

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG-CFSS. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG-CFSS. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Use of financial statements in Australia

Cover Note

Objective

- 1 The study *Is financial reporting still an effective tool for equity investors in Australia?* ('the Study') will be presented at the April 2018 ASAF meeting. The purpose of this session is to receive any comments from EFRAG TEG and EFRAG CFSS members on the study.

The Study

- 2 Motivated by claims that financial reports have lost relevance for equity valuation, the Study examines the relevance of financial reporting for equity valuation in Australia. The Study does so by:
 - (a) Examining the proportion of the variation in share prices three months after the financial year that can be explained by the variation in net profit after tax and book value of equity using 29 838 Australian firm-year observations from 1992 to 2015.
 - (b) Interviewing 7 investors, 5 regulators and 5 practitioners (of which at least some seem to be auditors).
- 3 The results indicate that both shareholders' equity and net income are decision-useful for equity investors in making investment decisions in Australia. On average, the book value of equity alone explains 60 per cent of a company's share price, while net income alone explains 52 per cent of a company's share price. The association between a company's share price and reported equity declined over the sample period, but the association between share price and net income remained stable. These results were supported by interviews.
- 4 The Study further examines the relevance of non-GAAP financial information and other non-financial information for investor decisions in Australia. The results indicate that EBIT and EBITDA explain 54 per cent and 57 per cent, respectively, of the company's share price, which is slightly more than net income (the Study does not show whether the difference is statistically significant). The Study, however, assesses that statutory profit and non-GAAP earnings are complements rather than substitutes. The interviews indicate that, in contrast to the view that the role of statutory financial information in investor decision making is primarily confirmatory in nature, non-GAAP financial information is often used by investors to help establish what part of current performance is expected to continue into the future (i.e. predicted, sustainable, persistent earnings).
- 5 The Study further examines the relevance of cash flows and non-financial information. It finds that operating cash flows explain 49 per cent of a company's share price. From the interviews it appeared that non-financial information is

considered at two levels in the investment process. Initially, the information is used as a 'screen' or 'hurdle' for assessing which companies to consider for investment, and subsequently, the information is used as a means of assessing the value of a company. The non-financial information that was highlighted by interviewees included: governance of an entity, risk information, information about business model and strategy, industry factors and competition, environmental information, social information, sales data, brand perception and customer satisfaction.

Questions for EFRAG TEG and EFRAG CFSS

- 6 What are the views of EFRAG CFSS members and/or EFRAG TEG members about the implications of the Study for the IASB activities?

Agenda Papers

- 7 In addition to this cover note, the following agenda papers have been made available for EFRAG TEG and EFRAG CFSS members as background material:
- (a) Agenda paper 13-02 – Presentation of study: Is financial reporting still an effective tool for equity investors in Australia? and
 - (b) Agenda paper 13-03 – The paper: Is financial reporting still an effective tool for equity investors in Australia?