some reliable insights and thus we believe that our findings and conclusions are generalisable for analysts in a Swedish setting.

We acknowledge that there exist certain weaknesses with an interview study, such as response bias and reflexivity, referring to when the interviewee gives answers that he or she thinks the interviewer wants to hear (Yin, 2003, p.86). To minimise the aforementioned risks, the interview questions were structured in a semi-structured manner, thus having open-ended

questions where our personal view is not reflected. Another measure adopted to limit these risks, was the use of control questions during the interviews. In regards to the procedural reliability of the study, the adopted data analysis process was both documented through the transcripts of the interviews as well as through the act of coding. As a result, there exists an evidence trail of our study, and hence we believe it is possible to reproduce the study.

### 6.3 Suggestions for future research

The combination of the framework of this thesis and the limited existing research leaves room for future research. During the process of investigating analysts' decision process with regards to IAC we have identified another possible approach to the subject involving examining how other actors in the investment community take IAC into consideration. In particular, we believe it could be of interest to study how much emphasis investors put on IAC and to what extent it impacts their investment decisions. Understanding what information investors' request regarding IAC may provide further depth to our analysis, since it possibly can explain the rationale behind sell-side equity research analysts' behaviour. Indeed, the information provided by analysts' will be influenced by the demands from investors, since they are the clients.

Finally, as mentioned in the theory section, the European Market and Securities Authority (ESMA), followed by all listed European companies, gave out new guidance for APM reporting in July 2016. This implies that since last year, companies are encouraged to provide more details on the adjusted key ratios that they report. One possible approach would be to analyse how these guidelines influence companies' reporting of IAC and do a comparative study of the financial reporting environment pre and post the recommendation.

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# 8. Appendix

## 8.1 Appendix 1: IAS 1 §82, §82A, §85 and §87

*The study refers to four paragraphs from the IAS 1 (IFRS Standards Part A 2017), §82 (p.A487), §82A (p.A487), §85 (p.A487-A488) and §87 (p.A488), which have been included below.*

Information to be presented in the profit or loss section or the statement of profit or loss

§ 82 In addition to items required by other IFRs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:

(a) revenue;

(b) finance costs;

(c) share of the profit or loss of associates and joint ventures accounted for using the equity method;

(d) tax expense;

(ea) a single amount for the total of discontinued operations (see IFRS 5).

Information to be presented in the other comprehensive income section

§ 82A The other comprehensive income section shall present line items for the amounts for the period of:

(a) items of other comprehensive income (excluding amounts in paragraph (b)), classified by nature and grouped into those that, in accordance with other IFRSs:
(i) will not be reclassified subsequently to profit or loss; and
(ii) will be reclassified subsequently to profit or loss when specific conditions are met

(b) the share of the other comprehensive income of associates and joint ventures accounted for using the equity method, separated into the share of items that, in accordance with other IFRSs:
(i) will not be reclassified subsequently to profit or loss; and
(ii) will be reclassified subsequently to profit or loss when specific conditions are met.

§ 85: An entity shall present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement(s) presenting profit or loss and

other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.

§ 87: An entity shall not present any items of income or expense as extraordinary items, in the statement(s) presenting profit or loss and other comprehensive income or in the notes.

## 8.2 Appendix 2: Table 1. Items regarded as being the most important to analysts in evaluating companies

**APPENDIX TABLE 1.**
**Items regarded as being the most important to analysts in evaluating companies**

| Item | Score |
|---|---|
| An Adjusted Earnings Figure (constructed by the analysts) | 4.44 |
| Line of Business Data | 4.44 |
| Reported Cash Flow | 4.06 |
| Use of Accounting Conservatism in Financial Reporting | 4.03 |
| Geographical Data | 3.97 |
| Revenue Recognition Policy | 3.88 |
| Assumptions Underlying Accounting Methods | 3.85 |
| Reported Earnings | 3.85 |
| Inventory Accounting Methods | 3.29 |
| Unusual Items | 3.23 |

*Source: Analyzing financial analysts: What they look for in financial reports and how they determine earnings' quality by Graham et al., 2002*

## 8.3 Appendix 3: Table 2. Interview sample details

**APPENDIX TABLE 2.**
**Interviews context**

| Company | Analyst | Date of interview | Time of interview |
|---|---|---|---|
| Company A | Analyst A1<br>Analyst A2 | 21/03/2017 | 14:00 |
| Company B | Analyst B | 28/03/2017 | 10:30 |
| Company C | Analyst C | 28/03/2017 | 14:00 |
| Company D | Analyst D | 28/03/2017 | 15:15 |
| Company E | Analyst E | 29-03-2017 | 15:00 |
| Company F | Analyst F | 30-03-2017 | 10:00 |
| Company G | Analyst G | 30-03-2017 | 13:00 |
| Company H | Analyst H | 31-03-2017 | 10:00 |
| Company I | Analyst I1<br>Analyst I2<br>Analyst I3 | 03-04-2017 | 10:00 |
| | Analyst I4 | 04-04-2017 | 14:00 |
| Company J | Analyst J | 10-04-2017 | 14:00 |
| Company K | Analyst K | 10-04-2017 | 16:00 |
| Company L | Analyst L | 11-04-2017 | 17:15 |

## 8.4 Appendix 4: The interview guide

Introduction/Interview set-up

- Ask about anonymity
- Ask about possibility to record the interview

Part one - work setting and process

- Questions regarding the analyst's background
    - Could you please describe your role?
    - How many years of experience do you have?
    - How many companies do you follow, and which ones?
    - How many analysts at [name of equity department] co-cover the same companies as you do?
- Could you please describe the process from when you start covering a company until you give out a recommendation?
- What valuation models do you use?

Part two - IAC

- What is your standpoint towards IAC?
- How do you define IAC?
- Which IAC are most frequent within your sector?
- Is there a balance of IAC reporting within your sector?
    - Are there any companies in particular which are more known for their IAC reporting?
- Is there a particular sector that you believe is more exposed to IAC?
- What valuations methods do you use when incorporating IAC?
- Which sources do you use to find the relevant information regarding IAC?
- If a company reports IAC, how is your approach in order to decide what you want to adjust for?
    - Do, and how, you ask the company about it specifically?
    - What factors will influence your decision?
- How often do you do the same adjustments as the company?
- Imagine that one of the companies that you follow would report the same IAC several quarters in a row, do you have a threshold regarding frequency?
- Are you satisfied with the way companies report IAC?

Part three - conclusion

- Is there anything of particular relevance you believe we have not asked you about?
- Ask about approval for citation
- Ask if the analyst wishes to receive a copy of our finished thesis