Journal of Accounting and Economics 61 (2016) 448–464

Contents lists available at ScienceDirect

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jae

The usefulness of historical accounting reports ☆

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ARTICLE INFO

Article history:
Received 4 March 2013
Received in revised form
19 November 2015
Accepted 7 December 2015
Available online 21 December 2015

Keywords:
Usefulness
Historical accounting reports
Information acquisition
EDGAR

ABSTRACT

In this study we investigate the usefulness of historical accounting reports (10-Ks and 10-Qs) by examining four settings where we expect investors to acquire historical reports in order to obtain qualitative and quantitative information that contextualizes and conditions information released in the current period. Using a novel dataset that tracks user requests for accounting reports stored in the SEC EDGAR database, we find that requests for historic reports during the fiscal year are positively associated with financial reporting complexity and that requests around earnings announcements are positively associated with accounting discretion and negative earnings shocks (particularly for conservative firms). Finally, we find that daily requests for historical reports are positively associated with shocks to firm value (particularly negative shocks). Overall, our evidence suggests that historical reports make up an important component of the information mosaic assembled by investors.

1. Introduction

In this paper, we examine the usefulness of historical accounting disclosures (forms 10-K and 10-Q, hereafter “accounting reports”) filed with the Securities and Exchange Commission (SEC). The reason that newly released accounting reports are useful to investors is rather obvious: they disclose new information to the market. Historical accounting reports, on the other hand, no longer contain news, so their utility to investors is likely found in their ability to provide information that contextualizes and conditions information released in the current period. Our objective is to examine specific contexts

☆ We are especially grateful to Scott Bauguess and many others at the Securities and Exchange Commission and to Dick Dietrich for assistance in acquiring and implementing the proprietary data used in this study. We thank Ross Watts (the editor) and K. Ramesh (the referee) for helpful comments and suggestions that greatly improved the paper. We thank Mary Barth, Scott Bauguess, Anne Beatty, Bob Bowen, Jonathan Brogaard, David Burgstahler, Nicole Cade, John Campbell, Ed deHaan, Thomas Gilbert, Trevor Harris, Frank Hodge, Dawn Matsumoto, Sarah McVay, Kathy Petroni, Lynn Rees, Terry Shevlin, Jeff Wilks, and workshop participants at the 2012 UBCOW Conference, 2012 Chicago Quantitative Alliance Annual Academic Competition, Brigham Young University, Columbia University, Massachusetts Institute of Technology, Michigan State University, Oklahoma State University, the Division of Risk, Strategy, and Financial Innovation at the U.S. Securities and Exchange Commission, Rice University, Stanford University, University of Georgia, University of Hawaii, University of California-San Diego, and University of Pennsylvania for valuable comments. We thank Zahn Bozanic for sharing textual analysis data, Isaac Kelly and Joseph Tate for computational assistance, and Bret Johnson and Nick Guest for excellent research assistance. Finally, we gratefully acknowledge the financial support of the Marriott School of Management, the Fisher College of Business, and the Foster School of Business. This paper was formerly circulated under the title “The Informativeness of Stale Financial Disclosures”.

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http://dx.doi.org/10.1016/j.jacceco.2015.12.001
0165-4101/

wherein historical financial information can be useful to investors in current-period decision making. By so doing, we aim to further our understanding of how investors make investment decisions using financial information.

The usefulness of information contained in historical accounting reports is rather obvious in the context of trend analysis (e.g., Lev, 1983) or fundamental analysis (e.g., Ou and Penman, 1989; Abarbanell and Bushee, 1998; Piotroski, 2000). It is clear from these literatures that historical reports provide benchmarks and fundamental signals that are associated with future performance. Our focus, however, is not on whether a given number in a historical accounting report is useful as a benchmark or investment signal. Instead, we examine why investors continue to acquire historical accounting reports long after their release, an activity that occurs frequently, as documented in Drake et al. (2015).

We argue that investors seek out historical accounting reports in an effort to acquire three types of information: qualitative information, textual explanations of recognized or disclosed quantitative information, and quantitative information disclosed in footnotes. We examine specific hypotheses related to four settings where we predict that investors would access historical accounting reports. These hypotheses relate to historical reports' ability to provide information to (1) help investors understand complex financial reporting issues, (2) assess the accounting discretion exercised by managers, (3) analyze and understand unexpected shocks to earnings, and (4) analyze and understand large shocks to firm value. We develop each of these hypotheses at length in the next section.

We test our hypotheses using a novel dataset that tracks all investor requests for historical financial reports hosted on the SEC's EDGAR database for the March 2003 to March 2012 time period.[1] The dataset records every “click” made by an investor to request a 10-K or 10-Q from EDGAR and thereby provides a direct proxy for investors' acquisition of historical accounting reports. A unique feature of these data is that they record the *timing* of investors' acquisition of historical accounting reports, which allows us to calculate the age of the information at acquisition.

From the EDGAR search data, we compute historical EDGAR search volume (*HESV*) as the natural logarithm of the number of investor downloads of accounting reports (10-Ks and 10-Qs) that are more than one year old (measured daily or annually). Anecdotally, we find that the average age of an accounting report when it is downloaded is 398 days. This statistic suggests that the majority of EDGAR activity is for historical accounting reports, and is itself prima facie evidence of the usefulness of historical accounting statements to investors.

Our main findings are summarized as follows. First, using both a levels and a first-difference specification, we find a positive association between *HESV* and reporting complexity (proxied by the number of words included in the historical accounting reports, the number of characters in the tables of the historical reports, and the number of non-missing COMPUSTAT items in the historical reports). This finding is consistent with our hypothesis that investors seek out historical accounting information when the underlying business transactions are more complex and therefore require more textual disclosures.

Second, we find a positive association between *HESV* around the annual earnings announcement and the amount of accounting discretion exercised by managers in the current period (proxied by absolute discretionary accruals) and in prior periods (proxied by balance sheet bloat and the level of prior period deferred revenue). This finding is consistent with our hypothesis that investors seek out contextual information from historical reports when the firm's accounting practices are subject to more judgments and estimates—i.e., historical accounting reports are more useful when managers are exercising greater discretion over financial reporting.

Third, we examine earnings announcements that disclose a “surprise loss” (i.e., earnings announcements that disclose a loss after at least three consecutive years of profits) or a “surprise profit” (i.e., earnings announcements that disclose a profit after at least three consecutive years of losses). We find a positive association between historical EDGAR search volume and negative shocks to earnings, but find no evidence of a significant relation with positive shocks to earnings. This asymmetry in investors' information acquisition is consistent with investors seeking historical accounting information to contextualize the negative earnings shock. Furthermore, we find that the positive association between historical EDGAR search volume and negative earnings shocks is even stronger (more positive) when the firm has been more conservative in the past (as proxied by the conservatism score from Khan and Watts (2009). Together, these results suggest that, given the inherent conservatism of financial accounting, negative shocks to earnings are more surprising than positive shocks and therefore elicit a greater search for historical information by investors.

Fourth, we identify days when firms experience large jumps and crashes in stock price (Hutton et al., 2009). We find that investor requests for historical reports are significantly higher in the days immediately following the jumps and crashes. We further find an asymmetric response from investors for jumps versus crashes, with crashes garnering a stronger response. These results are consistent with the notion that investors seek out historical accounting information to contextualize shocks to firm value.

Overall, our results are consistent with the idea that historical accounting reports make up a portion of the information mosaic investors assemble. We contribute to research that investigates the concept of financial statement informativeness. This stream of research is replete with evidence, mostly based on short-window event study methodologies, that the release of new financial information is positively associated with market activity, which provides consistent evidence that accounting reports play an important “news role.” However, Ball (2013) argues that the news role of accounting is merely the “tip of the iceberg” and that "financial reporting fulfills other economic functions" that are overlooked by researchers (p.

[1] See Drake et al. (2015) for a detailed discussion of the dataset.