

Analysts and earnings management - A sensemaking perspective

Insights from Swedish sell-side analysts

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Abstract

This thesis examines how analysts make sense of earnings management, a topic which previous research has largely neglected. To examine this subject, we have conducted a qualitative single-case study based on semi-structured interviews with nine analysts. We use sensemaking and sensegiving as our theoretical framework to analyze the empirical findings. With the use of these concepts, we find that while analysts do not deliberately make sense of earnings management, there is an indirect sensemaking of earnings management. This is due to analysts' aim of deriving the earnings quality. To derive the earnings quality, analysts make adjustments to certain items. The adjustments aimed at deriving earnings quality are found to also adjust for earnings management.

Keywords: Analysts, Earnings quality, Earnings management, Sensemaking, Sensegiving

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1. Introduction

1.1 Background

Earnings management is a practice that has been relevant for both researchers and companies for decades. The practice is still used by companies and has recently created scandals. For instance, Tesco, the UK's largest supermarket chain, was founded in 1919 and had grown to become an international supermarket chain. In 2013, the company reported a revenue of about 100 billion US dollars and had not reported a profit decrease for about two decades. But then the music stopped. In 2014, Tesco was found to have artificially pushed up their profits by 263 million pounds. Their pretax profits fell by 91.9 percent in the first half of 2014 (CNBC, 2014). The company's use of earnings management had proved perilous.

The Tesco story is not unique and poses serious questions concerning how such a giant company as Tesco flew under the radar. Equity research analysts, a group whose job description entails analyzing securities, had missed Tesco's earnings maneuvers entirely. These analysts are one of the premier groups in equity analysis whose recommendations move the entire market (Schlump et al., 2008). Previous research has found that these analysts function as benchmark providers and the market's expectation setters (Barker, 1998). They have also been described as becoming more influential as the importance of the capital markets grows (Kraus and Strömsten, 2012). What do these expert analysts, who are critical to the market, think of earnings management?

This study aims to answer this question by examining how sell-side analysts¹ make sense of earnings management. Previous research has examined analysts, their role in the market and their analysis to great detail. Barker (1998) and Beunza and Garud (2007) found that analysts play an important role as information intermediaries and frame-makers. This role entails analyzing available information and creating value-relevant reports and recommendations for clients. In their analysis, analysts have been shown to use different valuation models such as Discounted cash flow models and the Price/earnings multiple². While the DCF may be the primary valuation tool for many analysts, the PE multiple is still often used as a tool in the

¹ Of which equity research analysts are a part of. Hereafter referred to as analysts.

² Hereafter referred to as DCFs and PE multiple

communication with clients. Analysts have also been noted to alter their choice of valuation model after their clients' preferences (Imam et al., 2008).

Studies have also revealed that both accounting and non-accounting information are important components in the valuation of companies. However, while both accounting and non-accounting information are important, accounting information functions as an anchor by setting a constraint on which recommendations are plausible. Research has therefore paid significant attention to what type of accounting information is used. The primary measure used by analysts in valuations are earnings. More specifically, analysts aim to derive a measure of the earnings quality (Barker and Imam, 2008). This concept refers to earnings that are likely to be sustainable, repeatable or consistent (Dichev et al., 2013). To derive this measure, analysts make several adjustments to earnings. Among other things, this includes removing one-off items, gains and losses on disposals of assets and provisions for future cash flows. Another important factor in this judgment is looking at how the organic growth in the company's core operations is developing. Furthermore, non-financial information, such as quality of management and the effectiveness of the business model, have been proved to play a part in analysts' judgment of the quality of earnings (Barker and imam, 2008).

Given the analysts' apparent interest in earnings and earnings quality, there is reason to closely examine how companies may influence the earnings. Previous research has found that CFO's believe that over 20 percent of US companies engage in earnings management (Dichev and Graham, 2015). This practice can entail two different things. It can take the form of manipulation of accounting numbers but may also be real earnings management (Beneish, 2001). Real earnings management refers to the altering of underlying transactions such as cuts in discretionary spending or delaying an investment project. This has been noted as value destroying by CFOs' who, despite this belief, engage in real earnings management to a large extent (Graham et al., 2006). Several techniques have been developed to detect earnings management. However, little is known about how analysts engage with earnings management. It is to this research gap that our study contributes by examining how analysts make sense of earnings management.

1.2 Research question and purpose

The role of analysts in the market has been researched to a great extent. Some view them more as valuation benchmark providers and news filters (Barker, 1998) while others view them as frame makers (Beunza and Garud, 2007). The consensus seems to be that they function as a sort of information intermediary. Given their role in the market and their focus on earnings quality (Barker and Imam, 2008; Hjelström et al., 2014), it is relevant to consider whether or not they take earnings management into account. However, this has not been examined and presents a research gap. It is in light of this research gap that the purpose of this thesis is to examine how analysts make sense of earnings management. With respect to this, the research question is the following

How do sell-side analysts make sense of earnings management?

To obtain an understanding of this, we have conducted a qualitative investigation of how analysts make sense of earnings management. We have interviewed nine sell-side analysts from leading banks in Stockholm. By using the concepts of sensemaking and sensegiving as tools for analysis (Kraus and Strömsten, 2012; Goretzki and Messner, 2016) we found two primary contributions to the literature.

1.3 Contributions

The primary contributions of this study are twofold. Our first contribution relates to the literature on analysts' valuation process (Barker and Imam, 2008; Hjelström et al. 2014; Breton and Taffler, 2001; Imam and Barker, 2008; Demirakos, 2004). We find that due to analysts' strong focus on earnings quality, they make certain adjustments aimed at deriving the earnings quality. This in turn has the unintended effect of also adjusting for earnings management. This suggests that while there is no deliberate sensemaking of earnings management, analysts are indirectly making sense of earnings management through their adjustments.

The second contribution relates to the sensemaking literature. Previous research has found filtering, calculative reasoning and plausibilization to be three sensemaking mechanisms that professional users of financial information use to make sense of numbers from an internal perspective (Goretzki and Messner, 2016). However, we observe these concepts in a new

context where professional users of financial information made sense of numbers from an external perspective as well.

2.Theory and previous research

2.1 Analysts' role in the market

Equity research analysts are part of a larger group often referred to as sell-side analysts. These are generally seen as advisors who provide investors with information about a company, valuation-wise as well as about the company's overall situation (Hägglund, 2000, Cited in Graaf, 2021). This information takes the form of recommendations and is given to both institutional and private investors. The recommendations given by analysts are supposed to be objective, in order to provide investors with useful information (Jacob et al., 2008).

The grounded theory of the market for information theorized that the role of analysts is twofold. They work partly as a news channel whereby news is filtered and then delivered to, for instance, fund managers and partly as providers of valuation benchmarks. Fund managers thus need analysts in order to obtain some sense of the market's consensus expectations (Barker, 1998). Analysts' contribution to the market consensus expectations implies that the individual analyst's forecast is not as important (Spence et al., 2019, cited in Graaf, 2021). Research has also theorized that analysts are frame-makers who through their reports combine analogies, metrics and categories to create a calculative frame which generates the estimates needed for a valuation (Beunza and Garud, 2007). These recommendations have been shown to generate significant movements in the market. Furthermore, some of the changes in prices of stocks are shown to be permanent (Schlump et al., 2008).

Given the influential role of analysts in the market, the question of how analysts produce their recommendations becomes relevant. In order to understand the valuation process and in turn their recommendations, an examination of what information is used and how it is applied is necessary. This entails looking at what models are used and how they value different types of information.

2.2 Analysts' use of models and focal information

Analysts' analysis is based on both financial and non-financial information which are then used in a valuation model. Previous studies have found that unsophisticated valuation models such as the PE-multiple have held the position as the dominant valuation model (Barker, 1999). However, Demirakos et al. (2004) found that sophisticated valuation models have become increasingly important. Imam et al. (2008) contextualized the use of different valuation models. For instance, analysts have been shown to use the valuation method that fund managers prefer which suggests that there is a certain client-orientation in analysts' choice of valuation model. The choice of model is also influenced by a communication aspect. For example, while the DCF may serve as the primary model in valuation, the PE-multiple is often used as a communication tool in the dialogue with investors.

The application of these valuation models require input of data. Given that there is a broad supply of information available and a difference in the value-relevance of different types of information, there is an inherent need for analysts to filter and evaluate the information.

Previous research has examined how analysts relate to different types of information. Breton and Taffler (2001) found that analysts use two different types of information in their stock recommendation decision, accounting information and non-financial information. Accounting information includes measures relating to profitability and financial position while non-financial information relates to, for instance, management and strategy. They also found that while profitability is the most important accounting information, non-financial information is most important for a buy, sell or hold recommendation overall (Breton and Taffler, 2001). However, Barker and Imam (2008) viewed accounting information and non-accounting information as contributing with different perspectives to analysts' stock recommendations. In their exploration of these two perspectives, they found that accounting based information put a constraint on the possible views an analyst could express. When analysts viewed the accounting information positively, they were free to hold optimistic as well as pessimistic views on the non-accounting aspects. On the other hand, when analysts viewed the accounting information negatively, they were forced to be pessimistic overall.

The accounting based information, of which profitability is the most important according to Breton and Taffler (2001), serves as a frame wherein the non-financial information is the most significant directional factor (Barker and Imam, 2008). While Breton and Taffler (2001)

used the rather broad term profitability, other research has shown that analysts focus on earnings (Hjelström et al., 2014). In addition, financial performance is subject to judgment and can therefore be influenced by other concerns than the strict representation of financial activities. For these reasons, interest in earnings quality and earnings management has been generated.

2.3 Assessing earnings quality and earnings management

Earnings quality is a concept which has received significant attention in research given its importance for analysts, investors and other users of a company's report. Various studies have pointed to the fact that capital market actors focus on the quality of earnings (Barker and Imam, 2008; Hjelström et al., 2014). Furthermore, the extensive use of the PE-multiple reinforces the importance that analysts put on earnings quality (Demirakos et al., 2004). Despite the common use of earnings quality, there is no single, universal definition. An overview of previous research shows that most researchers relate earnings quality to earnings that are consistent, sustainable, repeatable, and reflecting long-term trends (Dichev et al., 2013). However, given the context of this study, what is most interesting is how analysts view earnings quality. Those studies that have focused more on how analysts view earnings quality suggested that analysts relate earnings quality to both financial and non-financial factors (Barker and Imam, 2008; Hjelström et al., 2014). According to Barker and Imam (2008), analysts reported that in order to derive a measure of sustainable earnings, they made adjustments to several items. This included removing one-off items, provision for future cash outflows, and gains and losses on asset disposals. Analysts also stated that the most likely source of high quality earnings was organic growth in the core business. Furthermore, the cash conversion ability of the business was an important factor in judging earnings quality. The application of consistent, conservative accounting policies was also perceived to be of importance. Finally, some analysts also viewed non-financial information as an important factor in determining earnings quality. The most important non-financial factors for judging the quality of earnings included quality of management, effectiveness of business model and willingness to disclose information (Barker and Imam, 2008).

Considering the importance of earnings to analysts, and their awareness that the quality of earnings differ, scholars have also investigated how companies manipulate their earnings. According to one study, CFOs on average believe that 20% of public companies actively

engage in earnings management for reasons such as meeting earnings expectations and influencing stock prices (Dichev et al., 2015). Similarly to earnings quality, earnings management has no single definition in the literature. While there are different definitions of earnings management, there is general agreement that it involves purposeful intervention by management to influence financial reporting (Dechow and Skinner, 2000). One definition by Schipper also highlights the distinction between manipulation of accounting numbers and timing of real investments and financing decisions (Beneish, 2001). According to Healy and Wahlen (1999), the manipulation of accounting numbers may occur in circumstances where management is able to exercise judgment in the financial reporting. This judgment can affect several items in the financial statements. This included estimations of expected lives and salvage-values of assets, losses from bad debts, capitalizations of R&D, and inventory valuation.

Unlike the manipulation of accounting numbers, which does not alter the underlying transactions, real earnings management refers to the altering of underlying transactions. Many CFOs believe that this type of earnings management can be value destroying. Despite their belief in the value destroying consequences, a significant number are willing to employ real earnings management. 80% of CFOs are willing to decrease discretionary spending and more than half would delay commencing a new project in order to meet an earnings target. This type of earnings management seems to be more frequently used than the manipulation of numbers (Graham et al., 2006). Given the extensive use of real earnings management and its value destroying consequences, there is good reason to understand how to make sense of earnings management. While researchers seem to be in agreement that it is important to understand earnings management, there is a stark division regarding how to make sense of it. Some have taken a more positive approach by viewing earnings management as a way for managers to smooth earnings which increases the informativeness of earnings. Others have viewed earnings management as a form of opportunism where managers try to transfer wealth from shareholders to themselves (Hunt et al., 1997).

Given that previous research showed that there are incentives for companies to engage in earnings management, it is relevant for analysts to understand this phenomenon as they are interested in the quality of the earnings. One way of deepening their understanding is to find ways to detect earnings management. Dichev and Graham (2015) found that practitioners and researchers looked for similar items in the financial statements when they tried to detect

companies that engage in earnings management. The consensus seemed to be that earnings management shows in the financial statements through weak correlation between accounting earnings and cash flows, unusual deviations from industry norms, consistently being in line with analysts' forecasts, large one time or special items, build up of inventory and receivables and frequent changes in accounting policies. According to Beneish (2001), researchers have, through statistical models, used different approaches to estimate earnings management. While these models have been criticized for their poor ability to detect earnings management, nevertheless, this points to the ability to identify earnings management. The question is thus if analysts are paying attention to earnings management, what they direct their attention to and how they interpret the possible occurrence of earnings management.

2.4 Summary of previous research

In summary, previous literature has shown that analysts play an important role in the information flow in the stock market. To perform their work as information intermediaries and framemakers, analysts need to consult a wide range of information. Among this information, accounting numbers have been found to be very important in their work. Previous studies have found that analysts are aware that accounting information has limitations and contains more than just the number itself, specifically earnings. Due to this, analysts usually make adjustments to derive a measure of earnings that reflect the core operations of the company. The purpose of these adjustments is to better assess the quality of earnings. Research has also shown that it is possible that many companies engage in earnings management. However, relatively less is known of analysts' specific engagement with the known practice of earnings management. The purpose of this study is to address this gap.

2.5 Theoretical framework

To analyze how analysts interpret earnings management we used the theories of sensemaking and sensegiving. These concepts are well established perspectives in the accounting literature, and have been used for different purposes and in different contexts. Much of the accounting research that has used sensemaking and sensegiving to analyze specific contexts, has to a large extent focused on organizations, and how accounting numbers influence their decision making regarding strategic issues (Kraus and Strömsten, 2012; Goretzki and Messner, 2016). Although the context of our study differs from previous accounting research, there are still certain similarities that make sensemaking and sensegiving relevant to

understanding our phenomena. Similarly to previous studies, we used these concepts to analyze people who work in a professional setting with understanding and communicating numbers to others. In addition, previous studies have investigated how accounting information is being used to make decisions. In a similar way, financial analysts used accounting numbers to make valuation of companies which in turn is used to give recommendations to clients. Our study is therefore based on sensemaking and sensegiving of accounting information from the external perspective of analysts.

Sensemaking has been described as a process of meaning creation through which actors “*create rational accounts about the world that enables action*” (Maitlis, 2005, p.21, cited in Goretzki and Messner, 2016, p.95). An intensification of sensemaking can occur in situations where organizational actors are confronted with ambiguity and uncertainty, which is usually triggered by information that is perceived as difficult to comprehend. Uncertainty means that there is a lack of information whereas ambiguity refers to available information being confusing. The sensemaking process that is used to deal with ambiguity and uncertainty can take place both individually and collectively. Sensemaking is an inherently social process, thus, it can take place on an individual and group-level. Since individuals tend to anticipate the views of others, the individual sensemaking will be impacted by the anticipated views of other people even if they are not present in the immediate process (Weick, 1995, cited in Goretzki and Messner, 2016).

As previously stated, sensemaking in relation to accounting information has been studied in different contexts. Research has generated different conclusions regarding if accounting information facilitates the sensemaking process, or whether it increases ambiguity. Some research has indicated that accounting information can be an important input in the sensemaking process due to its formal presentation of numbers. It can provide a common language for understanding complex situations which in turn facilitates the initial stages of the sensemaking process (Boland and Pondy, 1983). Furthermore, studies have shown that numbers are easier to analyze compared to qualitative information (Tillmann and Goddard, 2008, cited in Kraus and Strömsten, 2012), and that accounting numbers in particular can be a good source to reduce ambiguity (Kraus and Strömsten, 2012). On the contrary, other research has suggested that when presented numbers provide conflicting information about the same object, ambiguity may actually increase (Goretzki and Messner, 2016).

Accounting research has not only investigated if accounting information facilitated sensemaking or if it increased ambiguity. Studies have also investigated how the actual sensemaking process evolves and what mechanisms are present. Goretzki and Messner (2016) observed in their study that actors primarily employ three sensemaking mechanisms. One of these observed sensemaking mechanisms was called filtering. Filtering in this context was observed as a deliberate act to reduce the amount of information that calls for sensemaking. This allowed actors to focus energy on those issues that are perceived as most important at the moment. Analysts have access to an almost infinite amount of information when making valuations. This suggests that analysts are required to filter the available information.

Another observed sensemaking mechanism was “*calculative reasoning*” which refers to a process where “*one group of numbers that provides information about an object can be used to challenge the plausibility of another group of numbers that refers to the same object*” (Goretzki and Messner, 2016, p.106). The challenging of the numbers can be done by observing that there are large differences between the numbers referring to the same object. Given that analysts make forecasts of company earnings which can differ significantly from reported earnings, it is plausible that some form of calculative reasoning is present in their sensemaking process when they make valuations.

The third sensemaking mechanism observed in Goretzki and Messner’s (2016) study was “*plausibilization*”, a process where numbers are being judged by actors. The purpose is to judge whether the numbers are plausible, in order to move on, despite still being uncertain about the future. According to Weick 1995 (Cited in Goretzki and Messner, 2016), it is more common among managers to seek out plausible explanations rather than true or accurate ones. Given the focus that analysts have placed on assessing earnings quality, there is a need to judge which items accurately reflect the sustainable earnings. For instance, one-off items are sometimes excluded by analysts which suggests that there is some sort of judgment taking place. These three mechanisms, calculative reasoning, plausibilization and filtering, are important in understanding how actors make sense of accounting information.

Prior research has described sensegiving as “*the process of attempting to influence the sensemaking and meaning construction of others*” (Gio and Chittipeddi, 1991, p.442, cited in Kraus and Strömsten, 2012, p.189). Sensegiving can take the form of expressing an opinion

or explaining a situation (Matilis, 2005, cited in Kraus and Strömsten, 2012). In the context of this study, what is interesting to examine is analysts' sensegiving of information to other actors such as investors. As with sensemaking, it is plausible to assume that the sensegiving of analysts is shaped by their role-situated commitment. Role-situated commitment means that individuals will perform tasks and engage in activities that they perceive to be part of their professional role (Conrelissen, 2012, cited in Goretzki and Messner, 2016). For analysts, part of their work is in a highly client-facing environment, which suggests that they are sensitive to the needs and expectations of their recipient audience.

3. Method

3.1 Research design

To provide a deeper understanding of earnings management, this study builds on a qualitative case study methodology. Given that the research question aims to explore how analysts as a profession make sense of earnings management, a case study is appropriate. The chosen format allowed the study to gain perspectives from different analysts which together form part of a community's practice. Case studies are suited to answer how and why questions which is appropriate given our research question (Yin, 1989, cited in Cooper and Morgan, 2008).

Given the limited time and resources that constrained the scope of the study, some delimitations had to be made. First and foremost, we limited ourselves to analysts as these are the primary information mediaries in the stock market. Other actors, such as auditors, investment banking analysts or consultants could possibly also have interesting insights regarding earnings management. However, seeing the limited time, we thought it most effective to examine the profession we believed had the greatest impact on the stock price. We also limited the study to analysts based in Stockholm as we wanted, to the extent possible, to meet with the analysts live. Optimally, we would also have wanted to do a content analysis of analysts' reports and contrast this with the findings from interviews, however, this was not possible given the time constraint.

As noted in the literature review, previous research has focused on how analysts relate to earnings, what earnings management is and how to interpret it, and how models are used to

detect earnings management. There is thus a research gap as to how analysts make sense of earnings management in practice. Given this already existing theoretical knowledge, the study was approached abductively. According to Lukka and Modell (2010), this means that our analysis of the empirical findings related back to ideas and theories of previous research. However, the starting point for the analysis is the empirical findings with the known theoretical knowledge providing a basis in the search for plausible explanations.

The interviews in our study were of a semi-structured nature. To make sure that certain predetermined issues and questions were explored, we had prepared an interview guide (See appendix). Given the semi-structured nature of the interviews, follow-up questions were also a crucial part of the interviews as this enabled both clarifications and deep dives in interesting subjects. The primary advantage of semi-structured interviews is that they allow the interviewees to freely express their views and opinions on certain predetermined issues. Furthermore, discussion between interviewer and interviewee opens the possibility for interviewees to be “*stimulated to articulate and make explicit vague feelings and views they had not previously formulated at a conscious level*” (Hayes, 2018, p.144).

One risk of using interviews is that bias may influence the way the interviewers organize topics and formulate questions (Hayes, 2018). We therefore avoided leading questions that could signal a desired response. Another risk of interviews is that answers might become a lot about the opinion and not about, for instance, concrete examples. To deal with this, we tried to ask interviewees if they could elaborate on answers which many times made interviewees answer with a concrete example. A risk of semi-structured interviews is that it can be hard to notice interesting underlying topics during the interview. To mitigate this risk, we ensured that both of us were present at all interviews which helped to see the interesting topics as we touched upon them. In addition, we also divided the responsibilities during the interviews. One of us was responsible for asking the questions and the other one was responsible, to a larger extent, for follow-up questions. It allowed us to explore paths that prior research had not guided us into. Furthermore, as we conducted the interviews we noticed that certain interesting topics, outside of our interview guide, resurfaced several times which made us bring those topics up in other interviews. These precautions allowed us to reap the benefits of our chosen format.

3.2 Data Collection

Our empirics were collected from interviews with analysts based in Stockholm. A total of 31 analysts were contacted via email and 13 responded indicating interest. Ultimately, nine interviews were conducted with an average duration of 45 minutes. Due to the timing of the remaining four, these were excluded from the study. We targeted analysts from leading banks in Sweden. This was due to evidence that an important factor in the quality of analysts' reports is the size of the brokerage house at which they work (Hussain, 2002, cited in Barker and Imam, 2008). Within these banks, we looked for analysts with several years of experience in the profession. This was because we believed that experienced analysts would have deeper and more nuanced knowledge of the topic at hand. In many cases, the contacted analysts had studied at the Stockholm School of Economics. This proved to be a useful tactic to enroll potential interviewees because of their willingness to accept students from their alma mater. One potential consequence is that the individuals interviewed share similar educational backgrounds and therefore share views about earnings management. However, only three out of nine interviewees were from the Stockholm School of economics which suggests that this was not a problem.

Table 1. *Interviews held for the study*

<i>Interviewee</i>	<i>Place</i>	<i>Bank</i>	<i>Number of years</i>	<i>Date</i>
Arne	Office	A	>10	2022-10-14
Gunnel	Online	A	<5	2022-10-24
Gunnar	Office	B	>5	2022-10-14
Leif	Office	B	>10	2022-10-14
Stig	Online	C	<5	2022-10-17
Birgitta	Online	D	>5	2022-10-18
Hubert	Office	D	>15	2022-10-24
Thorsten	Office	E	>5	2022-10-24
Per	Online	F	>10	2022-10-24

Supplement questions asked over phone

The respondents had the opportunity to choose between live or online interviews. Out of nine interviews, four took place online on zoom, and the other five at their offices. This was done in order to make the interviewees feel comfortable during the interviews. Furthermore, all participants were assured of anonymity in the presentation of their responses to make sure that they were free to express their honest opinions and thoughts. We therefore created pseudonyms for all analysts (See table 1). We also avoided stating the exact research question before the interviews in order to make sure that their answers were not biased. Furthermore, we tried to not let our research question be too obvious in the interviews themselves.

3.3 Data Analysis

All interviews except one were audio recorded and transcribed shortly after. In one case detailed notes were taken as permission to record was not granted. The transcribed material was reviewed and analyzed with the use of the theoretical framework. This allowed for relevant information to be identified and coded which helped to categorize the data. This type of categorization allowed for an efficient presentation of the data (Bell et al, 2019). To establish a connection between data and theory coding was used as it aids a more organized style of analysis (Bansal and Corely, 2011). The interviews were conducted in Swedish as this was the preferred language of the analysts. The quotes selected to be in the study were all translated into English. This presented some linguistic barriers as the translations, potentially, could alter the meaning of the quotes. To make sure that the translation accurately reflected the intended response of the participant, we contacted interviewees where further clarification was needed. No major changes were needed, though two negligible changes were made.

4. Empirical Findings

4.1 Trust in numbers

A recurring theme in the interviews has been that analysts place a great deal of emphasis on numbers in their analysis. Analysts considered good numbers as a baseline requirement for even considering taking up coverage of a company. Arne expressed this view followingly *“You could say that if the numbers don't look interesting, it is not a company I'll cover”*. Multiple analysts would even consider taking up coverage of a company with a management considered unskilled, if the numbers looked good. In a similar fashion, once analysts have

taken up coverage of a company, numbers remain the main source of information in their analysis. This relationship applies regardless of whether the analyst is more oriented towards financial or non-financial information. For example Stig, who described himself as a “*numbers guy*”, explained that it was natural for him to always start from the numbers. He believed that numbers were the best way to get a neutral and objective picture of a company. Similarly, Leif, who described himself as being more oriented towards non-financial information, nevertheless claimed that “*if the numbers don't match what management says, I'd look at the numbers*”. Most analysts agreed with these opinions and explained that numbers are more difficult to manipulate compared to non-financial information. For that reason, numbers are considered the most trustworthy source of information as a starting point in analysts' work.

A general view was that “*the best information is found in the companies own financial reports*”(Gunnar). Financial reports are used among all analysts to evaluate a company's performance and derive estimates of future earnings. While there was some importance attributed to the balance sheet and cash flow statement, most analysts turned to the income statement in their analysis. The focus on profit turned out to differ, some focusing primarily on EBITDA while others find EBIT most relevant. It was not common among the analysts to focus on the bottom line. The reason why analysts focused on different profit items was mainly because they cover different industries, which according to them made it more important to look at a specific line of profit. However, what all analysts had in common in their approach to the income statement, was that they tried to establish how much of the earnings in a given period were generated from the underlying business. As Arne put it, “*you want to understand whether the underlying business is performing well or not*”. Several analysts elaborated on this statement and explained that companies usually provide some form of adjusted earnings in their financial reports. These were used as a starting point in order to understand how the underlying business has performed. However, most analysts still considered it necessary to derive their own estimates of earnings. Stig said the following: “*the company's adjusted EBITDA may not be my adjusted EBITDA [...] you need to make your own adjustments*”. The reason behind this was that they considered companies to be biased when making adjustments to earnings. Leif reasoned in the following way, “*companies can make whatever adjustments they want after they have reported the actual numbers to the auditor*”. He continued the discussion by highlighting that companies sometimes make strange adjustments to earnings, which in his opinion make them unusable for valuation

purposes. Most of the analysts agreed with Leif and Stig's opinion and explained that the earnings they use as inputs in their financial models, usually differ from the earnings that companies report in their financial statements. When analysts used earnings as inputs in their financial models, they wanted to make sure that the earnings reflect the actual performance of a company in a given period. For this reason, all analysts made their own adjustments to earnings. The adjustments originate from a careful analysis of the financial statements.

4.2 Improving the numbers

As stated in the previous section, analysts make adjustments to earnings in order to derive a true measure of how the underlying business is performing. The purpose of understanding the performance of the underlying business, is to estimate what level of earnings will be sustainable in the future. As noted by several analysts, not all earnings are considered to be of the same quality. Thorsten explained that *"High quality earnings mean that the level of earnings in one period will be repeated in future periods"*. To understand if earnings are of high quality, all analysts engage in some form of detective work which ultimately results in adjustments.

4.2.1 Adjustments for one-off items and temporary effects

Interviews revealed that the most common adjustment made by analysts related to one-off items. The majority agreed that some companies treat certain things as one-off items even though they have been recurring for several years. Per stated the following, *"it is not unusual for companies to put a lot of things in one-off items"*. Furthermore, multiple analysts highlighted that one-off items are more often used for events that impact earnings negatively than for events that temporarily increase the earnings. For this reason, several analysts considered it to be important to always examine whether the one-off items should be considered as non-recurring or not. However, it was noted that this examination of one-off items can be very difficult since there in many cases is not much information about what they include. There were different methods for analyzing one-off items when information was perceived as insufficient. The most common method for analyzing one-off items was to compare the present period with the company's historical treatment of one-off items. If it turned out that a company has had one-off items for several years, most analysts included them in their valuation. Hubert explained that the market sooner or later discovers when

companies misbehave with one-off items. His reasoning, which is nearly identical to that of other analysts, is as follows:

“If the company is of such nature that they almost always have extraordinary costs, then these costs are not removed. If one-off items are recurring, they may not be extraordinary and you have to take that into account in your forecasts. If this is not the case, they can be removed to a greater extent.”

Similarly to one-off items, though not mentioned to the same extent, analysts made several adjustments relating to temporary effects. Earnings that had been affected by temporary effects were not considered to be part of the long term sustainable earnings, and were therefore excluded or adjusted for in the analysts' valuations. An example of temporary effects that was brought up by a few analysts was currency effects. Per explained that *“if topline growth has been strong in one period as a result of currency effects”*, he would adjust for that in order to derive the underlying performance of the company. Similarly to Per, all other analysts that mentioned currency effects would make adjustments to these effects. Arne elaborated on Per's statement and highlighted that companies sometimes try to portray their growth as organic, whereas in fact, the growth is derived from currency effects. His opinion regarding this is as follows:

“For example, an acquiring company that has a lot of positive FX and top line growth one quarter highlights their organic growth. The next quarter their organic growth is negative but they have positive FX effects so their total growth is 20%. Then they just highlight that they have grown by 20%. I think that looks really bad, but it happens”

Thorsten gave another example of temporary effects that can impact earnings. He explained that several companies have increased their earnings a lot in recent times. However, at a time of high inflation, he is skeptical about how much of these earnings increases are due to volumes, and how much is driven by rising prices in the economy. Thorsten noted that it can be difficult for analysts to discern how much of the revenue is driven by organic growth, since companies do not always report volumes. His opinion was that *“it is hard to just look at numbers and say this is what's happened”*. As a result, analysts become forced to make judgments about organic growth based on the additional information that management wants to share. In addition to inflation, a few analysts discussed how some industries have benefited

greatly from the recent market fluctuations, implying that part of these earnings will not be sustainable. Thorsten highlighted the banking industry and explained the following:

“Banks are a good example, if a bank reports a strong commission income figure, it matters much less, you will extrapolate that improvement to a much smaller extent than if the bank had reported a very strong net interest income, which is high quality earnings. The probability is greater that it will lead to increased income in the future. While commission income does not lead to that.”

Another example of an activity considered to be a temporary effect was the recognition of accounts receivables. Stig explained that many software companies have recently begun to build up large amounts of accounts receivables on their balance sheets. He believed that they have become more aggressive in their revenue recognition compared to before, and it is not clear to him for how long it will continue. Stig explained that he monitors the development among these software companies carefully, since it can be the case that they have overestimated the topline. If he is right, it would mean that multiple adjustments should be made to the companies that he is covering. He expressed himself in the following way:

“Many software companies right now have started to build up a lot of accounts receivables [...] It can be the case that they have booked more revenue than they should because they might not actually get paid for it [...] then you find yourself in a situation where you have overestimated the topline. So you have to be careful about these movements on the balance sheet. Mainly accounts receivables perhaps”

4.2.2 Adjustments for discretionary spending and investments

Opinions regarding the analysis and adjustments for discretionary spending differed significantly among analysts. For example, Thorsten argued that there was *“little transparency on what costs companies actually have”*. His argument was that it is not possible to make an analysis and adjustments for expenditures when there is no information available about the specific expenses. To get more detailed information, the only option is to talk to the management. He notes that the credibility of the additional information provided by management comes down to how honest he judges them to be. In contrast to Thorsten, others argued that it is possible to discern if companies are cutting down more than they should on expenditures. For example, Hubert explained that it is in fact possible to make an analysis of how much a company should spend to maintain its position on the market. If he

judged a company to spend less than they should, he will factor that into his valuation. He expressed himself in the following way:

“If they spend less right now, you have to factor that into your forecasts, it’s not more difficult than that”

Stig agreed with Hubert and suggested that if companies cut down on discretionary expenses that are of importance for the company’s business, it will show in their results. He elaborated further on this by explaining that the possibility to cut down on discretionary expenses differs significantly between companies and industries. He gave an example relating to marketing expenditures:

“Coca-cola does not know which marketing dollars beat Pepsi, they must always compete with Pepsi in every thing there is. It is not possible for them to cut marketing expenditures then. In some cases, such as business to business companies, marketing expenditures may not be that important”.

The other analysts did not seem to have as clear a position on discretionary expenditures as Thorsten, Hubert and Stig. Most analysts gave some examples of discretionary spending that are of importance for the industry that they are covering. However, no further explanation of whether it is possible to analyze or integrate discretionary spending into the valuation was given. Per’s statement is a typical example of how the answers and reasoning in general sounded:

“I know it is common in the construction industry, it is a bit unclear how they do it though, there are a few different ways that they can adjust their costs to make it look more stable than what it actually is”

Opinions about discretionary spending clearly differed among analysts, however, something that they all agreed on was the importance of analyzing investment levels. Several analysts highlighted that it is easy to observe if companies start to reduce their investment level. Hubert said the following, *“You have to keep an eye on CapEx, what is the underlying level of investment required to maintain this business?”*. Similar to Hubert, many analysts noted that the investment analysis primarily is an analysis of CapEx and depreciation. Gunnel explained it as follows, *“What will eventually happen is that the depreciation will decrease if they don’t invest, if this is judged to be harmful to the company it must be included in the valuation”*. In

addition to examining the level of investments made by a company, analysts also looked at what kind of quality the investments had in terms of potential return. If the quality of an investment is judged to be poor, analysts will adjust for it. Gunnar's statement summarized the general discussion well:

"I look a lot at investment forecasts, what kind of return will they have on the capital, what do they expect the return on the capital to be? These are key factors if the company is to be assessed in the long term"

While there was quite a divide between analysts concerning how to deal with cuts in discretionary spending, analysts were predominantly in agreement regarding how to analyze investment levels. The following section presents findings regarding how analysts' deal with deviations.

4.2.3 Adjustments for deviations and comparability

Interviews showed that internal and external benchmarking make up a major part of analysts' work. The purpose of making comparisons was to get a better understanding of how a company has developed over time, both in relation to its own history and compared to competitors. Benchmarking analysis looked similar among the analysts. Most of them explained that they have a template of key ratios that they look at when a new report is released. This allows them to quickly form an opinion about the result and if other key ratios are in line with their estimates. Gunnel explained it like this:

"You check if there is something that deviates from your own estimates or the consensus [...] you usually know exactly which items to look at when a report comes out"

Similarly to Gunnel, most analysts explained that they have a selection of items that they regularly follow and analyze. When analysts encounter deviations from previous trends or their estimates, the first step for them is to understand what has happened and why. What is key according to Hubert, and several other analysts, is to "*understand if it is a temporary or structural cause*" that has created the deviation. Leif argued that the market usually sees through if a company comes with a temporarily higher profit and followingly adjusts for it. However, multiple analysts highlighted that deviations in profits and other items do not always occur because of changes in the company's performance or environment. In some

cases the profit might deviate significantly because of changes to accounting standards and methods. Some changes are voluntary, and others are imposed by regulators. In either case, most analysts consider it to be problematic when it happens, as the historical numbers no longer are useful for comparison. Per's comment on changes to accounting methods summarizes the general view well:

“Changes to accounting methods are extremely annoying because we build models on historical data and then all of a sudden all the historical data can just be thrown in the trash [...] it gets quite messy and difficult to compare”

Gunnar gave a concrete example on Per's statement and explained that a company he has followed for a very long time, recently changed its reporting regarding different segments. As a result of this, it was no longer possible for him to follow-up on the development of the different segments. He highlighted that it is necessary to be observant when this happens as it can mean certain things.

“Changes to accounting principles can be a way of hiding really bad numbers in some former segment that is now being absorbed into a larger business that is doing okay [...] Then you will not see that this segment that they used to report is going really badly”

He concluded the discussion by saying that a credible story must be told about why a company makes changes to segment reporting, otherwise it will look suspicious to him. Other examples of changed accounting principles that have created problems for the analysts were changes to depreciation method, valuation of inventory, IFRS 16, and reporting of volumes. All analysts agreed that these changes must always be quantified in some way, otherwise their analysis would be incomplete. Stig's opinion is representable for most analysts,

“If a company voluntarily changes from LIFO to FIFO, they must explain what the effect was, and then you have to adjust for it. Some kind of effect must be quantified [...] it is not serious if a company changes its accounting method frequently”

Although the analysts' were clear about preferring comparable numbers and consistent accounting methods over time, there was no great distrust against companies that make voluntary changes to their accounting methods. The majority believed that companies make

changes because they want to improve the quality of the information that they provide. Hubert and Per's statement is representable for most analysts:

"I think the transparency has gradually improved from the companies in general"
(Hubert). *"My view is that companies do it out of goodwill, because they believe it is
a better way to report numbers"* (Per)

Hubert summarized the discussion by pointing out that nothing should happen to the company's real value just because they change accounting methods. According to him, it would perhaps have been good if companies made more use of accounting to smooth out their profits in volatile sectors. Hubert reasoned in the following way,

*"Some industries have large variances in volumes. Then it might be reasonable if they
had periodized it more evenly, even in terms of costs [...] one might then have been
able to show an underlying trend rather than the large deviations that exist right now,
but I am not sure"*

4.3 Contextualizing the numbers

There was a common thought among analysts that numbers and adjustments are at the core of the valuation process. However, as described in previous sections, sometimes the numbers are too limited to provide analysts with the information that they need to make an in-depth analysis of a company. When the numbers can no longer support the analysis, analysts turn to management and their own expertise to contextualize and nuance the numbers.

The majority of analysts pointed to their level of confidence in management as an important component in the contextualization process. A strong confidence in management was generally seen as a reason to believe a company's explanation as to why a certain period did not go as planned. Stig argued that a management with a history of good performance can be a reason to believe in the company despite a period of poor performance. On a similar note, Thorsten explained that management's guidance was an influential factor in his own analysis as it can give him a clue of how the company will perform in the future. In addition, a management which succeeded in selling their story might even convince him to adjust what he used as input in his valuation model. He reasoned as follows,

“It is of course the case that it is important for management to sell a credible story. If they succeed in that, then perhaps you give them the benefit of the doubt and actually have in your estimates that they succeed in improving their margins, or that they succeed in buying things cheaper than what other players can do”

Thorsten noted that as an analyst there will always be blindspots in the information. This makes it vital to use management as an information source to fill in the gaps and contextualize the information. What he also noted was that the ability of an analyst to contextualize information is highly dependent on their experience. Analysts that have worked in the industry for a long time are perceived to be better equipped to judge whether a company's management is a good fit for the organization. The assessment is usually based on different criteria such as management's previous experience of leading companies, what their plans for the future are, and if they are known for delivering on promises. Gunnell's statement reflected the general view,

“Experience plays a big role in gaining an understanding of how management runs the company [...] and whether their strategy or vision seems suitable for the future”

Furthermore, one analyst pointed out that *“experience means that you can ask management better questions relating to the company's future performance”*. This statement was a general view among the analysts, they all regarded the quality of questions as dependent on experience. However, one experienced analyst highlighted that being able to ask good questions was not an advantage in itself since everyone has access to the answers:

“After all, most analysts listen to conference calls, [...] it's not like I can prepare a lot of well-thought-out questions for management that only I personally get the answers to” - Thorsten

Experienced analysts were also perceived to be better at interpreting what management is trying to communicate to the external market. *“An experienced analyst can tell the difference if management is very optimistic and confident in what they say or if there is some hesitation in their statements” (Per)*. Experience also increased an analyst's chances of picking up things during conference-calls that were possibly not intended to be discussed. Being able to understand when this happens requires experience according to several analysts. Per summarized it well:

“Experience is a big thing [...] you recognize situations in a completely different way [...]. Having followed a company and knowing the management makes it easier to read between the lines, understand their body language and feel the mood”

Among our interviewees, experience was highlighted as something important and advantageous. However, one analyst that has worked in the industry for over 15 years questioned how useful experience is for the market in general. He explained that most senior analysts tend to have similar share price estimates, and that analysts seldom deviate from these estimates. He expressed himself in the following way:

“ You are not as unique as you think. When you have calculated your estimate, you quickly realize that you are usually on consensus. I'm not saying it's always like that, but it's quite often that we all have the same reality and access to the same information - that someone has a completely different view is not common, but it can happen ” - Arne

Thorsten further elaborated on this and explained that analysts generally fear coming with deviating predictions. *“If you were to come to a conclusion that deviates significantly from the rest of the market, you would just look stupid”*. This is further supported by Gunnar who recalled one colleague who came with significantly deviating estimates several times many years ago. He concluded the discussion by explaining that this analyst is no longer working in the industry.

4.4 Considering the client

The last theme of the empirical findings that was identified as a critical component in analysts work was their client focus. Analysts considered what their clients want at different stages of the valuation process and attributed some importance to it. For instance, if they were considering taking up coverage on a company, they generally considered if this would be interesting for their clients. If the company was not going to be interesting for clients, it was not interesting for analysts. This was considered particularly important when analysts were considering taking up coverage of a small company. Arne noted that:

“If you are going to start covering a small company, for it to be worth covering it must be potentially interesting and above all potentially interesting as a buy case.

Because it's no idea to come out with a small share and say sell, everyone will just say okay then I won't buy it and then I don't have to meet you".

Thus, he was geared towards choosing companies where buy recommendations are plausible as this was more interesting for clients. Leif explained that the client-focus was present in the actual valuation and recommendation setting as well. He stated that if his valuation was 50% higher than the current price of the stock, he would be hesitant to actually put this in his report even if it was well supported by his analysis. Leif pointed out that while he may believe in this valuation, he was worried that investors would question his valuation. He would therefore put in a lower valuation, though higher than the current stock price, to hedge himself. Per voiced a similar thought, *"None of our customers are willing to pay for you to sit and shout about your DCF model and what value it points to"*. He explained that clients are not interested in if multiples or a DCF is used but rather in what factors will drive potential valuation changes. Arne had a similar line of thought. Models are used in the communication as they represent the quantitative part that provides support to the case. However, he believed that in order to build a successful equity case, quantitative models are not enough. He thought that analysts need to create a story surrounding the stock. Something that made other humans want the stock. He finished this reasoning followingly *"If you only have a numbers story and no meat on it, you won't get far"*.

5. Analysis

5.1 Sensemaking

5.1.1 Filtering

We found that analysts focused their attention on certain things that were regarded as most important for their analysis. The reason for filtering the information was that analysts could not absorb all the available information about a company. Much of the information that analysts deliberately choose to focus on had similarities with previous research that has shown that analysts are interested in specific things when doing valuations. For instance, we found that the first step in the valuation process was to start the analysis by focusing on the numbers, more specifically the income statement. Similarly to previous research (Barker and Imam, 2008; Hjelström et al. 2014), when analyzing the income statement, analysts found

earnings to be of great importance. The purpose of focusing on earnings was to establish the quality of them and derive a measure of the performance of the underlying business. In order to do this, analysts judged it to be necessary to make adjustments to earnings. Several of these adjustments coincide with what Dichev and Graham (2015) found to be areas where earnings management can be exercised by companies, which suggest that analysts unconsciously try to adjust for potential earnings management.

5.1.2 Calculative reasoning

Our findings showed that analysts frequently engage in calculative reasoning when making adjustments to different items. Similarly to previous research, although in a different context, calculative reasoning was used by analysts as a tool to question the numbers and point their attention to items that were perceived as not making sense (Goretzki and Messner, 2016). For instance, several analysts explained that the most common way to deal with one-off items was to compare the present period's figures with the historical figures. If the historical numbers happened to deviate from the present period, analysts would try to make an investigation of why that is the case. The level of effort put into understanding deviations depended on how large the variances were between present and historical numbers. As the information about one-off items often is limited, calculative reasoning was the only method analysts could use to make sense of one-off items. This provides nuance to previous research (Barker and Imam, 2008; Hjelström et al., 2014) as we find not only that there is a judgment process before excluding or including one-off items but also what that process looks like. Overall, these findings suggest that analysts will have a hard time detecting companies that are in the initial stage of misbehaving with one-off items, as there will be limited historical data to compare with.

Another finding from the interviews was that calculative reasoning played an important role in analysts' work when companies made changes to their accounting methods. All analysts emphasized the importance of comparable numbers as they to a large extent build their models and analysis on historical data. Followingly, if a company would report a significantly deviating profit number as a result of changed accounting methods, analysts would make sure to quantify the effect in order to maintain comparable numbers over time. In those cases where it is not possible to quantify the effect, such as when companies stop reporting certain segments, calculative reasoning still provides information as it creates awareness. For

example, one analyst pointed out that even though everything can not be quantified perfectly, being aware of and detecting changes to accounting methods is a source in itself. It can reduce questions that have occurred regarding the result and provide explanations as to why the results differ. By focusing on comparable numbers over time, analysts ensured that they detect when results differ due to both company performance and changes in accounting methods.

For some analysts, calculative reasoning also played a significant role in the analysis of discretionary spending levels. These analysts believed that the appropriate way of analyzing cuts in discretionary spending is to benchmark the company's current spending with what they need to spend in order to maintain their market position. If they judged that a company was spending too little on discretionary expenditures such as marketing, then they would adjust for this in their valuation. This benchmarking method is a clear element of calculative reasoning. A similar example of where calculative reasoning took place is when analysts consider investments levels. Analysts used both capital expenditures and depreciation to determine the adequate level of investment for a company. The aim of this is, just as with discretionary spending, to establish the investment level needed to maintain market position. If an analyst observed that depreciation charges were too low, this could be judged as harmful for the company and would affect the valuation.

5.1.3 Plausibilization

Interviews showed that plausibilization was an integral part in analysts assessment of the financial statements. Once an analyst had filtered the information and used calculative reasoning to question the numbers, the final step for them was to assess if there were plausible explanations to any deviating numbers. The reason analysts deemed it necessary to find a plausible explanation to deviating numbers, was because they judged deviations to have a large impact on their estimates of sustainable earnings. As a few analysts explained, one-off items have to be carefully examined and a reasonable conclusion about the probability of them occurring in future periods need to be made. Otherwise, the estimated future earnings may be wrong. Several examples emerged during the interviews of how the plausibilization process works.

One analyst highlighted that he had discovered tech companies becoming more aggressive in their revenue recognition. To understand if the increased revenue in the sector actually seemed reasonable, the analyst would consult several sources of information. Some examples being historical numbers, market trends and demand. The adjustment of revenue was thus based on an assumption derived from historical and current numbers. The analyst noted that the adjustment can not be perfect, but that he had to draw some conclusion about how much of the increase in trade receivables will be recognised as bad debt. Adjusting for short lived outliers was perceived by analysts as a critical part of doing their job properly. These findings show that numbers served as a framework for coming up with plausible explanations about the increased revenue recognition in the sector. It also helped the analyst to carry on with his valuation despite being uncertain if his adjustment is correct. This provides support to previous research (Goretzki and Messner, 2016), as it showed that professional users of financial information make use of numbers to derive plausible explanations, rather than accurate ones.

Analysts engaged in a similar plausibilization process when dealing with discretionary expenses, investments, and changes to accounting methods. However, it is not always the case that the numbers can reduce ambiguity and uncertainty to a level where it is possible to draw a plausible conclusion. For example, one analyst explained that some companies stop reporting numbers about certain segments. In such situations, it is not possible to consult historical or current figures to draw plausible conclusions. The only option analysts had in such situations was to turn to management for more information. Several analysts noted that the credibility of additional information provided by management was based on how honest they have been in the past and whether they are known for delivering on promises. It is against these criteria that any information or explanations from management is judged as plausible or not. A management with poor credibility and performance is unlikely to provide any plausible explanations according to analysts. This suggests that when previous numbers no longer can be compared with current numbers, uncertainty increases. In addition, if management is perceived as uncredible, the information which they provide might increase analysts' ambiguity since they do not know what to do with the information. The findings regarding analysts' use of numbers provides nuance to previous research (Goretzki and Messner; Kraus and Strömsten), since the results show that financial numbers can both increase and decrease ambiguity among analysts depending on context. The study also

confirms previous research (Barker and Imam, 2008; Breton and Taffler, 2001) as it shows that management affects the analysis of numbers.

5.2 Sensegiving

An inherent part of analysts' work is sensegiving. Everything analysts do; analyzing numbers, adjustments, talking to management, is aimed at producing a recommendation. Their goal with the entire valuation process is to give an opinion on a security and present it to clients. Several analysts highlighted that in order to create a successful case, the client's preferences must be taken into account.

One analyst noted there is a client focus in regards to what stocks he will cover and how he will present cases. That there exists a client orientation in analysts' work is in line with previous research (Imam and Barker, 2008). However, given that our findings showed that client focus plays a role in the selection of which stocks to cover, we find that client focus is more important than what previous research suggests. Adding to the importance of client focus is the fact that it influences analysts to favor buy recommendations. This bias towards buy recommendations could be stemming from their role-situated commitment as they are aware that they need to produce interesting cases for clients. It is plausible that they therefore view most information in a positive light. However, the reverse effect is also possible. If analysts valued a company too highly, they would hedge themselves as they did not want clients doubting their work. Thus, the client focus can work both ways and will affect the sensegiving of analysts in different ways depending on the situation.

Our findings also provide nuance to previous research (Barker, 1998) as our results revealed that while valuations are important to clients, many clients also seem to be interested in the factors that will actually drive a revaluation. This suggests that analysts also provide clients with the factors that are important for producing estimates and valuations. This would indicate that our findings support Beunza and Garud's (2007) finding that analysts create calculative frames wherefrom estimates may be generated. Another part of analysts' sensegiving is the "story" they create to make the stock more attractive to clients. The quantitative part is a vital component of the recommendation but perhaps even more important is how analysts portray the stock. One analyst noted that it was of great importance

to create a desire among his clients to want the stock. He emphasized that there is more to a recommendation than just presenting a valuation backed up by numbers.

5.3 Making sense of earnings management

In this study, we found that analysts do not deliberately pay attention to earnings management. There seems to be little, or none at all, effort spent on detecting whether a company makes use of earnings management. However, we find that analysts indirectly make sense of earnings management. This was due to analysts filtering information to focus on items that are relevant for deriving a measure of the earnings quality. The focus on earnings quality led several of analysts' adjustments to have the unintended consequence of adjusting for earnings management. For instance, one-off items were found by Dichev and Graham (2015) to be an item that can be used for earnings management purposes. Analysts' treatment of one-off items all but ensured that using one-off items for earnings management purposes is not possible. By using calculative reasoning and plausibilization analysts are able to determine if they should include or exclude one-off items. Similarly, cuts in discretionary spending, which Graham et al. (2006) noted was a type of real earnings management, is also analyzed using calculative reasoning and plausibilization. Just as with one-off items, this analysis often led to adjustments that made it difficult to cut discretionary spending to improve short-term earnings. The logic behind analysts' treatment of investment levels is nearly identical to the logic in how analysts handle cuts in discretionary spending.

In those cases where the process explained above is not sufficient to generate a conclusion, analysts generally turned to management to complement information from the financial statements. This could be the case when a company stops reporting a specific segment or when there is low transparency on what the costs consist of. Analysts' sensemaking of this information is based on two criteria, management's trustworthiness and their history of delivering on promises. Depending on whether analysts obtain more information and if they trust this information, their adjustments would differ. They may obtain information which they trust and may then adjust correctly, but it is also possible that they do not obtain information and make the incorrect adjustment. However, their goal is to exclude the effect that for instance, a changed accounting method may have as they want to derive the quality of earnings. They will thus try to indirectly adjust for earnings management.

6. Conclusion

6.1 Contributions

Our analysis of analysts' valuation process contributes to previous literature (Barker and Imam, 2008; Hjelström et al. 2014; Breton and Taffler, 2001; Imam and Barker, 2008; Demirakos, 2004) by shedding light on how analysts make sense of earnings management. We find that while analysts do not deliberately make sense of earnings management, there is an indirect sensemaking of earnings management. This is due to analysts' aim of deriving the earnings quality. To derive the earnings quality, analysts make adjustments to certain items. The adjustments aimed at deriving earnings quality are found to also adjust for earnings management.

We also contribute to previous sensemaking literature in accounting (Goretzki and Messner, 2016; Kraus and Strömsten, 2012; Boland and Pondy, 1983) by looking at how professional users of financial information make sense of numbers from an external perspective. In other words, we look at actors that, in contrast to previous research, are not part of the organizations where the numbers stem from. We thus find that Goretzki and Messner's (2016) three mechanisms are used to make sense of information from an external perspective as well.

The broader implications of this study are primarily about how professional users make sense of information. We found three sensemaking mechanisms, previously identified within management accounting (Goretzki and Messner, 2016), that were applicable within financial accounting. This suggests that these mechanisms are not context specific, but rather that they can be used to deal with different types of accounting information. The implication of this is that the findings and conclusions in this study are to some extent applicable to other disciplines. Therefore, this study can be used as a foundation for future research that aims to investigate how professionals work with accounting information in other contexts.

The practical implications of this study are significant for both financial regulators and investors. The findings of this study show how professional users interpret and use information from the financial statements. We have shown in which areas of financial reporting the information is perceived as lacking. This is why many analysts, at some point in

their valuation, feel forced to turn to management to obtain sufficient decision-useful information. In terms of investors, this study is relevant as it shows that analysts are subject to their role-situated commitment. The results from the interviews show that analysts are client orientated which causes a bias towards buy recommendations. In addition, several of the estimates used in their valuation are based on plausible assumptions, rather than true or accurate ones. This highlights that investors should be aware that all recommendations given by analysts are not always necessarily based neither entirely on objective factors nor complete information.

6.2 Limitations

The limitations of this study should also be considered. Given the qualitative nature of this study, there are some inherent limitations such as generalisability and the difficulty to establish cause-effect relationships. However, we will focus on the limitations relevant to our particular study. One limitation is that we have only used one source of data i.e., interviews. This possibly presents challenges to the reliability and validity of our results. To strengthen the findings, it would have been apt to triangulate the data. This could have been done by analyzing analysts' written reports and comparing them to the data from interviews. Another limitation of this study has to do with the limited set of data. We interviewed nine analysts, which is a considerably smaller sample compared to previous research. A larger sample would have contributed to creating an even more nuanced set of data. It is also plausible to assume that patterns and themes would have become more apparent with more respondents. Finally, a limitation to this study is related to the geographical region from which the data was collected. The selection of interviewees was limited to Stockholm. However, our findings are largely in line with what previous research has found which suggests that the geographical aspect is not significant.

6.3 Suggestions for future research

The main focus of this study has been to understand how analysts as a profession make sense of earnings management. We have mainly analyzed this from a broad perspective where no differentiation or adoption has been made depending on which industry an analyst covers. There were apparent differences in how analysts approached certain items and adjustments. A plausible reason for this could be that they cover different industries. This, potentially, means that their industry-specific approaches can have significant impact on how they analyze

information. We therefore call for future research to examine this industry-specific factor and how it relates to analysts' sensemaking of earnings management.

A recurring theme in the study is how analysts are client orientated in their analysis and communication. For instance, it affects which stocks they will cover, what recommendations they decide on and which models are used in the communication. This client focus thus seems to have far reaching implications for how analysts conduct their work. A suggestion to future research is to examine how big this impact is and whether it has a decisive influence on what analysts choose to make sense of.

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8. Appendix: Interview guide

Opening questions

- How do you proceed when you analyze a company ?
- Does the analysis differ between a company you have followed for a long time and a new one ?
- Does company valuation differ between different sectors ?
- Which sources do you find most useful for valuing companies ?
 - Financial information or non-financial information ?
- Do you think investor relations meetings give you valuable information or help you understand aspects that you were unsure about ?
- How important is experience when analyzing companies ?

Accounting questions related to earnings management

- How do you view earnings quality?
- If an interim report gives a, for instance, higher operating profit than forecasted, how much time goes into understanding why?
- If a company is an outlier compared to its industry, what does that signal?
- Do you need to focus on specific adjustments or items for different sectors?
- What type of information is usually included or excluded?
- How do you deal with:
 - Extraordinary items and one-time items?
 - Cuts in discretionary spending?
 - Changes in accounting method?
 - Changes in how the company measures its performance?
- Which type of earnings is most important to look at?

Perception of earnings management

- Can you identify if a company is adjusting its profits purely through accounting?
 - If yes, what does that signal to you?
 - If not, how do you make sure that the earnings accurately reflect the company's actual performance?

Finishing question

- Is there anything else that you think would be relevant for us to know regarding company valuation that we have not touched upon?