Pay Attention to the Details

By Shiwon Song , INSEAD

Focusing on the right information can pay dividends for any investor.

Trading in stocks and shares used to be the domain of hedge funds, stockbrokers and banks. Yet, the last decade has seen a growing number of retail investors looking to play the markets.

The rise of trading platforms and easy access to firms' financial information online have made investing a viable choice for many individuals, whether as a hobby or a way to earn some extra income. **Institutional Investor** found that everyday investors were behind 52 percent of global assets under management (AUM) in 2021, with this number set to rise to over 61 percent by 2030.

Obviously the goal of any investor, be it a professional institution or an individual, is to make money. This is achieved by spotting profit opportunities and investing while they remain available. This typically involves identifying an undervalued firm and investing while its share price is low and selling when the stock price rises.

The best way to spot such opportunities is by studying an individual firm's available financial information, be that quarterly reports or annual financial statements. Investors then use that data to make their own prediction on how that firm might perform in the future.

The challenge is making the right decisions by paying attention to the correct data. For every winner there needs to be a loser. The fact that many investors don't make the right trading decisions is what allows the market to operate. But what leads people to make bad investments and allows others to profit at their expense?

One issue, highlighted by my **recent research**, is that despite having access to additional information, many individual investors still focus on earnings summaries. They then make misinformed investments, which institutional investors can exploit.

Understanding the accrual anomaly

The accrual anomaly is one such investment mistake. It means that many investors fixate too heavily on how much profit or loss a firm makes when deciding if it is a good investment.

There is nothing wrong with this per se, but it fails to consider the full financial picture of a company. To get that, investors need to consider accruals. An accrual is the revenue earned or expense incurred by a company, although the cash related to that transaction has not yet changed hands.

Take a company who makes solar panels. It has to buy the raw materials from a third-party supplier. Rather than paying cash at time of delivery, the firm benefits from delayed payment terms, so it can sell the finished products before paying the supplier. In accrual accounting, the purchase of raw materials would be marked down as an accrual expense, a negative figure in the accounts balance sheet.

In the same way, the firm may sell 10,000 finished solar panels to a government agency. Under the terms of the deal there may be delayed payment terms for the panels. Yet the money the agency agreed to pay in the future will be recorded as an accrual revenue at the time the deal is struck.

Considering these accruals obviously gives an investor a much clearer picture of a firm's financial health. The accrual anomaly arises when investors fail to distinguish between actual earnings and accruals. As a result they can become overly optimistic about the prospects of firms that hold high accruals. A good profit return might suggest a firm is performing well, but if it has a high level of accruals – say in the form of uncollected revenues that have already been recorded – then the longer term outlook may not be as bright.

On the flip side, firms with low accruals can be undervalued by sections of the market. They record less profit, so may not seem a great investment. Understanding this anomaly leaves opportunities for investors with a more holistic view of a firm's finances to exploit this misalignment.

This is not a new or unknown phenomena. Richard Sloan correctly tested the theory in a **1996 paper**, while **it has been argued** that the concept can be traced back to the 1930s. Hedge funds have previously taken great advantage of the strategy, resulting in a significant decline in the effect by the early 2000s.

Failing to focus

However, as my paper demonstrates, the anomaly does persist, even when firms receive high levels of attention and investors have access to the accruals data. Why? Is it that many investors simply don't have the time or is it that they just don't pay attention to the right information?

Based on my research, I believe it is the latter, especially for less sophisticated individual investors. By studying Google Trends for records of searches for accounting information I could identify if investors were searching for this type of information. I could then cross check that against the subsequent investment decisions made.

Investors who paid more attention to accounting information showed better efficiency in processing simpler data, reacting favourably to positive earnings reports. However, even when there was heightened attention to a company's accounting data, less sophisticated investors didn't show the same effective processing of accrual information to make investment decisions. This was not the case for institutional investors.

Imagine Amy and Ben, two investors both looking at fictional company TechCo's positive earnings report. Ben, a busy engineer and retail investor, is aware of the company's earnings growth through the media. However, he doesn't have the resources (either time or expertise) to fully comprehend the firm's accruals.

The financial year in question saw TechCo purchase new equipment and property to expand their operations. They paid cash, but the purchases were not recorded as expenses but marked down as assets. The firm's net profit was therefore higher than their cash spending. Yet these assets will be expensed in the future in the form of depreciation. As a result Ben overprices the value of TechCo.

Meanwhile, Amy who works for a hedge fund pays attention to the full accounting details. Her grasp of both earnings summaries and accrual information allows her to get a clearer picture of TechCo's true financial situation.

This discrepancy illustrates the study's main finding: Attentive investors can accurately process accounting information for informed decisions. Less attentive investors might misinterpret or overlook important details, leading to less accurate investment choices.

As the number of retail investors continues to increase around the world, the greater the need to ensure their protection. Better education and raising awareness around the accrual anomaly by organisations such as the US Securities and Exchange Commission (SEC) could be one simple way to level the playing field. It can't guarantee individual investors will make better investment decisions but at least they would be making decisions based on the right information.

Find article at

https://knowledge.insead.edu/economics-finance/pay-attention-details

---

About the author(s)

Shiwon Song is an Assistant Professor of Accounting and Control at INSEAD. Her research interests include strategic disclosures, qualitative accounting information, and the informational impact of accounting on capital markets and product markets.

About the research

The Working Paper "**When Paying Attention Is Not Enough: Investor Misreactions to Accounting Information**" is published in *Social Science Research Network*.