

Improving the effectiveness of predictors in accounting-based models*

Duarte Trigueiros (ISTAR-IUL, University Institute of Lisbon)

Abstract

Financial ratios are routinely used as predictors in modelling tasks where accounting information is required. The purpose of this paper is to discuss such use and to show how the effectiveness of ratio-based models can be improved. The paper first identifies the inadequacies of ratios when used as multivariate predictors, and then develops a theoretical foundation and methodology for constructing accounting-based models. Under plausible assumptions about the cross-sectional behaviour of accounting data, the paper shows that the effect of size that ratios remove can also be removed by modelling algorithms, facilitating the discovery of meaningful predictors and leading to significantly more effective models. Experiments confirm that the new methodology outperforms the conventional methodology, avoids the need to select ratios, and makes model construction less arbitrary. The new methodology can end the current uncritical use of modelling tools and unlock the full relevance of accounting information when used to support investment and other value-creating decisions.

I. Introduction

Financial institutions, analysts, and investors, increasingly rely on multivariate models to assess credit risk, to estimate the likelihood of default, to forecast earnings' changes, to detect financial misstatement and to carry out other predictive tasks (Ak *et al.*, 2013). The purpose of this paper is to improve the effectiveness of accounting-based models, something that is probably a minor concern for research-driven modelling, but which is vital when the aim is to support actual decisions. In the paper, an improved effectiveness means a higher level of accuracy and explained variability, and the lessening of biases (Wilcox, 2010).

Among factors determining model effectiveness, the paper attends to the adequacy of predictors. Accounting-based models use ratios as predictors. Ratios are indeed indispensable in the analysis of financial statements where they bring to light financial features such as

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Profitability or Solvency while allowing the comparison of varied-size firms. But the fact that ratios are adequate in the context of financial analysis should not exempt them from scrutiny when the purpose is predictive modelling. The specific inadequacies of ratios when used as predictors are the need to find appropriate ratios among many alternatives (Tian *et al.*, 2015) and their erratic, not well-behaved distributions (So, 1987; Lau *et al.*, 1995) that may lead to misrepresentation of essential qualities of the data being modelled (Kotz *et al.*, 2005).

The paper develops a theoretical basis to show that the effect of size, which ratios remove, can also be removed by modelling algorithms. While removing size, algorithms portray financial features required by the relationship being modelled as though ratios were there yet avoiding the mentioned inadequacies of ratios. A model-building methodology derived from such theoretical basis is proposed, capable of retaining ratios' most valuable traits, namely interpretability. Three experiments are performed to compare the new and the conventional methodologies. The experiments verify that the new methodology delivers markedly more accurate, unbiased, and robust prediction.

The findings reported here have the potential to expedite the use of accounting-based models in predictive tasks where to date accuracy is not conclusive enough to support actual decisions. Better investment decisions, for instance, may result from a superior accuracy in predicting earnings' changes (Holthausen and Larcker, 1992) and other market-related attributes. Also, in the face of concerns about the declining value-relevance of accounting information (Lev and Gu, 2016), the sizeable performance gains now at hand will provide support to the claim that such apparent decline is not intrinsic to accounting information but may result, among other causes, from inadequately constructed models (Clout *et al.*, 2016).

II. Critical review of the use of ratios in accounting-based models

This section exposes ratios' inadequacies when used as predictors in multivariate models, presenting the case for the proposed methodology and summarising related research. First,

the difficulty presented by the need to seek appropriate ratios is outlined. Next, the section calls to mind the cause of ratios' erratic distributions and the ensuing consequences for modelling. Then, a relevant case of ratio-induced misrepresentation is discussed in relation to current modelling practice. Finally, the propensity of ratios to bias models by selectively generating missing values is examined.

The ratio selection process is unsatisfactory

The selection of multivariate predictors is generally seen as a difficult task and given the profusion of alternative predictors available such difficulty increases when the predictors are financial ratios. To solve this problem, some authors select predictors based on theory while other authors follow *ad-hoc* approaches.

When the aim is to test research hypotheses, ratios are pre-selected according to theory. But in Palepu (1986), Beneish (1999), and in other studies where model effectiveness should be a concern, ratios are equally selected based on individual qualities stated by theory. These studies are transposing to the multivariate domain an essentially analytic (univariate) routine. The consequence is that the predicting algorithm is limited in its choices and is unable to use all information available in sets of accounts.

Multivariate algorithms are synthesisers. They estimate moments and covariance matrices from multivariate distributions and then they extract from such estimations, and not from any specific ratio, whatever variability is optimal in modelling a relationship. This is why models where effectiveness is important tend to favour the use of *ad-hoc* approaches to select ratios from a larger set (Altman, 1968; Du Jardin, 2009; Dechow *et al.*, 2011; Xu *et al.*, 2014; Tian *et al.*, 2015), with the view to obtain optimal or nearly optimal prediction. But since the number of ratios that are potentially useful to model a relationship can be very large, some useful ratios may end up not being included in the selection procedure.

Both theory-driven and *ad-hoc* ratio selection are therefore unsatisfactory for applied

modelling. In addition, the task of selecting ratios typically is time-consuming and laden with arbitrary choices. In Altman and Sabato (2007), for instance, this procedure involves 4 steps, including theory- and literature-based ratio gathering, univariate pre-selection, multivariate selection, and backward removal of weak predictors.

The methodology proposed in the paper can bypass ratio selection entirely. Variability required to model a relationship is identified as contained in the set of items directly taken from financial statements, not in ratios. So, rather than being at the inception of the model-building process, ratios follow from the modelled relationship.

Ratio distributions may distort models

The irregular and not well-behaved distributions found in ratios have led authors interested in building accounting-based models to propose ad hoc remedies such as winsorisation or outlier pruning (Trigueiros, 1995; So, 1987; Lau *et al.*, 1995), the transformation of ratios (Watson, 1990; Altman and Sabato, 2007), or the use of robust estimation (Ohlson, 1980; Zmijewski, 1984). Today, these ad hoc remedies are still very popular (Sun *et al.*, 2014; Ohlson and Kim, 2015; Leone *et al.*, 2017), suggesting that ratio distributions are still treated as mild oddities that need to be addressed somehow.

In fact, distributions of ratios are not odd and are easy to understand. For continuous numbers, randomness is the result of many interacting effects. Effects are aptly called additive when they add up, or multiplicative when they multiply. Additive distributions, such as the normal distribution, reveal the action of additive effects whose probability of occurrence is governed by the additive law of probability. Multiplicative distributions, such as the lognormal distribution, also reveal effects whose probability of occurrence is governed by the multiplicative law of probability.

It has long been established that income, wealth, firm size and other economic accruals resulting from the accumulation of random amounts obey a multiplicative law of

probability, such as the Pareto or Gibrat laws, rather than an additive law, such as the central limit theorem (Ijiri and Simon, 1964; Singh and Whittington, 1968). Because the statistical behaviour of financial statement numbers approximates other economic accruals, their cross-sectional distributions obey a multiplicative law of probability (Tippett, 1990; Trigueiros, 1995; Falta and Willett, 2011), and the ratios formed from them are also multiplicative (Johnson *et al.*, 1994). Based on this premise, McLeay and Trigueiros (2002) can explain the different distributions found in ratios.

Nor are the distributions of the ratios by any means mild. In additive data, it is rare to find cases that differ from the mean by more than three standard deviations. For example, the height of an adult human is limited because humans are neither taller than mountains nor shorter than mice. For multiplicative data, however, such disparities are not only possible, but likely. In fact, multiplicative distributions behave exponentially, i.e. as cases are ranked by size, they increase exponentially. Consequently, as the occurrences of a multiplicative variable increase, the dispersion of cases increases very rapidly as their density decreases abruptly. In the resulting distribution, almost all cases are concentrated in a small interval and a few cases are widely scattered (Johnson *et al.*, 1994).

The term ‘heteroscedasticity’, i.e. an uneven distribution of cases, does not do justice to the exponential behaviour of ratios. When it is claimed that least squares or maximum likelihood estimation, which are inefficient but not biased by heteroscedasticity, can be used in ratio-based modelling (Ohlson, 1980), it is clear that such a claim ignores the multiplicative nature of ratios, where extremely influential cases will directly bias model coefficients, while the aforementioned abrupt drop in case density, which cannot be approximated by a least squares or maximum likelihood fit (Kotz *et al.*, 2005), leads to models in which the distributions are misrepresented. It is also clear that the type of extreme observation found in multiplicative data is not necessarily anomalous. Therefore, pruning or

winsorisation is not only counterproductive, but can be a source of bias (Leone *et al.*, 2017).

The methodology presented in this paper deals adequately with the multiplicative behaviour of accounting items, avoiding ad hoc remedies and improving model accuracy.

Ratios may misrepresent class likelihoods in classification tasks

Most accounting-based models are classifiers (Amania and Fadlallab, 2017), and a long-lived example (Altman, 1968, 1983) predicts firm failure using a balanced sampling design in which classes contain roughly equal numbers of failed and nonfailed cases. Today, however, balanced sampling is no longer used because the research community has been led to believe that balanced sampling is inadequate. In fact, balanced sampling leads to a biased estimate of likelihoods (Palepu, 1986), but this bias does not change the position of the estimated likelihoods relative to each other, so if the aim is to find the cases that are most and least likely to belong to the class of interest, balanced sampling is not only adequate but also the most information-efficient design (Cosslett *et al.*, 1981).

To avoid this bias, class frequencies in model-building datasets are now designed to mimic the underlying prevalence, i.e. the real-world class probabilities. For example, if the a priori probability of failure is 6 out of 100, then the model-building dataset must contain 6 per cent of failed firms and 94 per cent of non-failed firms. However, there are reasons to discourage this practice. First, the prevalence is often small, which can compromise the generalisability of models if there are not enough cases in the minority class to adequately represent its distribution (Zmijewski, 1984). This damage is particularly evident in tasks such as predicting takeover targets (Palepu, 1986) and detecting financial misstatements (Beneish, 1999), where not only prevalence but also predictive power is low. Second, class frequencies in the data available for modelling rarely reflect prevalence, and the data must be manipulated in one way or another before they can be used. Such manipulation will inevitably introduce new biases. Finally, if no attempt is made to deal with the exponential

behaviour of the data, the predicted class frequencies will be misrepresented, as it is pointless to try to make the modelled classes resemble prevalence.

Procedures are available to deal appropriately with class imbalance in balanced sampling. Apart from the possibility of using estimation procedures compatible with balanced sampling (Manski and MacFadden, 1981), it has been shown that when the modelling algorithm is logistic regression, class imbalance affects only the intercept coefficient, so that models can be built from balanced samples and then the intercepts can be corrected to account for imbalance (Xie and Manski, 1989).

The methodology presented here puts an end to the misrepresentation of distributions in accounting-based models and allows the use of efficient sampling designs that do not require data manipulation. Where appropriate, balanced sampling opens the way to the use of matching and other methods that can control for undesirable characteristics of the data.

Ratio-generated missing values may also misrepresent class likelihoods

Most accounting-based empirical research relies on third-party databases of financial statements. There is increasing concern that data quality issues may affect research findings. Here, Casey *et al.* (2016) review the literature on the quality of databases of financial statements. Among other problems, they identify the presence of too many missing values.

To make matters worse, another source of missing values besides poor database quality is the use of ratios, where any missing ratio component or a zero denominator creates a new missing value. Missing values will distort models if the number of withdrawals is related to the variable being predicted. For example, companies that did not pay dividends in the previous period will be improperly dropped from models predicting earnings, where a popular predictor is the change in dividends per share from the previous period.

The paper presents instances of ratio-generated, class-dependent missing values, showing how the new methodology helps reducing the consequent bias.

III. A new model-building methodology

This section develops a theoretical foundation from which a new modelling methodology is derived. The underlying premise is that, except in well-known cases, financial ratios can be validly used in the analysis of financial statements. More than one hundred years of testing and intensive use supports this premise.

The valid use of ratios is based on the assumption that ratios can remove the effect of size and thus make financial features comparable across firms of different sizes. This has two implications (McLeay and Trigueiros, 2002). First, a common effect that accounts for size differences between sets of accounts is present in the two components of the ratio and is removed when the ratio is constructed. Second, such an effect is removed when the two components are multiplicative, that is, when they have distributions in which the effects multiply each other. In fact, when a ratio is formed from two numbers that have the same factor in common, this factor is cancelled out.

The most general instance of multiplicative behaviour is the lognormal distribution. When lognormality is hypothesised, the two implications just mentioned require that the cross-sectional variability of x_{ij} , the i^{th} item from the j^{th} set of accounts, be described as

$$\text{Log } x_{ij} = m_i + z_j + \epsilon_{ij} \quad (1)$$

where the logarithm of x_{ij} is explained as an expectation m_i accounting for the overall mean and the deviation from the mean specific to item i , plus z_j , the size effect specific to set of accounts j , plus size-unrelated residual variability ϵ_{ij} .

Formulation (1) is not intended to minutely portray the cross-sectional behaviour of items but to describe z_j , the common effect of size. The ϵ_{ij} are not necessarily independent and, after size is accounted for, there may remain positive or negative correlations between the residuals of any two items.

Given two items, $i = 1$ and $i = 2$ and the corresponding x_1 and x_2 from the same set

of accounts, the logarithm of the ratio of x_2 to x_1 is, according to (1), written

$$\text{Log} \frac{x_2}{x_1} = \text{Log} x_2 - \text{Log} x_1 = (m_2 - m_1) + (\epsilon_2 - \epsilon_1) \quad (2)$$

where, trivially, the effect of size, z_j , is no longer present. The median ratio $\exp(m_2 - m_1)$ is a suitable norm against which comparisons can be made, while $\exp(\epsilon_2 - \epsilon_1)$ is the deviation from this norm observed in the ratio. For example, $\exp(\epsilon_{Expenses} - \epsilon_{Sales})$ shows whether the Operating Ratio is above or below the norm. Thus $\epsilon_2 - \epsilon_1$ is, in logarithms, the information conveyed by a ratio about a financial feature.

To the extent that ratios are suitable as analytical tools, the premises leading to (1) are verified. If this were not the case, ratios for large firms would behave differently from ratios for small firms. For example, profitability would be useless in a cross-sectional analysis.

The case of items where negative values can occur

Formulation (1) cannot explain negative values, such as those found in Net Income. But items where negative values occur are subtractions of two positive-only items. Consider $x = x_A - x_B$ where x_A and x_B are positive. For any sign of x , an algebraic manipulation leads to

$$\text{Log} |x_A - x_B| = \text{Log} x_A + \text{Log} |1 - \frac{x_B}{x_A}|. \quad (3)$$

Since x_A is positive, (1) applies to $\text{Log} x_A$. And since, as shown in (2), $\frac{x_B}{x_A}$ is size-independent, z_j is not present in $\text{Log} |1 - \frac{x_B}{x_A}|$. Using the notation adopted in (1), the expected value of $\text{Log} |x_A - x_B|$ is written as m' , being the result of adding m_A to the expected value of $\text{Log} |1 - \frac{x_B}{x_A}|$. Similarly, residuals are written as ϵ' . From (3),

$$\text{Log} |x| = m' + z_j + \epsilon' \quad (4)$$

for positive- and negative-valued x . Although m' and ϵ' in (4) no longer have the intuitive meaning of m and ϵ in (1), notably z_j in (4) is the same as in (1). Basically, this is the reason why ratios remove the effect of size, even when one component is negative. Now, if ratios

remove size no matter the sign of components, it should be possible to use any item, not just positive-valued items, in modelling tasks requiring the removal of size. When items are transformed so that the effect of size is preserved regardless of sign as in (4), their subtraction will remove size in a way like (2), also regardless of sign.

One such size-preserving transformation is $\text{Log } |x|$ coupled with a dummy retaining the sign of x . In classification tasks, dummies may be replaced by a fixed displacement d_{neg} of $\text{Log } |x|$ for negative x only, where x is transformed into $\text{Log } |x| - d_{neg}$.

Another transformation worth mentioning at this stage is $\text{sign } x \text{ Log } |x|$, known as Log-Modulus (John and Draper, 1980), where negative x are transformed into $-\text{Log } |x|$. Here, the sign of x is preserved but a subtraction of two items will not remove size from negative values. Log-Modulus is an alternative to be considered when the goal is simply to transform multiplicative variables into well-behaved variables and size is not an issue.

Within the range $-1 < x < 1$, the mentioned transformations are equivocal but monotonic alternative exist. Also, since multiplicative numbers require an accumulation to be formed, zero values should be treated as not multiplicative and kept as zeros.

The role of firm size in the modelling of size-independent relationships

Consider the loglinear relationship

$$y = a + b_1 \text{Log } x_1 + b_2 \text{Log } x_2 + \dots \quad (5)$$

where $x_1, x_2 \dots$ are items taken from the same set of accounts and y is the attribute to be predicted. In the case of a classifier, y is the underlying linear score. Where predictors obey (1), then (5) is

$$y = A + b_1 \epsilon_1 + b_2 \epsilon_2 + \dots + (b_1 + b_2 + \dots) z_j \quad (6)$$

where $A = a + b_1 m_1 + b_2 m_2 + \dots$ is constant. That is, variability available to model y has a size-independent term $b_1 \epsilon_1 + b_2 \epsilon_2 + \dots$ and a size-related term $(b_1 + b_2 + \dots) z_j$. If y is

size-independent, the term $(b_1 + b_2 + \dots) z_j$ must be zero to bar size-related variability from entering the relationship. Coefficients b_1, b_2, \dots must add to zero.

For example, when such size-independent y is predicted by two log-transformed items, then (5) is $y = a + b_1 \text{Log } x_1 + b_2 \text{Log } x_2$ with $b_2 = -b_1 = b$, that is,

$$y = a + b(\text{Log } x_2 - \text{Log } x_1) \quad \text{or} \quad y = a + b \text{Log } \frac{x_2}{x_1}. \quad (7)$$

Ratio x_2 to x_1 is formed in response to y 's size-independence. Suppose that the ratio x_2 to x_1 predicts bankruptcy accurately. When the logarithms of its components are shown to a modelling algorithm, the linear combination explaining bankruptcy optimally is found when $b_2 = -b_1$ as in (7) because, at that point, size is removed, the ratio is formed, and its predictive power is released. Similarly, when a size-independent y is predicted by three items, then $b_3 = -b_1 - b_2$ and (5) now is $y = a + b_1 \text{Log } \frac{x_1}{x_3} + b_2 \text{Log } \frac{x_2}{x_3}$. That is, in response to size-independence, two ratios are formed from three items.

In the general case, size-independent y could indeed induce $N - 1$ ratios from N items, but algorithms are not capable of pairing items two-by-two. Instead, as part of the modelling process, size-related variability is assigned to a number of predictors to compensate for size-related variability in other predictors. The algorithm will assign the role of 'ratio denominator' to some predictors (negative-signed b coefficients) and that of 'ratio numerator' to others (positive-signed b coefficients) so that $b_1 + b_2 + \dots = 0$, the overall effect being the removal of size. The resulting linear combinations are high-dimensional ratios in logarithmic space. Because they are independent of size, they are capable of representing the financial features required by the relationship at hand. And to the extent that transformations applied to items are intended to preserve size, items with negative values will also form linear combinations capable of removing size. When, for instance, $\text{Log } |x| - d_{neg}$ is applied to $x_1, x_2 \dots$ in (5), the term $(b_1 + b_2 + \dots)(z_j - d_{neg})$ will be formed where d_{neg}

is distinct but constant for positive and negative values. As before, size-independent relationships will cause $b_1 + b_2 + \dots = 0$.

The conclusion to be drawn at this stage of the paper is that the task of selecting ratios capable of representing financial features while removing size is not a modelling prerequisite. In response to size independence, the algorithm will form optimal high-dimensional ratios from log-transformed items. The algorithm will form a ratio from two predictors.

The case of size-related relationships

When a size-related y is modelled by individual items as in (5), size is not fully offset. The term $(b_1 + b_2 + \dots) z_j$ in (6) creates dependencies in coefficients and algorithms will face multicollinearity. Models that include financial ratios plus a size proxy as predictors are immune to this complication because even if size is present in a relationship, ratios cannot account for it. On the other hand, as noted above, ratios are not very reliable and easy to use for multivariate prediction.

By adding to (5) the condition $b_1 + b_2 + \dots = 0$, size-independent variability would explain the size-independent part of the variability of y . Such condition holds when, instead of N items as in (5), $N - 1$ pairs subtracted as in (7), that is, $\text{Log } x_2 - \text{Log } x_1$, are used as predictors. Similar to ratios, subtracted pairs are intrinsically size-independent. The spare degree of freedom should be utilised to account for the effect of size.

The methodology

Log-transformed items can be used directly in modelling size-independent relationships as in (5). Here the financial features are formed while the effect of size is offset, as if ratios were present. Predictors that obey (1) behave well, but the coefficients of the models cannot be interpreted, a feature that is at odds with analysts' practice, and unlike models that use ratios, size-related changes would require the models to be rebuilt.

Consistent with the previous discussion, the new methodology is now outlined. First, the comprehensive set of M log-transformed items, together with the attribute to be predicted, is shown to the modelling algorithm as in (5). A model is built with the sole purpose of selecting the subset of $N \ll M$ items possessing predictive power. Then, at a second stage, pairs made of the N items selected at the first stage are subtracted, forming predictors similar to $\text{Log } x_2 - \text{Log } x_1$ in (7). No more than $N - 1$ pairs should be formed and none of the N selected items should be omitted. The algorithm estimates the final model using such pairs.

By selecting predictors from the comprehensive set of M items and not from the much more numerous and ill-defined set of potentially useful ratios, the new methodology greatly simplifies the predictor-selection process while reducing the chances of overlooking variability possessing predictive power.

Practical suggestions for implementing the methodology are given below.

1. Databases of financial statements typically scale all numbers down by one million. Items must be descaled to avoid falling within the range $-1 < x < 1$. For the same reason, pre-existing ratios such as Earnings per Share will also need scaling.
2. When items have negative values, $\text{Log } |x| - d_{neg}$ is suited for classification tasks where d_{neg} should exceed the descaling power, that is, for a 10^6 descaling, then $d_{neg} > 6$. Above such threshold value, the choice of d_{neg} is irrelevant. Dummies, in turn, are suited for regression tasks.
3. If second-stage accuracy is smaller than first-stage accuracy, the relationship is size-related. A size proxy can be added as second-stage predictor, but the methodology is no longer effective in identifying optimal ratios.
4. Changes Δx and $\Delta x/x$ in relation to the previous period are both transformed into

$$\Delta \text{Log } x = \text{Log } x_t - \text{Log } x_{t-1} \quad (8)$$

where $t - 1$ and t are subsequent periods. In the case of positive- and negative-signed

x , a sign-preserving transformation is required and $\Delta \text{Log } x$ will be size-related.

Contrary to ratios, (8) will not create missing values when $x_{t-1} = 0$.

IV. Three experiments

This section illustrates the use of the new methodology by comparing conventional models based on ratios with first-stage models based on transformed items and their subtracted pairs, i.e. second-stage models. The comparisons cover three well-documented classification tasks illustrating low, medium and high levels of difficulty, namely bankruptcy prediction, financial misstatement detection and earnings forecasting. Classification tasks are preferred to regression tasks because model effectiveness is easier to compare in the former.

The three comparisons are made using a controlled experimental design in which, except for the predictor used, all other model characteristics, i.e. data used to build and test the models, class frequencies, modelling algorithm, randomisation and information provided, are strictly identical for the ratio-based model and the newly developed methodology.

Experiments contemplate *ex-ante* and *ex-post* prediction, size-independent and size-related relationships, and balanced sampling as well as data not subject to sampling. In ratio-based models, cases are not pruned. At the first stage of the new methodology, item x to be tested for inclusion (i.e. Table 1), is descaled into original values and then,

- for $x > 1$, x is transformed into $\text{Log } x$.
- for $x = 0$, x is not transformed.
- for $x < -1$, x is transformed into $\text{Log} |x| - d_{neg}$ for bankruptcy prediction, and into $-\text{Log} |x|$ for earnings forecasting. No negative values occur in the misstatement detection experiment.

The transformation applied in the first stage is used in the calculation of (8) and in the second stage. The Logistic regression is the modelling algorithm used throughout the three experiments and first-stage selection of predictors is performed via standard variable-

selection algorithms attached to the Logistic regression. Multicollinearity is checked in first-stage models.

-- Table 1 --

Bankruptcy prediction

The first experiment follows Altman's (1968, 1983) bankruptcy predicting models. Ohlson (1980), Zmijewski (1984) and Taffler (1982) discuss bankruptcy prediction and offer alternatives to Altman's models. A review of this research, where high accuracy levels are customary, can be found in Balcaen and Ooghe (2006) and in Sun *et al.* (2014).

The experiment aims, not so much at illustrating the benefits of the new methodology, but at introducing its distinctive characteristics. A total of 2,997 bankruptcy filings are drawn from the UCLA-LoPucki data¹ and from other sources. Filings but the first to occur in each firm, and filings about which financial statements are not available, are discarded. Both 'Chapter 7' and 'Chapter 11' filings are included.² Two samples of nearly 900 cases each are drawn from the remaining filings. The two samples contain firms listed in U. S. exchanges, present in the Compustat file. They span the period 1979-2008. All size categories, computed as the deciles of the logarithm of Assets, and all the 24 Global Industry Classification Standard (GICS) groups are represented.

To lessen unwanted variability, firms in the two samples are matched with firms not bankrupt. Matching is based on the GICS group, on size decile and on year. One bankrupt case is randomly assigned to its peer and then the peer is made unavailable for matching. One of the datasets is utilised to build the models and the other to measure their effectiveness.

The ratio-based model uses Altman's (1983) X1 to X5 ratios detailed in Table 2. At the first stage of the new methodology, the algorithm selects 5 predictors from components of

¹ <http://lopucki.law.ucla.edu/>

² Under Chapter 11 debts are restructured; under Chapter 7 assets are liquidated to repay debts.

the same X1 to X5 ratios. Negative values are transformed into $\text{Log } |x| - d_{neg}$, where the chosen $d_{neg} = 7$ slightly exceeds the 10^6 descaling.

Table 2 shows that accuracy is high in both models, but ratios fail to use variability available in their components, as Chi-square and R-Square statistics are visibly higher in the first-stage model than in the model based on ratios. Table 2 also compares class frequencies in the model-building dataset with class frequencies predicted by the model.

-- Table 2 --

Size-offsetting, mentioned in relation to (5), is visible in first-stage coefficients. Working Capital and Total Liabilities have positive signs and add to 9.74. These are the numerators of internal ratios. The denominators are Total Assets, Retained Earnings and Operating Income after Depreciation, with negative signs and adding to 10.35.

The 5 predictors selected at the first stage are now paired and the components of each pair are subtracted, forming 4 new predictors to be used at the second stage. Among other possible combinations, the algorithm may estimate the score

$$0.95 + 0.13 \text{Log } \frac{WCAP}{AT} + 7.92 \text{Log } \frac{LT}{AT} - 0.47 \text{Log } \frac{RE}{LT} - 0.43 \text{Log } \frac{OIADP}{LT}$$

where abbreviations refer to Table 1 and, to emphasise model interpretability, subtractions of two paired items are depicted as ‘Log’ followed by the fraction sign. $\text{Log } \frac{WCAP}{AT}$, for instance, really means $(\text{Log}|WCAP| - d_{neg}) - \text{Log } AT$ where d_{neg} is zero for positive $WCAP$ and 7 for negative $WCAP$. Zero $WCAP$ remain zero.

This model has the same R Square as that at the first stage. Chi-square is 1,912 with 4 degrees of freedom (df). Overall accuracy is 96 per cent with 97 per cent not bankrupt and 96 per cent bankrupt cases correctly classified. Performance is the same for other pairings of the 5 items. Since size is not required in this case, second-stage performance, based on size-independent predictors, is not smaller than first-stage performance.

Detecting misstated sets of accounts

Reported sets of accounts are extremely efficient in revealing financial features of firms and this efficiency is the ultimate reason why accounts are so often misstated (Eilifsen and Messier, 2000). Predictive models can help detect misstatement (Beneish, 1999; Dechow *et al.*, 2011; Sun *et al.*, 2014) with an overall accuracy of around 80 per cent for non-homogeneous samples and 93 per cent for homogeneous samples (Liou, 2008). However, in these models, the minority class is poorly predicted, while the opposite class is very well predicted, rendering the models useless.

The second experiment compares the *ex-ante* effectiveness of a misstatement detection model based on ratios with that of a similar model based on positive-only, log-transformed items. Misstated accounts are defined as having been the object of an Accounting and Auditing Enforcement Release resulting from investigations made by the US Securities and Exchange Commission for alleged accounting misconduct.³ Releases are divided in two sets, one with cases from years 1978 to 1999 and the other with cases from years 2000 to 2008. The 1978-1999 set is utilised in model-building, the 2000-2008 set is utilised to measure the effectiveness of models. The two sets are matched with an equal number of firms which are neither the object of releases throughout the period nor are bankrupt in the release year. Matching is based on the GICS group, size decile, and statement year. One misstatement case is randomly assigned to its peer and then the peer is made unavailable for future matching.

To build the ratio-based model, ratios taken from Beneish (1999) and from other studies are shown to the selection algorithm. As detailed in Table 3, 12 ratios are selected, where 5 are from Beneish. Overall accuracy is 74 per cent. False-positives are far more likely than false-negatives and predicted class frequencies diverge widely from frequencies in the

³ Data from the Centre for Financial Reporting, Haas School of Business, University of California.

model-building dataset.

-- Table 3 --

The dataset utilised to build the ratio model has 358 missing and 781 not missing values. To allow comparison, these 358 cases are excluded from the first- and second-stage models, although here the number of missing values is only 18. At the first stage, items made present to the selection algorithm are components of ratios that entered the ratio-based model, and their changes, computed as in (8). Table 3 shows the selected 7 items and 2 changes. Overall accuracy is now 84 per cent and predicted class frequencies closely follow frequencies in the model-building dataset. The variability explained is almost twice that of the ratio-based model. It is therefore clear that ratios fail to use much variability available in their components. Again, size offsetting is clearly visible: Cash, Liabilities and Capital, have negative-signed coefficients, magnitudes adding to 15.4. Assets, Receivables, Debt and Revenue, have positive signs, magnitudes adding to 16.2.

From the 7 items selected at the first stage, 5 pairs are formed at the second stage, as nothing is to be gained by adding a sixth pair. $\Delta \text{Log } LT$ is included but the other change also selected, $\Delta \text{Log } CHE$, is non-significant here. From such predictors, the score

$$-5.90 + 3.48 \Delta \text{Log } LT - 1.87 \text{Log} \frac{CHE}{REVT} - 9.75 \text{Log} \frac{AT}{LT} + 0.77 \text{Log} \frac{CSTK}{RECT} \\ + 0.26 \text{Log} \frac{CSTK}{DLTT} + 0.51 \text{Log} \frac{CSTK}{REVT}$$

is estimated, where subtractions of two transformed items are depicted as 'Log' followed by the fraction sign, and 'Δ' refers to (8). This second-stage model has the same R Square as that at the first stage. Chi-square is 696 with 6 df. Overall accuracy is 84 per cent with 87 per cent not misstated and 81 per cent misstated cases correctly classified.

Forecasting the direction of earnings' changes one year ahead

The third experiment is inspired by Ou (1990) who offers evidence on the ability of ratios to

forecast the direction of unexpected changes in Earnings per Share one year ahead. Ou and Penman (1989), Holthausen and Larcker (1992) and others, use Ou's model in the prediction of market returns while Bird *et al.* (2001) examine the robustness of Ou's model to different time periods and industries and include a review of published research where the reported predictive gains are poor, by some 6 to 10 per cent at best.

The distinctive features of the experiment are the absence of sampling, the large number of cases (of which predicted classes are computed) and a size-related relationship. The experiment also highlights the bias that ratio-generated, class-dependent missing values have on predicted class frequencies. For example, among the ratios used by Ou (1990), the percentage change in inventories to assets has 20 per cent missing decreases in earnings, while for increases it is 43 per cent. Changes in dividends per share relative to the previous year have 29 per cent missing decreases, while for increases it is 57 per cent.

After excluding missing values, some 140,000 cases remain, where nearly 65 per cent are not increases and 35 per cent are increases. From this dataset, two samples with the same size are drawn at random, one for model-building and the other for measuring the effectiveness of models. All ratios in Ou (1990) plus other ratios are tested for inclusion. Ratios formed from Net Income or related items are not excluded from selection. The algorithm selects 9 ratios as detailed in Table 4, of which 3 are from Ou (1990). A size proxy, the logarithm of Assets, is also included in the ratio-based model, bringing the total number of predictors to 10.

When building the model obeying the new methodology, predictors are taken from components of ratios selected by the ratio-based model and their changes computed as in (8). The change in Dividends per Share relative to the previous year fails ratio-selection but, after being transformed as in (8), is selected to enter at the first stage. Negative values are transformed into $-\text{Log } |x|$, which would be an inadequate transformation for size-

independent relationships but is not particularly inadequate here. The first stage selects 6 transformed items, plus Dividends per Share, plus 3 changes. Class frequencies, performance, coefficients, and significance are also displayed in Table 4.

-- Table 4 --

Accuracy of the ratio-based model is 74 per cent with 89 per cent no increases and 47 per cent increases correctly classified. Class frequencies observed in the model-building dataset are grossly misrepresented. By contrast, first-stage accuracy is 80 per cent with no class misrepresentation. The variability explained is twice that obtained by ratios.

At the second stage, 4 pairs are formed from 5 of the 6 items selected at the first stage. The remaining item, *Log AT*, takes the role of size proxy and is not paired. The score

$$0.420 - 0.108 \operatorname{Log} \frac{RE}{LT} - 0.044 \operatorname{Log} \frac{OANCF}{LT} - 0.061 \operatorname{Log} \frac{TXT}{LT} - 0.095 \operatorname{Log} \frac{GP}{LT} - 0.256 \operatorname{Log} AT \\ + 0.036 \Delta \operatorname{Log} RE + 0.054 \Delta \operatorname{Log} GP + 0.107 \Delta \operatorname{Log} DVPS - 0.205 \operatorname{Log} DVPS$$

is estimated, where subtractions of two transformed items are depicted as ‘*Log*’ followed by the fraction sign, and ‘ Δ ’ refers to (8). The accuracy, balance and the R Square of this second-stage model are the same as that at the first stage. The Chi-square is 27,143 for 9 df.

In addition to demonstrating the gains in accuracy that can be achieved with the new methodology, the three experiments show how ratio-based models can grossly misrepresent distributions. In fact, the improvements brought about by the new methodology are due to the fact that the predicted class frequencies now resemble the modelled frequencies.

Figure 1 compares the ROC curves of ratio-based and second-stage models, showing the dominance of the latter and the asymmetry of the former.

-- Figure 1 --

V. Conclusion

Without exception, ratios are the predictors used in multivariate modelling tasks where

accounting information is required. However, such use is fraught with difficulties due to the need to select ratios among many alternatives, the irregular and not well-behaved distributions of ratios, and their propensity to misrepresent essential characteristics of the data being modelled. The paper has developed a theoretical foundation from which a model building methodology is derived that avoids the aforementioned shortcomings of ratios. Experiments have shown that the new methodology preserves the meaning of the ratios while providing significantly more accurate, unbiased and robust models.

In addition to expanding the use of accounting-based models for tasks that have not yet achieved a usable level of accuracy, the reported gains in effectiveness strengthen the belief that the apparent irrelevance of accounting information may be due to the use of poorly specified and inadequately constructed models. Thus, before examining other causes, limitations of accounting-based models should be attributed to the uncritical use of ratios. The multiplicative behaviour of ratios, which aptly leads to size removal in financial analysis, makes ratios unsuitable for modelling. Ignorance of this incompatibility of ratios, coupled with the use of modelling designs that are incompatible with the objectives of modelling, are the reasons for the limited effectiveness of accounting-based models.

It is high time to recognise the multiplicative behaviour of ratios, so that the modelling of accounting relationships goes beyond pure empiricism and does not repeat the work of Altman and Sabato (2007), who found clear improvements in their Z-score models after logarithmic transformation of ratios, but without trying to understand the reasons for this. We believe that when authors begin to explore the possibilities opened up by knowledge of the statistical properties of ratios and the role of the common effect of size, a whole new understanding of accounting and its relationship with markets will emerge.

The developments reported in this paper are the consequence of explicitly considering the effect of firm size. When size is considered as a statistical effect, it is easy to explain why

ratios remove size from cross-sections of financial statement data, and it is equally easy to show that size can be removed by modelling algorithms.

The paper suggests that models should be built in two stages. First, the reduced set of items that can optimally explain the relationship is found. In the second stage, appropriately transformed ratios are formed from the reduced set. The final model is estimated using the transformed ratios. In addition to gains in efficiency, modelling becomes less arbitrary because predictors are now selected from a smaller, well-defined list of candidates, and ad hoc remedies such as pruning extreme cases are no longer necessary.

The methodology is limited in scope, as it aims to improve model accuracy and robustness, which is a minor concern when the aim is to test research hypotheses. In addition, only cross-sectional and size-independent relationships are considered, and accounting identities and other interactions between items are ignored. The paper is therefore a first step, and the notional approximation from which the new methodology is constructed can be refined and adapted for other purposes at a later stage.

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Table 1
Set of accounts' items used in experiments

CHE	Cash and Short-Term Investments *	RE	Retained Earnings *
RECT	Receivables (total) *	SEQ	Shareholders' Equity (total)
INVT	Inventories (total)	REVT	Revenue (total) *
ACT	Current Assets (total) *	XOPR	Operating Expense (total) *
WCAP	Working Capital *	COGS	Cost of Goods Sold
PPENT	Property Plant and Equipment (total, net)	GP	Gross Profit (loss) *
INTAN	Intangible Assets (total)	XSGA	Selling, General and Administrative Expenses
AT	Assets (total) *	DP	Depreciation and Amortization (total)
AP	Account Payable/Creditors (trade)	OIADP	Operating Income after Depreciation *
XACC	Accrued Expenses	XINT	Interest and Related Expense
TXP	Income Taxes Payable	TXT	Income Tax (total) *
LCT	Current Liabilities (total) *	IB	Income Before Extraordinary Items
DLTT	Long-Term Debt (total) *	NI	Net Income (loss)
LT	Liabilities (total) *	OANCF	Net Cash Flow from Operating Activities *
BKVL	Book Value of Common and Preferred Stock	CAPX	Capital Expenditure
PSTK	Preferred Stock	EPS	Earnings per Share (basic, before extraordinary items)
CSTK	Common/Ordinary Stock *	DVPS	Dividends per Share (ex-date, fiscal) *

The table lists the 32 items plus 2 pre-existing ratios tested for inclusion at the first stage of the new methodology, where both current values and changes (8) in relation to prior year are tested, and the components of ratios tested for inclusion in ratio-based models. Asterisks show items selected at the first stage by any one of the three experiments. Item values, abbreviations and names are taken from the Compustat file, except BKVL which is computed from other items in the same file.

Table 2
Bankruptcy prediction

	Ratio model		First-stage model	
Model-building data, number of not bankrupt cases and percentage of total	845	50.12%	845	50.12%
Model-building data, number of bankrupt cases and percentage of total	841	49.88%	841	49.88%
Model-testing data, not bankrupt, N, and percentage N / (N+P) of total	837	49.76%	837	49.76%
Model-testing data, bankrupt, P, and percentage P / (N+P) of total	845	50.24%	845	50.24%
Overall, correctly classified, TP + TN, and percentage (TP+TN) / (N+P) of total	1,601	95.18%	1,619	96.25%
Number of not bankrupt correctly classified, TN, and percentage TN / N	782	93.43%	810	96.77%
Number of not bankrupt incorrectly classified, FP, and percentage FP / N	55	6.57%	27	3.23%
Number of bankrupts correctly classified, TP, and percentage TP / P	819	96.92%	809	95.74%
Number of bankrupts incorrectly classified, FN, and percentage FN / P	26	3.08%	36	4.26%
Precision, TP / (TP + FP)		93.71%		96.77%
Recall (sensitivity), TP / (TP + FN)		96.92%		95.73%
Predicted as not bankrupt, (TN + FN) / (N+P), and % difference to model-building	48.04%	-2.08%	50.30%	0.18%
Predicted as bankrupt, (TP + FP) / (N+P), and % difference to model-building	51.96%	2.08%	49.70%	-0.18%
Cox and Snell pseudo-R-Square	0.595		0.682	
Chi-Square, degrees of freedom and significance	1,526	5 ***	1,931	5 ***
ROC curve, predicted probability and standard error	0.979	0.002	0.991	0.001
X1, ratio of Working Capital to Assets (total)	-1.309	***		
X2, ratio of Retained Earnings to Assets (total)	-0.028	*		
X3, ratio of Operating Income after Depreciation to Assets (total)	-4.343	***		
X4, ratio of Book Value of Common and Preferred Stock to Liabilities (total)	-1.015	***		
X5, ratio of Revenue to Assets (total)	0.023			
Logarithm of absolute value of Working Capital, minus 7 for negative values			0.075	*
Logarithm of Assets (total)			-9.55	***
Logarithm of Liabilities (total)			9.66	***
Logarithm of absolute value of Retained Earnings, minus 7 for negative values			-0.402	**
Logarithm of absolute value of Operating Income after Depreciation, minus 7 for neg. v.			-0.401	***
Constant term	1.934	***	6.539	***

Top to bottom: sample size, accuracy, predicted class frequencies and differences in relation to model-building class frequencies, goodness-of-fit statistics, and model coefficients. All line items are descaled by 10^6 before transformed. 'Logarithm' refers to base 10 logarithm. All zero values are kept as zero. 'T' means correctly classified, 'F' means incorrectly classified. Significances are shown as asterisks: '***' is $p \leq 0.001$, '**' is $p \leq 0.01$ and '*' is $p \leq 0.05$.

Table 3
Financial misstatement detection

	Ratio model		First-stage model	
Model-building data (1976-1999), number of not misstated and percentage of total	376	48.20%	376	48.20%
Model-building data (1976-1999), number of misstated and percentage of total	405	51.80%	405	51.80%
Model-testing data (2000-2008), not misstated, N, and percentage N / (N+P) of total	312	43.57%	312	43.57%
Model-testing data (2000-2008), misstated, P, and percentage P / (N+P) of total	404	56.42%	404	56.42%
Overall, correctly classified, TP + TN, and percentage (TP+TN) / (N+P) of total	530	74.02%	602	84.08%
Number of not misstated correctly classified, TN, and percentage TN / N	202	64.74%	272	87.18%
Number of not misstated incorrectly classified, FP, and percentage FP / N	110	35.26%	40	12.82%
Number of misstated correctly classified, TP, and percentage TP / P	328	81.19%	330	81.68%
Number of misstated incorrectly classified, FN, and percentage FN / P	76	18.81%	74	18.32%
Precision, TP / (TP + FP)		74.89%		89.19%
Recall (sensitivity), TP / (TP + FN)		81.19%		81.68%
Predicted as not misstated, (TN + FN) / (N+P), and % difference to model-building	38.83%	-9.37%	48.32%	0.12%
Predicted as misstated, (TP + FP) / (N+P), and % difference to model-building	61.17%	9.37%	51.68%	-0.12%
Cox and Snell pseudo-R-Square	0.335		0.596	
Chi-Square, degrees of freedom and significance	312	12 ***	707	9 ***
ROC curve, predicted probability and standard error	0.821	0.011	0.947	0.005
DSRI, Days Sales in Receivables index, see caption	0.178	*		
SGI, Sales growth = Revenue / Revenue prior year	0.435	*		
DEPI, Depreciation to Property, Plant and Equipment, see caption	0.921	**		
SGAI, Sales, General and Administrative Expenses index, see caption	0.439	*		
LVGI, Leverage index, see caption	0.737	**		
Ratio of Net Income to Revenue	0.120	**		
Receivables growth = Receivables / Receivables in prior year	-0.062	*		
Current Ratio = Current Assets (total) / Current liabilities (total)	0.142	*		
Ratio of Revenue to Assets (total)	1.140	***		
Ratio of Cash and Short-Term Investments to Assets (total)	-2.298	***		
Ratio of Inventories to Assets (total)	1.574	*		
Ratio of Liabilities (total) to Assets (total)	-4.426	***		
Logarithm of Cash and Short-Term Investments			-1.733	***
Logarithm of Cash and Short-Term Investments, change Δ in relation to prior year			0.481	*
Logarithm of Receivables (total)			0.549	**
Logarithm of Assets (total)			11.31	***
Logarithm of Long-Term Debt			0.230	***
Logarithm of Liabilities (total)			-11.82	***
Logarithm of Liabilities (total), change Δ in relation to prior year			3.760	***
Logarithm of Common/Ordinary Stock (Capital)			-1.80	***
Logarithm of Revenue (total)			4.186	***
Constant term	-1.118		-15.47	***

Caption of Table 2 applies here. $DSRI = (RECT/REVT) / (RECT/REVT) \text{ prior year}$.

$DEPI = DEP / (DEP + PPENT) \text{ prior year} / DEP / (DEP + PPENT)$.

$SGAI = (XSGA/REVT) / (XSGA/REVT) \text{ prior year}$.

$LVGI = ((DLTT + LCT)/AT) / ((DLTT + LCT)/AT) \text{ prior year}$.

Table 4
Earnings' direction forecast

	Ratio model		First-stage model	
Model-building data, number of not increases and percentage of total	41,875	64.66%	41,875	64.66%
Model-building data, number of increases and percentage of total	23,303	35.34%	23,303	35.34%
Model-testing data, not increases, N, and percentage N / (N+P) of total	41,762	64.66%	41,796	64.66%
Model-testing data, increases, P, and percentage P / (N+P) of total	22,826	35.34%	22,841	35.34%
Overall, correctly classified, TP + TN, and percentage (TP+TN) / (N+P) of total	48,008	74.33%	52,006	80.46%
Number of not increases correctly classified, TN, and percentage TN / N	37,266	89.23%	35,828	85.72%
Number of not increases incorrectly classified, FP, and percentage FP / N	4,496	10.77%	5,968	14.28%
Number of increases correctly classified, TP, and percentage TP / P	10,742	47.06%	16,178	70.83%
Number of increases incorrectly classified, FN, and percentage FN / P	12,084	52.94%	6,663	29.17%
Precision, TP / (TP + FP)		70.49%		73.05%
Recall (sensitivity), TP / (TP + FN)		47.06%		70.83%
Predicted as a not increase, (TN + FN) / (N+P), and % difference to model-building	76.41%	12.16%	65.74%	1.49%
Predicted as an increase, (TP + FP) / (N+P), and % difference to model-building	23.59%	-12.16%	34.26%	-1.49%
Cox and Snell pseudo-R-Square	0.178		0.342	
Chi-Square, degrees of freedom and significance	12,773	10 ***	27,297	10 ***
ROC curve, predicted probability and standard error	0.753	0.002	0.86	0.002
Ratio of Cash flow from Operating Activities to Liabilities (total)	-0.091	**		
Ratio of Income Tax to Liabilities (total)	-3.449	***		
Ratio of Retained Earnings to Liabilities (total)	-0.023	***		
Ratio of Net Income to Assets (total)	-0.063	**		
Ratio of Liabilities (total) to Assets (total)	0.055	**		
Ratio of Gross Profit to Assets (total)	-0.201	***		
Growth in the Revenue to Assets (total) ratio (Ou, 1990)	0.030	**		
ROR, Income Before Extraordinary Items to Shareholders Equity prior year (Ou, 1990)	-0.008	**		
ROR in prior year (Ou, 1990)	0.005	*		
Logarithm of Assets (total)	-0.685	***	-0.614	***
Logarithm of Liabilities (total)			0.643	***
Log-Modulus of Retained Earnings			-0.106	***
Log-Modulus of Retained Earnings, change Δ in relation to prior year			0.036	***
Log-Modulus of Gross Profit			-0.094	***
Log-Modulus of Gross Profit, change Δ in relation to prior year			0.053	***
Log-Modulus of Income Tax			-0.060	***
Logarithm of 1,000 times Dividends per Share ex-date, fiscal year-end			-0.208	***
Logarithm of 1,000 times Dividends per Share, change Δ in relation to prior year			0.110	***
Log-Modulus of Cash-Flow from Operating Activities			-0.043	***
Constant term	5.080	***	0.702	***

Caption of Table 2 applies here. The Log-Modulus transformation of x is $sign\ x \text{Log}_{10} |x|$.

Figure 1
ROC curves

Figure 1A, bankruptcy prediction.

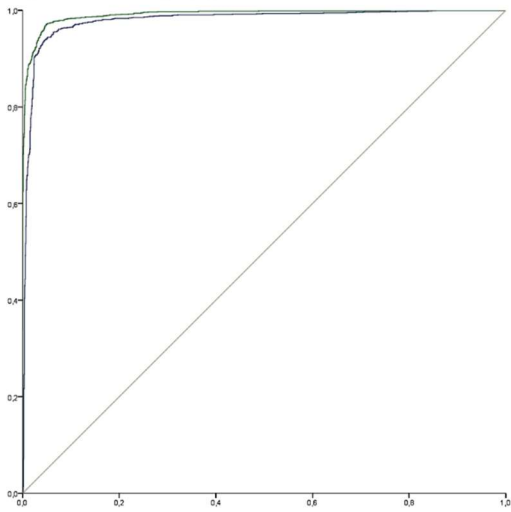


Figure 1B, misstatement detection.

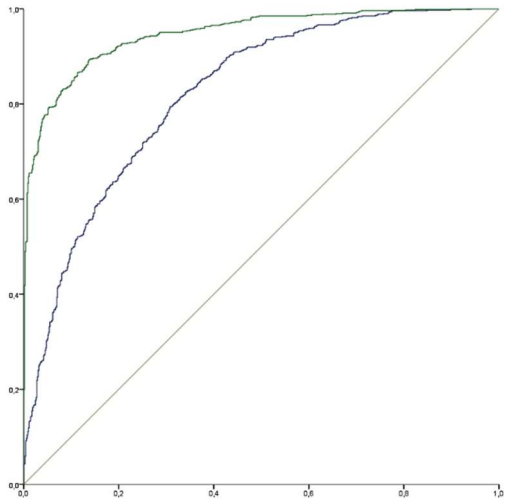


Figure 1C, Earnings' direction forecasting.

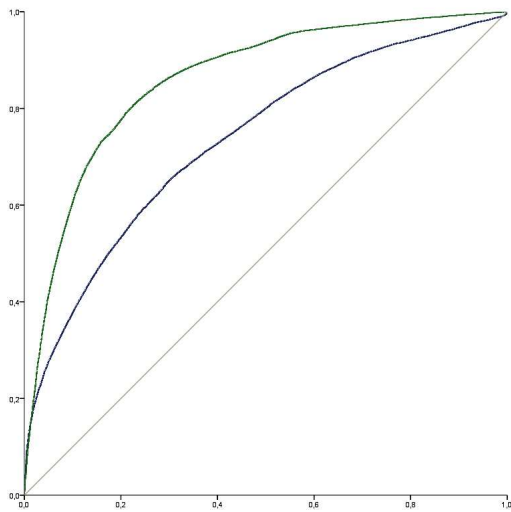


Figure 1: ROC curves comparing ratio (blue) and second stage (green) models, showing the substantial performance increases stemming from the proposed methodology for all sensitivities.

The X-axis is the specificity of the positive class (bankruptcy, misstatement, earnings) and the Y-axis is the sensitivity (bankruptcy, misstatement, earnings).