

# An Empirical Research on Fu-Wang Foods Ltd: Industry, Strategy, Accounting, Ratio, Valuation and Proforma Analysis

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## Abstract

In this study an attempt was made to prepare the research on Fu-Wang Foods Ltd. We have also analyzed the strategies, accounting policies and ratios. Historical and Proforma income statements, balance sheet and cash flow statement have been made. We have also determined, loosely speaking, the intrinsic value of stocks of firm. The company is in food processing industry. The position of Fu-Wang is good in this industry. Its long term profitability and sustainability is also secured. The accounting policies and estimates of Fu-Wang as well as the food industry are flexible enough. Management enjoys moderate discretionary powers. Analysis of the various ratios over the five years reveals that many of them are satisfactory and some are not. By doing the valuation of the company with some assumption we found the intrinsic value of the firm is approximately 36 tk. Sensitivity of stock price by changing the discount rate and sales growth rate has also been examined. By projecting the historical accounting figures we have also prepared Proforma income statements, balance sheets and cash flow statements and found that the future of Fu-Wang Foods Ltd. is rather satisfactory, given some assumptions.

**Keywords:** Fu-Wang Foods Ltd, Industry, Strategy, Accounting, Ratio, Valuation, Proforma Analysis.

## 1. Introduction

Prior research examines the influence of investor sentiment on corporate decisions such as capital investments, dividend payments, stock splits, and corporate name changes. However, as Baker, Ruback, and Wurgler [2007] observe, there is limited evidence on the association between investor sentiment and managers' disclosure decisions. We address this issue by examining the relation between investor sentiment and the discretionary disclosure of "pro forma" (adjusted) earnings measures.

Specifically, we examine the influence of investor sentiment on managers' decisions to (1) disclose adjusted earnings metric within the quarterly earnings press release; (2) exclude higher levels of recurring and nonrecurring items in calculating the pro forma earnings figure; and (3) emphasize the pro forma metric by placing it more prominently within the earnings press release. We further investigate whether the relation between investor sentiment and pro forma earnings disclosure reflects managers attempt to inform or mislead investors, or whether it reflects managers' own sentiment-driven beliefs.

While investor sentiment may influence various forms of corporate disclosure, we focus on proforma earnings disclosure for three reasons. First, in a recent survey of financial executives, Graham, Harvey, and Rajgopal [2005] find that managers view pro forma earnings to be one of the most important performance metrics disclosed to investors. Second, while prior research finds that investors perceive manager-adjusted pro forma earnings to be more informative than GAAP earnings (see, e.g., Bhattacharya et al. [2003]; Lougee and Marquardt [2004]; Bowen, Davis, and Matsumoto [2005]), several studies suggest that some managers use pro forma earnings disclosures aggressively and that investors may be misled by overly optimistic pro forma measures (e.g., Doyle, Lundholm, and Soliman [2003]; Frankel, McVay, and Soliman [2010]; Brown, Christensen, and Elliott 2011). This evidence is particularly salient since prior research suggests that less-sophisticated investors—who are most affected by sentiment (Kumar and Lee [2006], Baker and Wurgler [2007])—rely heavily on pro forma earnings information and are arguably the most at risk of being misled (Fredrickson and Miller [2004]; Elliott [2006]; Bhattacharya et al. [2007]). Third, anecdotal evidence suggests that pro forma reporting trends closely track recent stock market bubbles (Bradshaw and Sloan [2002]; Dyck and Zingales [2003]; Bhattacharya et al. [2004]) and that investor sentiment may have influenced the disclosure of pro forma earnings measures during bubble periods (Henry [2001]; D’Avolio, Gildor, and Shleifer [2002]). Taken together, these arguments suggest that pro forma earnings disclosure provides a unique setting for exploring the relation between investor sentiment and managers’ disclosure decisions.

## **2. Literature Review**

We examine the influence of investor sentiment on managers’ discretionary disclosure of “proforma” (adjusted) earnings metrics in earnings press releases. We find that managers’ propensity to disclose an adjusted earnings metric increases with the level of investor sentiment and, in particular, the propensity to disclose an adjusted number that exceeds the GAAP earnings figure. Further, our analyses suggest that as investor sentiment increases, managers (1) exclude higher levels of both recurring and nonrecurring expenses in calculating the pro forma earnings number and (2) emphasize the pro forma figure by placing it more prominently within the earnings press release. Additional analyses indicate that the association between investor sentiment and managers’ pro forma disclosure decisions at least partly reflects opportunistic motives. Finally, we find that managers’ own sentiment-driven expectations also play a role in their pro forma disclosure decisions. (Brown, N. C., Christensen, T. E., Elliott, W. B., & Mergenthaler, R. D., 2012).

Drawing on recent research on accounting-based valuation, this paper ventures to produce a structural approach to financial statement analysis for equity valuation. The structure not only identifies relevant ratios, but also provides a way of organizing the analysis task. The result is a fundamental analysis that is very much grounded in the financial statements; indeed, fundamental analysis is cast as a matter of appropriate financial statement analysis. The structural approach contrasts to the purely empirical approach in Ou and Penman (1989). That paper identified ratios that predicted earnings changes in the data; no thought was given to the identification. The approach also contrasts to that in Lev and Thiagarajan (1993) who defer to “expert judgment” and identify ratios that analysts actually use in practice.

## **2. Data Analysis**

### **2.1 Industry Analysis of Fu-Wang Foods Limited**

1.1 The industry my selected company belongs to: Food Processing Industry

1.2 Potential profitability of the Industry:

1.2.1 Maintaining the quality of the product and keeping the processing of food hygienic are two most critical factors for the profitability of the industry.

Two factors that are also very important and related for the profitability of the industry are:

- Threat of new entrants
- Intra-industry rivalry

On the basis of Porter's five factor model, the followings can be considered:

- ❖ Threat of new entrants is highest since:
  - Capital requirements are low in foods industry.
  - Customers' switching costs are low
  - Government does not provide subsidy or regulate prices/entry
  - Low BEP in foods industry
- ❖ Bargaining power of buyers is not highest as:
  - Buyers can not in-source backward
  - Buyers don't know the production costs well
  - Foods industries are concentrated
- ❖ Bargaining power of suppliers is not highest because:
  - Suppliers can not forward integrate
  - Suppliers' products are not highly differentiated
- ❖ Intra-industry rivalry is fiercest as:
  - Large number of competitors in the industry
  - Industry is growing
  - Buyers have low switching costs

1.3 The industry is capable of retaining the profit it makes because of the following factors:

- Threat of new competitors entering the industry
- Rivalry among current competitors in the industry

1.4 Other reasons

- Food is one of the essential products
- Industry is in growing state
- Bargaining power of buyers and suppliers are not that much dominant

## ***2.2 Strategy Analysis of Fu-Wang Foods Limited: Generic strategy pursued by Fu-Wang Foods Limited is "Differentiation"***

We think the company can survive and prosper given its strategy because of the following factors:

- Higher demand at given price
- Less price - sensitive demand
- More varieties of product
- More value added service
- Quality product

### **2.2.1 What kind of competition is observed - profit enhancing or profit destroying?**

Fu-Wang Foods Limited belongs to Food Processing Industry. This industry has too many competitors like Bangas Foods Ltd., BD Foods Ltd., Apex Foods Ltd., Bengal Foods Ltd., etc. Before we reach to any conclusion

whether the competition is profit enhancing or profit destroying, the followings can be discussed-

Competition can be done in two sectors -price segment or non-price segment. Price competition means changing price of products to attract more customers while non-price competition refers to sales promotions, advertisement, free samples etc.

In general, price competition erodes profit by compelling the firm to receive fewer prices per unit of product unless the industry is in a growing phase. While the industry is stagnant in terms of life cycle, price competition will erode industry profit.

Non-price competition has both negative and positive impacts. Impact can be negative because fixed cost is up due to installing new and efficient machineries to provide value added services. Impact can be positive as marginal cost and unit cost of value added services and core product are supposed to be decreasing due to efficient machineries. Moreover, differentiating the product gives the firm the opportunity to make the products dissimilar to those of others, hence making it increasingly difficult to enter the industry.

Our firm believes in product differentiation. So do others in the industry because they are not indulging in price competition.

Lastly, it can be that said I observe the competition is profit enhancing and not profit destroying.

### **2.3 Accounting Analysis**

#### **2.3.1 Identifying Key Accounting Policies**

Fu Wang is a manufacturer of processed foods. So, inventory valuation is very critical for it. So is its bad debts provision policy. The key accounting policies can be identified as below:

**2.3.1.1 Inventory Valuation:** Inventories include raw material, finished goods and packing materials. They are stated at lower of the lower of cost and net realizable value on consistent basis. Net realizable value is based on estimated selling price less any further costs expected to be incurred for completion and disposal.

**2.3.1.2 Bad debts Provision:** There is no substantial amount of bad debts in the firm and it has no bad debt provision whatsoever.

**2.3.1.3 Depreciation Allowances:** Depreciation is mainly charged on a straight in a basis with a range of 2.5% to 20%.

**2.3.1.4 Tax Holiday Reserve:** The Company is enjoying tax holiday from August 1997 to July 2002 and is recording Tax holiday reserve for future.

**2.3.1.5 Employee Benefit Obligations:** The Company did not introduce any employees' benefit plan at first but at latter years.

**2.3.1.6 Revenue Recognition:** The revenue during the year represents revenue from the sale of foods items which are recognized when deliveries are made, against the dale order received.

#### **2.3.2 Assessing Accounting Flexibility**

The firm belongs to the foods processing industry. Apparently no severe restriction of any accounting treatment is imposed on such firms. Managers of the firm are given the flexibility and power to reflect the true condition of the firm. The firm can, at its discretion, charge bad debt provisions at the true level as well as use any type of depreciation method it likes at a consistent basis. Though the firm has been enjoying tax holiday, it was deducting tax holiday reserve for future purpose. All these reflect considerable accounting flexibility.

### 2.3.3 Evaluating Accounting Strategy

The accounting strategy followed by it can be comparable with the norm of the foods processing industry (Apex foods ltd, Bangas ltd, Pran ltd etc.).

The possibility of having strong incentives to manipulate the profit figure or to do window dressing can't be rejected just because the management owns about 40% of the stocks and the quality of the information disclosure is not up to the mark.

The firm did not change any of its accounting policies these years. For example, depreciation method is straight line over the time. The only substantial change is that the firm has been enjoying tax holiday from August 1997 to July 2002 and is recording Tax holiday reserve for future. Now the firm is charging provision for income tax instead.

The firm does not structure any significant business transactions so far. It did not alter the lease rental method or did not have any acquisition of other companies.

### 2.3.4 Evaluating the Quality of Disclosure

The disclosure of information is not that much satisfactory in some cases. It did not specify whether it uses LIFO, FIFO or Weighted Average method for inventory valuation. There is also no trace about bad debt allowance for such a manufacturing firm. There is no long term debt either but short-term debt with interest is termed as notes payable.

On the other hand, in many places it reveals justifiable information. It tried to let the stakeholders know their significant accounting policies. It showed all the individual debtors with the amount owed by them. The depreciation schedule of various fixed assets along with rate are given. The extent, to which preliminary expenses and share issue expenses have been capitalized and are written off, provides much clarity.

The mode and extent of contingent liabilities have been elaborated and the accounting ratios have been given. Unlike many other firms, it provides us with the composition of the shareholders.

### 2.3.5 Identifying Potential Red Flags

**2.3.5.1 About Audit Reports or Auditors:** The audit reports of the firm are consistent and are unqualified. But the matter of regret is that the auditor of 2015-16 and the auditor for the rest of the years are not the same. The change of the auditor is not backed by information.

**2.3.5.2 Related Party Transactions:** Fu Wang ceramic ltd is an associate undertaking of Fu Wang Foods ltd. During the year of 2015-16 it paid 441000 tk as factory rent to Fu Wang Ceramic ltd for use of its land. Afterwards nothing significant is mentioned.

**2.3.5.3 Unusual Increases in AR in Relation to Sales Increase:** The diagram shows that AR increased disproportionately in the second accounting year, which may be a result less strict credit policy and negligence in AR collection.

0.24	0.43	0.22	0.21	0.24
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**2.3.5.4 Unusual Increases in Inventory in Relation to Sales Increase:** From the diagram below we can say that inventory increased disproportionately in the second accounting year, which may be a result of fewer sales.

0.10	0.17	0.10	0.14	0.13
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**2.3.5.5 An Increasing Gap between Reported Income and OCF:** The reported income as a percent of OCF is showing a constant proportion over time.

0.79	0.79	0.87	0.84	0.80
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**2.3.5.6 An Increasing Gap between Reported Income and Tax Income:** As data is not available, whether such a thing is occurring or not can't be verified.

## 2.4 Ratio Analysis

**2.4.1 Current Ratio:** Current ratio is diminishing over time which may be considered as bad. CR decreases because of the expansion of current liabilities. Among the current liabilities, notes payable (Bank loan) is comparatively increasing to meet up the increased demand. Moreover, increase of CL is more than that of CA over time.

**2.4.2 Quick Ratio:** Quick ratio is showing a decreasing trend over time and it is very ominous. QR diminishes principally due to the increase of inventory and current liabilities. Increase in inventory might have happened due to frail sales strategy or weak demand.

**2.4.3 Inventory Turnover Days (ITD):** It is relatively low in second year due to lowered CGS. However, ITD is relatively satisfactory for Fu Wang. Increase of ITD is looked as inefficiency as goods are taking longer time to be finished. Launching new machineries and training labors may lower ITD. However, the decrease of ITD is not a result of JIT inventory management.

**2.4.4 Average Collection Period:** It is remaining stagnant over time because sales are increasing and A/R is almost increasing at the same rate. This may be good but credit policy must be reviewed according to the business scenario.

**2.4.5 Fixed Asset Turnover:** FSA of the firm is not quite satisfactory. Alarmingly, it is fluctuating over time and then shows an increasing pattern. This indicator shows operating leverage of the firm, which is, of course, not satisfactory for this firm.

**2.4.6 Total Asset Turnover:** TAT is also very low. It is slightly decreasing due to wearing out of assets, suggesting manufacturing inefficiency and then has a U-turn.

**2.4.7 Debt Ratio:** It is slightly increasing over time due to increase in current liabilities and expansion of business. Though optimum debt level varies among firms, the firm has already almost 35% short-term loans on average and other current liabilities, indicating financial risk.

**2.4.8 Time Interest Earned Ratio:** This ratio showed a good situation for the first three years but due to profit reduction this ratio is showing an alarm-bell for the last years.

**2.4.9 Long Term Debt Ratio (Ltd):** The value is zero as no long term debt has been utilized.

**2.4.10 Gross Profit Margin:** Here no significant trend is shown. It increases a bit, perhaps, because of utilization of high operating leverage.

**2.4.11 Operating Profit Margin:** It is also relatively constant over time due to no substantial change in operating expenses.

**2.4.12 Net Profit Margin:** Net Profit is vulnerable and slightly decreasing over time due to short-term interest amount (we termed short term bank loans as notes payable). To meet up the increased demand Fu-Wang Foods Limited has taken loan from bank which increases the notes payable over time, so does the interest. That is why net profit margin is declining.

- 2.4.13 ROA:** ROA is satisfactory but vulnerable. It is vulnerable over time due to the vulnerability of profit.
- 2.4.14 ROE:** ROE is also quite good but decrease for some years due to increased CGS and unidentified admin and selling expense. It is vulnerable due to the fluctuation of profit.
- 2.4.15 EPS:** EPS is following an upward trend with deviation. Earnings of around 2 plus taka out of face value or market value of 10 to 14 taka is not bad at all. It is vulnerable due to the vulnerability of net profit.
- 2.4.16 P/E Ratio:** This is not unsatisfactory. But again it is fluctuating over time due to the vulnerability of price and earnings.
- 2.4.17 Sensitivity of ROE:** ROE is more sensitive to total assets turnover and less sensitive to profit margin and financial leverage. From the sensitivity analysis it is seen that total assets turnover has greater standard deviation and the other two indicators have lesser standard deviation.

## **2.5 Valuation:** Discounted Cash Flow Analysis

The valuation of a company can be done with various methods and various accounting figures. We have used discounted free cash flow valuation model. According to the model, the value of a company can be estimated as:

$$\begin{aligned} V &= \text{PV of all FCF} \\ &= \text{PV of limited time initial growth FCF} + \text{PV of adjusted growth FCF thereafter.} \end{aligned}$$

There are some assumptions in the valuation model and the statement from which the FCFs are derived resembles income statement but is not accurately an income statement.

### **The assumptions are:**

- Secondary growth rate is 0.5%. The reason is that the firm is a manufacturer of essential goods and the growth of demand of this sector is not too much.
- No assets disposal will occur.
- Depreciation rate for the extension is 10%. The depreciation for the extended periods is calculated in a simplified way. The depreciation of this year is equal to depreciation of the previous year plus capital expenditure time's depreciation rate.
- Interest expenses are negligible for our firm and the short-term notes payable interest amount is not considered for the valuation model.
- Capital expenditures are assumed to be 35000000 Tk for each year for the extended periods as the firm is trying to expand itself.
- Sales growth rate is calculated as the average of the first four changes of historical sales figure.
- Other accounting figures are also projected to the extended periods by expressing themselves as percentage of sales and then smoothing.
- FCF is defined as unlevered net income plus depreciation plus capital expenditures and changes of NWC.
- Cost of equity (part of discount rate) is calculated with the help of SML model. The calculations are done in latter parts.

The model is bisected and the first part is just projection of historical accounting figures and the second part is just the normalized value of the last projected values.

The SML model comes up with the individual rate of return for a certain security, which can then be used as discount rate. The market rate of return (DSE 20) is approximately 26% and B of Fu Wang is 0.48. The T-Bill



rate of return is 7.85%. So the cost of equity is 16.56%. This rate can be approximated as cost of capital because the cost of debt (which is almost 10%) has little impact on the total capital invested. But due to rising inflation, this WACC might tend to overestimate the value of the firm. So, the appropriate discount rate must be more than 16.56% and should be in the range between 22% and 25% as inflation is almost 8 to 9%. We took WACC as 23.5%, to be conservative.

The projected figures for 2017-18 to 2021-22 are discounted at 23.5% and the 2021-22 figures is further projected at 0.5% growth rate and discounted to get the value of 711,685,097 tk. From this value cash balance and short term interest debt are deducted to get the equity value. Equity value is then divided by shares outstanding (18000000) which yields 36.34 tk.

Along with the valuation model, there are sensitivity analysis and scenario analysis. The sensitivity analysis allows altering two variables to see what the change of dependent variable is - in this case the stock price. Also the scenario analysis allows changing more than two variables and see what the change of stock price is.

From the sensitivity analysis, we can see the change of stock price due to changes of discount rate and sales growth. For example, when discount rate is 19% and sales growth rate is 16% then stock price is 58.56tk.

Similarly, scenario analysis shows the change of stock price for various values of discount rate, sales growth rate as well as tax rate. For each of the three scenario's (base, better, worse) respective values, the stock prices are about 36.34 tk, 153.07tk, and 20.14tk respectively.

<b>Discount Rate</b>	.235	.235	0.15	0.26
<b>Sale Growth</b>	.21	.21	.25	.12
<b>Terminal Growth</b>	.005	.005	.030	.001
<b>Intrinsic Value</b>	36.34	36.84	153.07	20.14

From our estimation can we necessarily infer that the stock price is in the vicinity of 36.34 tk? The answer is: we don't know it exactly. However, the result tries to represent the intrinsic value of the firm. There are so many assumptions (WACC rate, sales growth rate, and depreciation rate), so many unknown factors (management decisions about future capital expenditure and capital restructuring) and so much systematic risks (economic recession, inflation, natural calamities etc), that the resulted number is nothing but a ballpark number.

Is the stock underpriced? Not necessarily. One may raise his eyebrow when it comes to his notice that our intrinsic value is in the range of forty taka per stock. Two factors, we think, contributed this. They are: sales growth rate and discount rate. Firstly, sales growth is very vulnerable year to year and is probably overestimated. We used the AM of the sales growth rate for future approximation because GM is biased of negative values (two of the four rates are negative). Another GM formula could be used:

$$GM = [ \{ (.7) * (2.07) * (1.11) * (.94) \}^{(1/4)} - 1 ] = .11$$

Funnily, this GM formula tends to neutralize the negative values. So, our initial guts proved right that growth rate is a bit overestimated.

Another reason for discrepancy is inflation. Bangladesh is experiencing inflationary problem for some years and the rate is 6 to 8% for almost all the years. Certainly, the firm will look forward to increasing the sales price which is reflected on future revenues but the fly in the ointment is that cashflows are not adjusted to inflation properly or partially.

Hence, we think the stock price of the firm hovers around the initial two- digit figures.



## 2.6 Proforma Analysis

For preparing the Proforma statement of Fu-Wang Foods Ltd. we have prepared the following statements:

- Income Statements
- Balance Sheets
- Cash flow Statements

### 2.6.1 Method

From the past 5 years historical data (income statement, balance sheet and cash flow statement) we have projected another 5 years prospective statements.

First of all, we prepared common size income statement which is expressed against total sales and common size balance sheet which is expressed against both in terms of sales and total assets. From the common size statements we have identified the rate of change and ratios of needed accounting estimates and then smoothing the estimates we have projected those for the future five years.

### Assumptions

- Sales growth rate will be approximately 21%.
- CGS is assumed to be 78% of sales.
- Inventories growth rate will be approximately 20%.
- Cash and cash equivalent growth rate will be approximately -2%.
- Accrued expense growth rate will be approximately 27%.
- Sundry creditors' growth rate will be approximately -25%.
- SGA expense will increase by 10.55%.
- Loans, advances and deposits growth rate will be approximately 21%.
- The company will issue additional 0.2 million shares in 2008-09 and as a result share issue expense will increase. Share issue expense will be amortized substantially.
- Payout ratio will change to 12.5% in the year 2016-17
- Credits, Short Term Bank Loans-Secured growth rate will be approximately 5%.
- Sundry debtors growth rate will be approximately -47% per year.

The proforma statements yield the following results:

Net incomes after tax for the forecasted 5 years are:

2017-18	2018-19	2019-20	2020-21	2021-22
48,198,118	59,892,306	72,469,690	87,688,325	106,102,874

Total assets or total liabilities for the forecasted 5 years are:

2017-18	2018-19	2019-20	2020-21	2021-22
448,815,638	356,444,592	305,124,327	286,219,721	289,260,386

Changes in cash for the forecasted 5 years are:

2017-18	2018-19	2019-20	2020-21	2021-22
(403,614)	(394,577)	(385,742)	(377,106)	(368,662)

The position of Fu-Wang is expected to be good in this industry. Its long term profitability and sustainability is also secured.

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