

# Is Financial Reporting Still an Effective Tool for Equity Investors in Australia?

# Project Team and Partner Organisation



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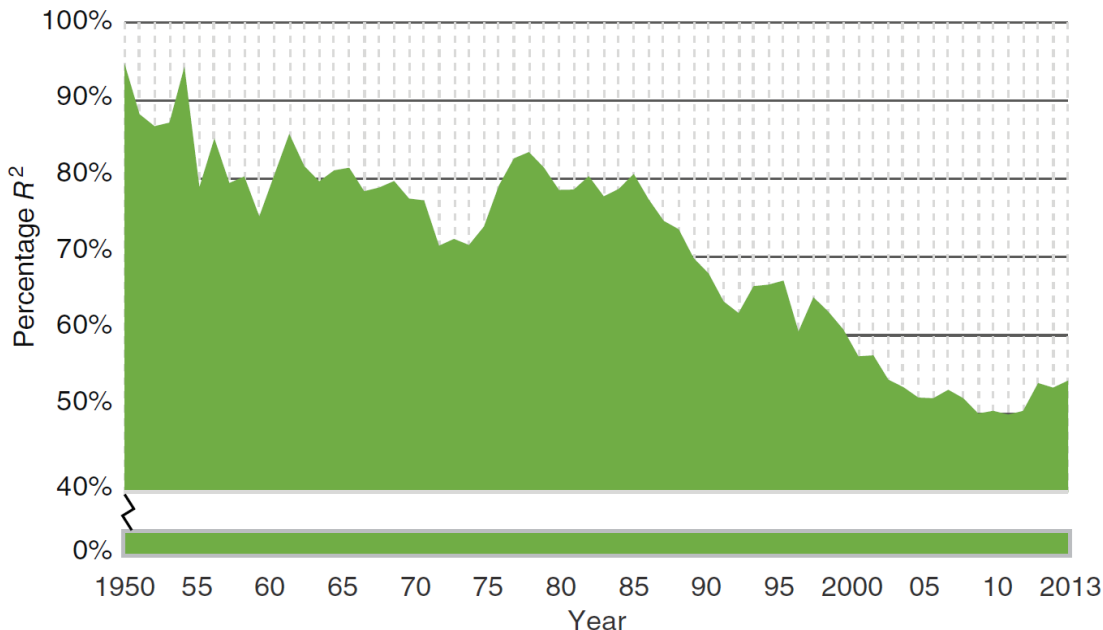


# Introduction

- Financial reporting has been the subject of significant criticism over the past decade regarding the decision usefulness of financial statements
- Various reasons provided for the purported loss of relevance include:
  - Availability of more timely forward-looking information from alternative sources (i.e. non-GAAP disclosures)
  - Increase in the occurrence and reporting of one-time or non-recurring items; and
  - Inability to capture firm value from increasingly present knowledge-based intangible assets
- Some evidence in the United States that financial reporting has declined in relevance across time

# Loss of Relevance of Financial Reporting: US Evidence

Adjusted  $R^2$  of regression of corporate market value on reported earnings and book value, 1950-2013



- Steady decline in usefulness of reported earnings (NPAT) and book value (shareholders' equity) to US equity investors
- For example, in the 1950s reported NPAT and shareholders' equity explain over 90 percent of share price levels, whereas by 2013 they only explain approximately 50 per cent of a company's share price
- Potentially due to those reasons previously stated

Lev, B., and Gu, F., 2016, *The end of accounting and the path forward for investors and managers*, John Wiley & Sons Inc., at p. 31.

# Objective and Research Questions

- Objective is to provide evidence on the relevance of financial reporting for equity valuation in Australia, and if this has changed across time

## *Research Question 1*

Are annual financial statements relevant for equity investors in making investment decisions, and has this changed across time?

- Are **net income, shareholders' equity** and **operating cash flows** relevant for valuation, and has their relevance for valuation changed across time?

## *Research Question 2*

What other types of information are considered relevant for equity investors in making investment decisions?

- Is **non-GAAP** information relevant for valuation, and has this relevance for valuation changed across time?
- What **other non-financial information** is considered decision useful for equity investors in making investment decisions?

# Methodologies Employed

- Mixed method approach was employed to answer our research questions

## *Archival*

Examined time-series trends in value relevance of annual financial reports by examining the association each year between share price and accounting amounts

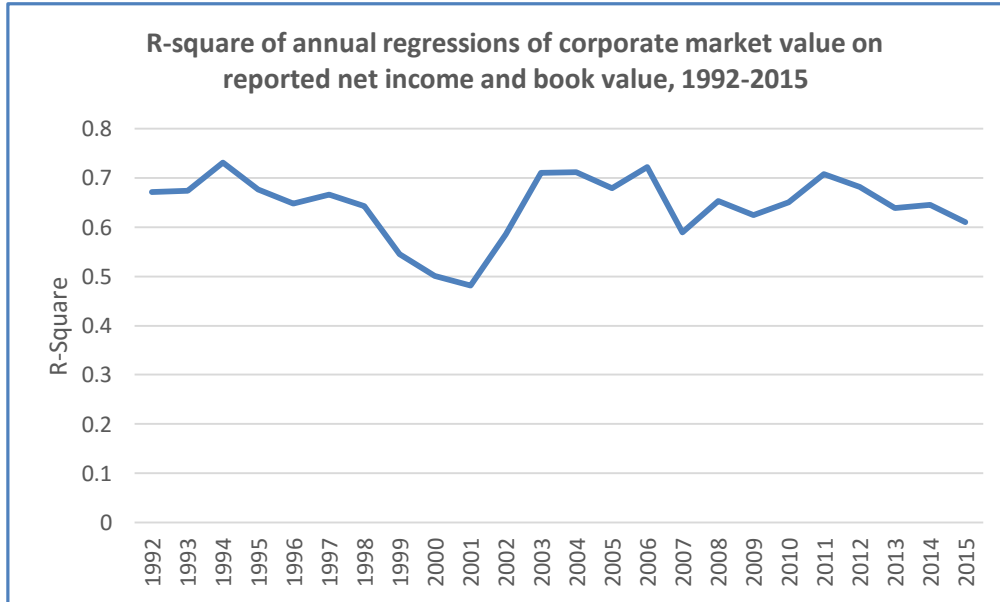
- Our archival sample consists of 29,838 firm-year observations from 1992 to 2015

## *Field Interviews*

We conducted 17 interviews with professional investors (7), regulators (5) and practitioners (5) to contrast the perspectives of the different stakeholder groups

- Developed a semi-structured interview protocol comprising seven main questions
- Interviews averaged 28 minutes. Transcripts amounted to over 69,000 words and 107 pages

# Relevance of Financial Statements: Archival Evidence



Average = 0.64

- Reported net income (NPAT) and shareholders' equity are consistently incorporated into Australian companies' share prices over the time period
- On average, 64 per cent of a company's share price is associated with information contained within reported NPAT and shareholders' equity
- Financial reporting has not declined in relevance in Australia over the period studied

# Relevance of Financial Statements: Interview Evidence

- Interviewees typically viewed the relevance of financial statements as stemming from their confirmatory role in assessing firm performance:

*Clearly financial information is, by and large, the thing that you're going to at least be primarily concerned about (Investor 1)*

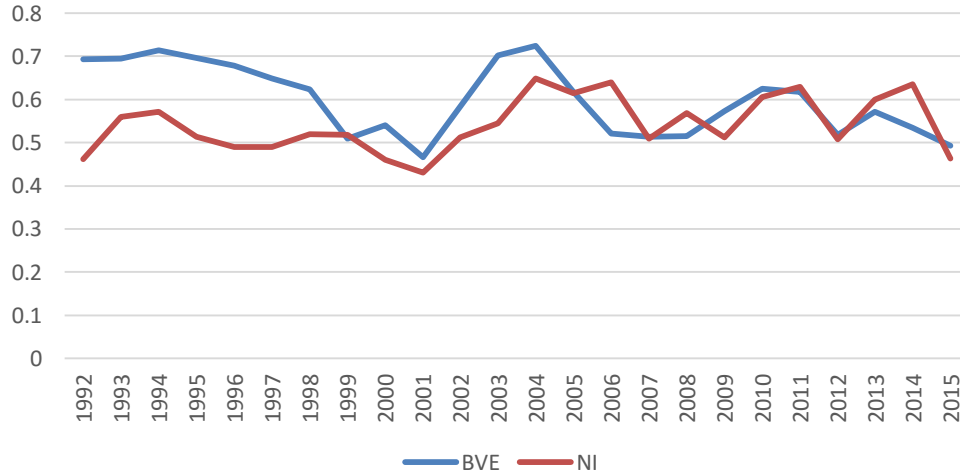
*The financials ... are the thing that give us confidence (Investor 2)*

*It should be the first thing anybody reads. Well, obviously, I think it provides a pretty comprehensive track record... of results, financial position being reported to the market. So ... I've always seen it as confirming a report card. So, it's confirming maybe what professional investors and others are estimating as [what is] actually happening in the business (Auditor 2)*



# Relevance of Separate Financial Statements: Archival Evidence

R-square of separate annual regressions of corporate market value on reported net income and book value, 1992-2015



Average = 0.60

Average = 0.52

- On average, 60 per cent of a company's share price is associated with information contained within shareholders' equity
- On average, 52 per cent of a company's share price is associated with information contained within NPAT
- Ability of shareholders' equity to explain company share prices is declining over time to a level comparable with that of NPAT

# Relevance of Separate Financial Statements: Interview Evidence

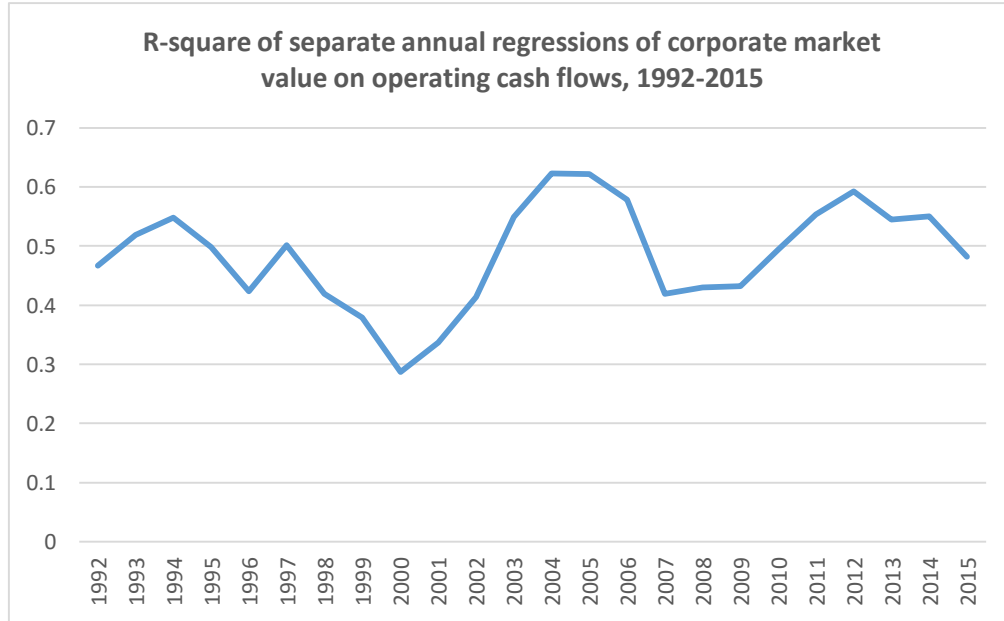
- Most interviewees commented that investors would use all financial statements in combination:

*a large proportion of investors these days use the income statement but...a lot of value investors...use the balance sheet more heavily. But it's definitely a combination of the two (Investor 5)*

- The reliance on each financial statement is influenced by industry and nature of the investment decision:

*It depends on the investors. So, some investors are investing for the long-term, obviously, so I think they'll look at the quality of the profitability of the company... whereas others are looking at the shorter-term results... If it is a yield investment they'll focus on the profitability and things like that but if it's for the longer term I think they look at the quality of the assets and the quality of the profit and loss ... How predictable that is going forward (Auditor 4)*

# Relevance of Cash Flows: Archival Evidence



- On average, 49 per cent of a company's share price is associated with information contained within operating cash flows
- Operating cash flows exhibit greater volatility in explaining company share prices, and are less able to explain share prices, than NPAT
- Coinciding with the Global Financial Crisis, since 2007 operating cash flows have increased in relevance in Australia

# Relevance of Cash Flows: Interview Evidence

- Nuanced views from interviewees as to the importance of cash flows and the cash flow statement:

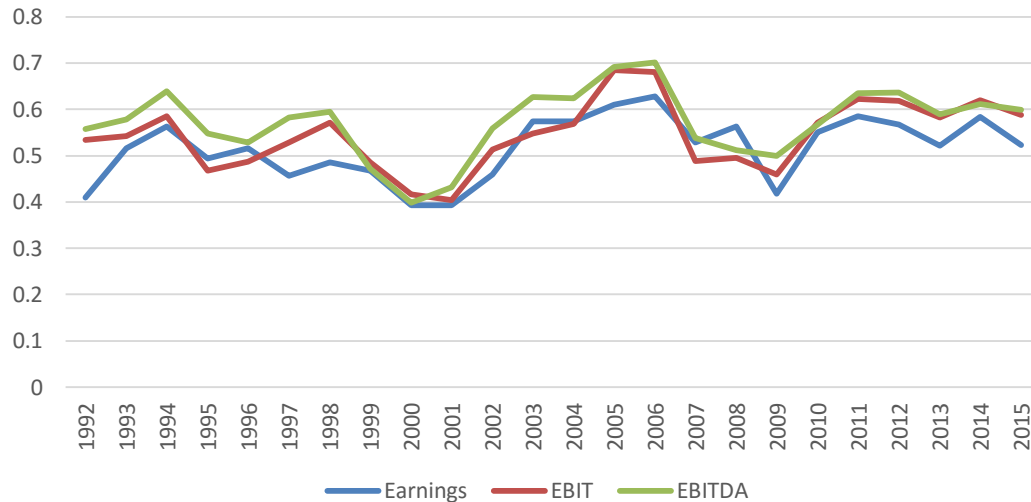
*I think cash is always king. You always have to look at ... what the cashflows are, where they're coming from. If it's a cash producing business, but you always have to come back to the balance sheet with respect to valuations because if something is producing ... cash then the question is – well, what are we paying for that? (Investor 7)*

*Cashflow statement we don't tend to play with very much (Investor 6)*

*I don't think enough investors really look at the cash flow statement...But... it's historical, isn't it? It's not a predictor of what's going to be generated in the future (Auditor 4)*

# Relevance of Non-GAAP Financial Information: Archival Evidence

R-Square of annual regressions of corporate market value on net income, EBIT and EBITDA, 1992-2015



Average = 0.49

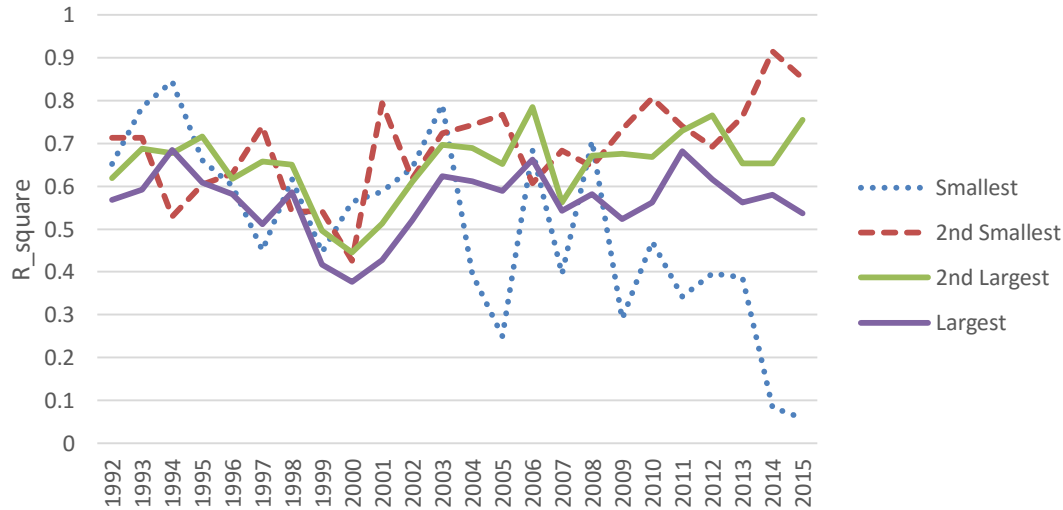
- On average, a company's EBITDA, EBIT and earnings (NPAT) are associated with 57, 54 and 52 percent of their share price, respectively
- Investors view those items that comprise NPAT but not EBITDA or EBIT as less relevant for valuation purposes
- Trend in relevance of EBITDA, EBIT and NPAT is comparable over the sample period, suggesting they are complements and not substitutes

# Relevance of Non-GAAP Financial Information: Interview Evidence

- Non-GAAP information is used to ‘better communicate’ financial results to investors:  
*There’s only so far that statutory reporting can go because ... it’s very difficult to capture the nuances of every industry, every company... So the non-GAAP reporting I think is essential to help users of the accounts better understand the dynamics of those companies and their cashflows*  
*(Investor 4)*
- Interviewees noted a lack of transparency in the development of the information, and called for a reconciliation back to statutory profit:  
*the problem... with the non-GAAP measures is that how they’re constructed is sometimes a bit of a black box* *(Investor 1)*  
  
*If [companies] had to provide written disclosure of how [non-GAAP measures] reconcile, that would definitely be helpful* *(Investor 7)*  
  
*It would be useful if you could reconcile ... back to all the statutory accounts* *(Investor 4)*

# Relevance of Financial Statements Based on Size: Archival Evidence

R-square of annual regressions of corporate market value on reported net income and book value across company size quartiles, 1992-2015



- For large and medium size firms, the relevance of NPAT and shareholders' equity has stayed reasonably constant across time
- For the very smallest portfolio of firms there is a clear trend downwards in relevance of NPAT and shareholders' equity across time
- Industry sectors most affected in the very small portfolio are consumer discretionary and telecommunications

# Relevance of Non-financial Information: Interview Evidence

- Non-financial information plays an important role in the investment process:

*If a company has a low overall ESG score... then below a cut-off those companies are excluded so they don't even get into the investible universe to be look at or modelled or considered. They just get knocked out in round one...Round two – once we are down to 150 or so investible companies... we take the ESG score in again as a positive differentiating factor (Investor 6)*

- Financial and non-financial information are not used in isolation:

*An environmentally disruptive company is eventually going to run into business prospect issues because they will face issues...So sustainability does probably play out in future earnings (Investor 7)*



# Project Contributions and Implications

- Evidence that financial reporting is still an effective information tool for equity investors in Australia:
  - Archival findings and evidence from field interviews on how and why financial reports are used in investment decision making
  - Play a confirmatory role in investor decision making
  - Financial information is an input to investor valuation models
- Financial reports are necessary but not sufficient:
  - Non-GAAP financial information is relevant for investor decision making
    - Seen as a complement to statutory financial information
    - Of interest to the IASB as to whether to introduce additional subtotals, such as EBIT, into the statement of financial performance