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THE ROLE OF COMPANY SPECIFIC INFORMATION IN VALUATION MODELS USED IN THE UAE

Hafiz Imtiaz Ahmad, New York Institute of Technology
Khaled Aljifri, United Arab Emirates University

ABSTRACT

The role of company specific information in valuation is important. In this paper, we explore company specific information as considered by the UAE's financial analysts. A questionnaire and interviews were used to answer the research questions of this study. Thirty-five investment analysts, in cooperation with the CFA Society, Emirates, participated in the questionnaire. The sample covered most of the analysts who have professional qualifications such as CFA and CAIA (coupled with an academic degree such as the MBA) and an average of more than eight years of experience in the relevant sectors. Descriptive and comparative analysis was employed in this study. The results reveal that, , in analyzing a listed stock,the financial analysts and fund managers in the UAE give more weight to the assessment of management and performance sustainability and less to historical performance and reviews of research and development.

JEL: M41, M49

KEYWORDS: Financial Analysts; Valuation Models; Company Specific Information; UAE

INTRODUCTION

Analyzing a company strategy and its financial statements as a whole is an important element of financial analyst's job. It helps analysts to question the economics of the firm at a qualitative level in order to ground the accounting and financial analysis in business reality. This also enables analysts to assess the sustainability of the firm's current performance and to forecast future performance. The firm's value is its ability to earn a return higher than its cost of capital. What are the factors that enable a firm to accomplish this objective? How do financial analysts perceive these factors? Normally, capital markets are responsible for the cost of a firm's capital, while the firm's profit potential is determined by its own strategic choices made to enhance competitive advantages, management, earnings, balance sheet, return on capital, future earnings growth, etc. (Palepu et al, 2004; Penman, 2007). The purpose of this article is to highlight the company specific information that the analysts in UAE consider when analyzing a listed stock. The company specific factors that are important to financial analysts have been studied in the literature (Barker, 1999a; Block, 1990). The survey employed in this paper was structured on the basis of certain previous studies (Arnold and Moizer, 1984; Pike et al. 1993; Barker, 1999a, 1999b; Block, 1999).

The study replicates, with modifications, the study of Barker, (1999a) and provides additional insights. Its research methods focus on surveys (a questionnaire and semi-structured interviews). To generate a broader understanding of financial statement analysis than that given by company specific information alone, the questionnaire includes a section related to accounting ratios (Breton and Taffler; 1995). Foster (1986) states that investment analysts depend heavily on accounting ratios in their valuations. The current study, unlike all previous ones, draws its results from an emerging economy in the Middle East which has been ranked as one of the most developed in the world and is in the top three countries for attracting infrastructure investment. Another distinctive point of this study is the time frame involved. Similar studies in the literature have taken 5- 6 years to complete, whereas for this research the survey was launched in 2014 and interviews were completed in 2015. Omran (2003) studies equity valuation in the context of the UAE, focusing on the determinants of three valuation multiples (namely, price earnings; price book value; the price sales). However, to the best of the authors' knowledge, no study in this region has addressed analysts' choices of company specific information for the valuation models. This indicates the originality of our work. The major findings of this study are remarkably consistent with those of Barker, (1999a). This study contributes to the literature as follows: (1) it provides evidence of the company specific information used by analysts in an emerging economy (that of the UAE, which has become one of the most attractive countries in the world for investment). The results suggest that the financial analysts in the UAE, in analyzing a listed stock, give more weight to the assessment of management and of performance sustainability and less to historical performance and reviews of research and development. The study addresses the following three questions: (1) "What types of company-specific information do analysts in the UAE use?", (2) "What accounting variables do these analysts employ?", and (3) "Why do analysts use this information?" The study of this particular developing country presents an interesting case study for understanding its analysts' choice of company specific information used in valuation models. Although this study has specific relevance to the UAE business environment, it is believed that many other developing countries, especially those countries in the Middle East that face similar problems and needs, could benefit from the findings below. The remainder of the paper is structured as follows. Section 2 provides a literature review, followed by a description of the research methodology in section 3. Section 4 reports and discusses the results. Section 5 presents a summary and conclusions.

LITERATURE REVIEW

The reliability of the analysts' forecasts is a function of the accuracy of the information on which the model is built. There is a great deal of literature that discusses financial analysts' work. In a recent paper, Imam, and Spence (2016) find that the primary value of sell-side analysts' work lies in the rich contextual information that they provide to buy-side analysts. In order to successfully provide this information, analysts have to instill a large amount of technical capital in their habitus. Similarly, Christopher (2015) concludes that, "there is just support for a positive relation between firm-level corporate governance and forecast accuracy in civil law countries, and only support for a negative relation between firm-level corporate governance and forecast dispersion in common law countries." However, all firms with strong corporate governance in both types of country have a greater following among analysts. Ahmad & Helfenstein (2015) study the impact of internal audit and enterprise risk management (ERM) on valuation and conclude that valuing companies without considering the influence of the internal audit and ERM functions, analysts may be ignoring an important source of risk that materially affects value. Green et al (2014) find that changes in analysts' recommendation have a greater price impact when the broker has a conference-hosting relationship with the firm. Conference-hosting brokers also issue more accurate earnings forecasts than non-hosts. They suggest that access to management remains an important source of analysts' informational advantage following the passage of Regulations on Fair Disclosure.

Company-specific information does play a critical role in letting an analyst to reach his/her conclusions about value. The most important information for both analysts and fund managers is the information which is sourced directly from the companies (Arnold and Moizer, 1984; Vergoossen, 1993; Barker, 1998; Holland, 1998; Barker, 1999); it is helpful to understand the characteristics of company sourced information that is useful. The kinds of company specific information that we cover in the present study are derived from Barker (1999a) and cover the categories of both accounting and non-accounting information; the aim being to understand the role of accounting information in the context of the broader information set that is available to analysts and fund managers (Yap, 1997). We find only one study discussing the equity valuation in the context of the UAE, that of Omran (2003), who tested the determinants of three valuation multiples for 46 UAE companies listed in local share directories. The three valuation multiples are price sales (PS), price book value (PBV) and price-earnings (PE). He used a regression analysis of panel data for the years 1996–2001 and found that PS, PBV, and PE are significantly linked to the net profit margin, return on equity, and the payout ratio. As far as we are aware, ours is the first study that documents company specific information considered by analysts in the UAE. The above literature indicates that understanding analysts' choices of the company specific information that financial analysts use to reach their conclusion of value in a country such as the UAE is crucial for practitioners and academics. As mentioned in the introduction, this study will complement previous studies by examining the analysts' choice of company specific information in the valuation models in a country whose economic development has been rapid and which is considered one of the world's major business centers.

DATA AND METHODOLOGY

This section reports the empirical methods used to address the research questions of this study, describes the questionnaire design, presents a detailed description of the sample, and discusses the sample selection. Analysts in the UAE were asked to complete a questionnaire which was electronically and randomly distributed to them with the help of the CFA Society, Emirates. The questionnaire was distributed and collected between October 2014 and March 2015. The response rate of this questionnaire (around 42%) appears reasonable compared with those of similar studies (see for example Block, 1999). In addition, Nulty (2008) states that, "In general, online surveys are much less likely to achieve response rates as high as surveys administered on paper—despite the use of various practices to lift them." A total of 35 analysts of different nationalities participated in the questionnaire: Emirati, Egyptian, Moroccan, Lebanese, Libyan, American, British, French, Indian, and Pakistani. Of the total, eight (23%) were sell-side analysts, and 27 (77%) were buy-side analysts. Twenty-three percent of the analysts had less than five years of work experience, thirty-four percent had 5-10 years of work experience, and the remainder (43%) had more than ten years of work experience; the average was more than eight years. The sample covered most of the analysts who have professional qualifications, such as CFA and CAIA (coupled with an academic degree such as the MBA). Table 1 summarizes the details of the sample who completed the questionnaire and reveals that 86% of the analysts came from the Financial Sector followed by the Real Estate sector (8%), the Media sector (1%), and other sectors (1%). Table 2 yields descriptions of the sample used in the semi-structured interviews and shows that most of the analysts (97%) were buy-side and 3% were sell-side analysts. These are the two types of financial analyst: buy-side analysts work in fund management firms. They use information provided by sell-side analysts and other sources for portfolio investment decisions. They also write reports for their employers which are confidential. According to recent studies, buy-side analysts have more influence on the trading decisions of fund managers than sell-side analysts do (Crawford et al, 2011; Frey and Herbst, 2010; Cheng et al, 2006). Buy-side analysts are also known as 'in-house' analysts and fund managers as 'portfolio managers' who are responsible for pensions, insurance, and unit funds among other things. Sell-side analysts work in the equity research departments of investment banks. They generate and publish earnings forecasts, recommendations (to buy, hold or sell) and price targets. They write research reports that are used by fund managers and buy-side analysts.

As presented in Table 1, our sample of survey participants consisted of 27 buy-side analysts and 8 sell-side analysts (total 35); those who participated in the semi-structured interviews comprised 13 buy-side analysts and 1 sell-side analyst (total14) (see Table 2). The questions in the present study, which could be answered on a 5-point Likert scale, fell into six sections: demographic questions; questions on valuation models, accounting variables, accounting ratios , company specifc information; and an open question, asking which valuation models were used by analysts in the UAE and how well they functioned. This study covers only the sections related to company specific information and accounting variables used by the analysts to support their valuation. The other sections have recently been covered in a recent study by Aljifri and Ahmad (2017). In addition, semi-structured interviews were employed to get more insight into the participants' answers and improve the level of consistency and reliability in the results (Harris et al., 2010).

Table 1: Descriptions of the Sample Used in the Questionnaire

Participants	Sectors				Total Participants in the Questionnaire
	Financial	Real Estate	Media	Others	
Buy-Side Analysts	23 (85%)	3 (11%)	1 (4%)	-	27 (77%)
Sell-Side Analysts	7 (87.5%)	-	-	1 (12.5%)	8 (23%)
Total	30 (86%)	3 (8%)	1 (3%)	1 (3%)	35 (100%)

This table presents the sample size with more details on the sectors and the participants. It reveals that the sample was predominantly buy-side analysts and the financial sector.

Table 2: Descriptions of the Sample Used in the Interviews

Participants	Sectors				Total Participants in the Interviews
	Financial	Real Estate	Media	Others	
Buy-Side Analysts	13 (93%)	-	-	-	13 (93%)
Sell-Side Analysts	1 (7%)	-	-	-	1 (7%)
Total	14 (100%)	-	-	-	14 (100%)

This table shows the sample size of participants used for the interviews. It reveals that the sample was also predominantly buy-side analysts and the financial sector.

RESULTS

What Types of Company-Specific Information Do the Analysts in the UAE Use?

To better understand the above research question, it is important to know that the accuracy of each valuation model depends on the reliability of the information on which the model is built. Each valuation case is unique. Certain types of information become more or less important depending upon the growth phase of the company, the industry it belongs to and the overall economic outlook. To be more precise, the most important information for the analysts is that which is directly sourced from the companies (Anrold and Moizer, 1984; Vergossen, 1993; Barker,1998; Holland,1998; Barker, 1999). Table 3 presents a list of the 9 different types of information that is useful to the analysts. This list is derived from the literature (Barker, 1999). Broadly speaking, this list can be divided into two main categories of information i.e., accounting information and non-accounting information. The objective here is to understand the role of accounting information in the context of non-accounting information that is available to the analysts (Yap,1997). The accounting information in Table 3 is: 'classification of financial statements', 'segmental information (business unit and geographic), 'your own assessment of the quality of financial statements', and 'analysis of historical performance'. The accounting information presented in the list above plays a critical role in the valuation, even though it is historical in nature. But areas of information such as 'performance sustainability', 'industry competition' and 'corporate strategy' can make sense only in the presence of accounting information. It is also more important than the review of investment projects and research and development. Actually, the value relevance of information relies on the certainty of its forecasts. For example, the analysts' assessment of factors such as industry competition and corporate strategy is value relevant but the certainty of this forecast diminishes with the extension in the forecast horizon. Accounting information is reliable, but its value relevance depends upon how it can be envisioned in the future. At the same time, the investment projects and research and development are value relevant but their projected payoff is not certain, making them a less useful information source in Table 3. In a nutshell, we can say that the analysts' analytical process is rooted in accounting information and it takes into account financial statements and other sources of information depending upon their reliability in the foreseeable future.

According to residual income valuation (RIV) model of Ohlson (1995), non-accounting information in the present affects future abnormal earnings or residual income auto-regressively. The firm's market value equals its book value adjusted for current profitability (as measured by abnormal earnings) and future profitability (i.e., goodwill as measured by other information). In this context, the most important category of information in Table 3, as ranked by UAE analysts, is their own assessment of management. Why do analysts rank this category higher than the other categories? The reason is that this assessment is a proxy for the capacity of a business to outperform in periods beyond the foreseeable future. Good managers will influence future performance and the quality of management can be assessed now, but future performance itself is unobservable. The kinds of information presented in Table 3 clearly imply that the analysts in the UAE consider their own assessment of the management to be the most important, with a mean of 4.03 and standard deviation of 1.22. This ranking of the assessment of management as the most important information is consistent with Barker (1999), who found that the UK financial analysts consider this the most important, too. In the UAE the financial analysts ranked the assessment of performance sustainability as the second most important information (mean =4.03 and standard deviation= 1.22). Barker (1999) notes that the UK financial analysts ranked it at no.3. The table below reveals that the respondents to our survey, keeping in view the unique economic, legal environment and industrial set-up of the UAE, agreed that the review of corporate strategy (mean=3.80 and standard deviation= 1.18), their own assessment of quality of financial statements (mean = 3.66 and standard deviation= 1.41), clarification/classification of financial statements (mean=3.54 and standard deviation=1.48), review of investments projects (mean=3.54 and standard deviation=1.12), segmental information (mean=3.51 and standard deviation=1.31), analysis of historical performance (mean=3.49 and standard deviation=1.22) and review of research and development (mean=3.11 and standard deviation of 1.18) were less important items of company specific information. Our results are consistent with Barker (1999) in the UK context, especially for the first two categories and the last category. The rest of the categories are also quite close to those of Barker (1999) but not exactly the same.

Table 3: Characteristics of Company Specific Information Useful to the Analysts in UAE

	N	Mean	Median	Std. Deviation
Assessment of Management	35	4.03	4	1.22
Assessment of Performance Sustainability	35	4.03	4	1.22
Review of Corporate Strategy	35	3.80	4	1.18
Assessment of Quality Financial Statements	35	3.66	4	1.41
Clarification/Classification of Financial Statements	35	3.54	4	1.48
Review of Investment Projects	35	3.54	4	1.12
Segment Information	35	3.51	4	1.31
Analysis of Historical Performance	35	3.49	4	1.22
Review of Research and Development	35	3.11	3	1.18

This table provides a summary of the characteristics of company specific information found to be useful the analysts in UAE. A high proportion of participants considered Assessment of Management and Assessment of Performance Sustainability to be the most important.

The findings for the analysts in the UAE may be directly compared to those of fund managers, which are reported in Table 4. Here, the buy-side analysts ranked the performance sustainability (with the mean=4 and standard deviation= 1.3) as the highest that is followed by the assessment of the management (mean=3.9

and standard deviation =1.3). The review of the corporate strategy (mean =3.7 and standard deviation=1.3) is ranked at number three. Analysts in the UAE consider 'your own assessment of the management' (mean=3.6 and standard deviation =1.5), analysis of historical performance (mean= 3.6 and standard deviation=1.3), review of investment projects (mean= 3.6 and standard deviation=1.2), clarification/classification of financial statements (mean=3.5 and standard deviation=1.6), segmental information (mean =3.6 and standard deviation= 1.5) and review of research and development (mean= 3.1 and standard deviation=1.2) as progressively less important. Our findings for the buy-side analysts' preference of company specific information are also quite consistent with that of Barker (1999a), particularly, the review of research and development, clarification/classification of financial statements, and review of corporate strategy. The rest of the categories are also very close to what Barker (1999a) has found in the UK, but not exactly the same.

The information categories such as performance sustainability, corporate strategy, and industry competition are value relevant but also carry some kinds of uncertainty attached to their payoffs. This information is incremental to financial information. In Table 4, the second broad category of information is based on financial statements such as 'your own assessment of the quality of financial statements', analysis of historical performance, clarification/classification of financial statements. Table 4 suggests that despite its reliability this information is lower ranked by the analysts. As discussed previously, this evidence may be interpreted in the framework of the residual income valuation (RIV) model (Peasnell, 1982; Ohlson, 1995).

Table 4: Characteristics of Company Specific Information Useful to Buy-Side Analysts in UAE

	N	Mean	Median	Std. Deviation
Assessment of Performance Sustainability	27	4	4	1.3
Assessment of Management	27	3.9	4	1.3
Review of Corporate Strategy	27	3.7	4	1.3
Assessment of Quality Financial Statements	27	3.6	4	1.5
Analysis of Historical Performance	27	3.6	4	1.3
Review of Investment Projects	27	3.6	4	1.2
Clarification/Classification of Financial Statements	27	3.5	4	1.6
Segment Information	27	3.4	4	1.5
Review of Research and Development	27	3.1	3	1.2

This table provides a summary of the characteristics of company specific information found to be useful the buy-side analysts in UAE. A high proportion of participants considered Assessment of Performance Sustainability and Assessment of Management to be the most important.

Why do Analysts Use This Information?

We explored this question in the research interviews that we conducted after the survey and dicovered that the analysts in the UAE are of the view that to value a business one should have a business sense (an overall understanding of the business) and an ability to go beyond numbers apart from a basic understanding of financial statements. Below are some revealing extracts from the analysts' interviews:

> *I think to be a good analyst, one not only needs to know company fundamentals, valuation tools but also possess a business sense - how to run and own a business e.g., a restaurant like Mc Donalds, or a property company. Knowing this makes one a good analyst. (Financial Analysts)*

> *For an analyst, no matter which industry he is covering, he should have the ability to make economic sense of how the numbers are generated in terms of revenue, costs, and growth. He should have the ability to value a business at any given time. (Financial Analysts)*

The analysts should take into account the whole idea (context); how the numbers arrive; events that took place during the year. And if I am comparing this company with another company in another industry you need to know what the industry dynamics are. (Financial Analysts)

On the industry level, the analyst must be aware of the importance of macro-economic environment, demand and supply, barriers to entry, etc.(Financial Analysts)

I think you cannot value a company without actually sitting with the management. It is about how management wants to grow the business, what they are doing, what they did in the last three years, and what actually they can achieve. So sitting with management gives you a really different point of view. (Financial Analysts)

Sector analysis needs to be really strong. Compared to developed markets, in an emerging market sector research is not well covered. In the MENA region, there are many sectors which are not properly covered, e.g., the aviation industry. Today it is very difficult for us to find proper research on aviation. (Financial Analysts)

To conclude this section, we can say that the usefulness of a given piece of company information is dependent upon its value relevance. If a piece of information does not reduce the uncertainty attached to the riskiness of future cash flows, then analysts and fund managers in the UAE do not consider it useful. We can also say that the characteristics of company specific information considered by UAE financial analysts are most of the time quite similar to what analysts in a developed market such as the UK would consider. Any deviation in ranking that is found is quite small.

What Accounting Variables Do These Analysts Employ?

Table 5 presents the ranking of the analysts regarding the importance of accounting variables. The table shows that analysts perceive free cash flow (4.31), operating cash flow (3.91), and operating earnings (3.63) to be the most important variables to consider in their valuation. It also shows that the book value of equity (3.06), revenues (3.43), and net income (3.46) are the least important variables. This indicates that analysts in the UAE give more priority to cash-based valuation models than accrual-based valuation models. Another insight from this result is that the financial system in the UAE provides a wide range of information from which analysts can select more complicated valuation models.

Table 5: Accounting Variables Used by the Analysts

	N	Minimum	Maximum	Mean	Std. Deviation
Free Cash Flow	35	0.00	5.00	4.31	1.39
Operating Cash Flow	35	0.00	5.00	3.91	1.44
Operating Earnings	35	0.00	5.00	3.63	1.37
Net Income	35	0.00	5.00	3.46	1.27
Revenues	35	0.00	5.00	3.43	1.24
Book Value of Equity	35	0.00	5.00	3.06	1.47
Others	35	0.00	1.00	0.03	0.17

This table shows that the free cash flow and operating cash flow are the most important variables that analysts in UAE consider in their valuation. On the other hand, the participants ranked revenues and book value of equity as the least important variables.

These findings were explored in the semi-structured interviews with the analysts. Below are their arguments for the choice of these accounting variables:

Cash flow based estimates give a better picture of the company so cash flow and cash flow yields are better indicators than accrual-based estimates because of earnings management, receivables, *working capital requirements, etc. So cash flow would not be distorted by these things. (Financial Analysts)*

Actually, to me, cash flow is more important. It is important to value a business, not only by using the immediate cash flow but also by using the projected cash flow. For earnings manipulations, the job of the analyst is to adjust for that.

(Financial Analysts): When we value the company using DCF model, we use cash instead of net profit which is very prone to accounting manipulations (IFRS & US GAAP). FCF is more relevant as business is worth of the money it is bringing in.

(Financial Analysts): In this region, I have found that liabilities are not always correctly stated or they may not be categorized correctly. Assets such as land and other things are overvalued and this can influence the valuation. So we have problems with EBITA because of accounting treatments. (Financial Analysts)

To conclude this section, we can say that the analysts in the UAE prefer cash flow based accounting variables for valuation purposes and rely less on book value of equity and revenues. In other words, we can say that the analysts in the UAE consider the ability to use resources (generation of cash flow/ assessment of management) more important than actual resources.

CONCLUDING COMMENTS

This paper provides insights into the two most important aspects of a listed company valuation: the characteristics of company specific information considered by the analysts and their preference in terms of accounting variables. In this study, we approached the research objectives by using the survey research methods of questionnaire and interviews. The surveys cover the sectors of Finance, Real Estate, the Media and others. Overall, this paper suggests that both analysts and fund managers in the UAE use accounting information with reference to its reliability and value-relevance, and they heavily discount information that is value relevant but whose pay-offs are uncertain (e.g., research and development). Management quality and performance sustainability are ranked highly by both analysts and fund managers in the UAE. This is because management has the ability to influence future performance, and this ability can be noted and also evaluated. But how the actual assessment of the management is made is still a question mark to us and thus a clear area of future research. A limitation of this study is that it did not include the content analysis of the equity research reports because of the difficulty of collecting these reports and because of the preponderance of buy-side analysts in our survey and interviews. Another limitation is that the sample concentrates on a few industries, most of them in the financial sector. The study did not include enough sell-side analysts, especially in the semi-structured interviews. Further research should include, in addition to the survey, the content analysis of equity research reports. In other words, it should include questionnaires, interviews, and content analysis. This study could be extended by increasing the sample size, considering other countries and including more analysts from other sectors.

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BIOGRAPHY

Hafiz Imtiaz Ahmad (Ph.D; CVA; MAFF) is serving as an Assistant Professor and Director of Professional Enrichment at the School of Management, New York Institute of Technology, Abu Dhabi Campus. Dr. Ahmad graduated from University of Lille, Lille, France, with a specialization in Finance. His domain of research includes equity valuation specifically residual income and abnormal earnings. He can be reached at hahmad02@nyit.edu.

Khaled Aljifri is a Professor of Accounting at United Arab Emirates University. He has published in Business, finance and accounting journals such as the European Accounting Review, International Business Review, Advances in Accounting, Accounting Educator's Journal, and Managerial Auditing Journal. He can be contacted at k.aljifri@uaeu.ac.ae .