

POST AAP DRAFT

**Is financial reporting still an effective tool for equity investors
in Australia?**

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Abstract

Financial reporting has been the subject of recent criticism, particularly regarding the relevance of annual financial statements for investor decision making. In response, using a mixed-method approach we investigate whether annual financial statements are still useful for equity investors in Australia.

We examine the relevance of financial reporting for equity valuation in Australia, and if this has changed across time. We find that financial reporting, as measured by reported net income and shareholders' equity, is relevant for investment decisions in Australia and remains so over time. This result is further supported by evidence from field interviews, which provide insight into how and why financial statements remain value relevant to investor decision making. The field evidence also shows that investors do not prefer one financial statement over others.

Given the increasing availability of more timely forward-looking information from alternative sources, we then examine the relevance non-GAAP financial information and other non-financial information for investor decision making in Australia. We find that non-GAAP financial information (as proxied by EBIT and EBITDA) is more value relevant than statutory performance measures, and a broad range of non-financial information is utilised by investors in making investment decisions both as a 'screen' and for valuation purposes.

The findings of our study provide a valuable contribution to the ongoing debate about the relevance of financial reporting. It provides evidence to inform key decision makers, standard-setters and regulators in the financial reporting system as to the continuing relevance of financial statements in Australia, and the complementary nature of non-GAAP financial information and other information in investor decision making.

1. Introduction

The objective of this paper is to provide evidence on the relevance of financial reporting for equity valuation in Australia, and if this has changed across time¹. Applying a mixed-method approach utilising both archival and field research methods, we examine two key questions:

1. Are annual financial statements decision useful (i.e. relevant) for equity investors in making investment decisions, and has this changed across time?
2. What other types of information are considered decision useful (i.e. relevant) for equity investors in making investment decisions?

The paper is motivated by the significant criticism of external financial reporting over the past decade in relation to the decision usefulness and relevance of financial statements for equity valuation. Frequent assertions have been made that traditional financial reports have lost their relevance for investor decision making. Three main reasons have been put forward for why the relevance of financial reports may have declined²:

- the availability of a substantial amount of more timely forward-looking information from alternative sources (i.e. non-GAAP financial information).
- an increase in the occurrence and reporting of one-time or non-recurring items.
- the shift from an industrialised economy to an intangible knowledge-based economy, and the inability of financial reporting to capture firm value from these knowledge-based intangible assets.

The majority of evidence relating to the value relevance of financial reports over time is based on U.S. GAAP-based financial statements. In general, existing US studies show that accounting information has declined in value relevance across time³. There are, however, some exceptions to this conclusion with some studies finding no evidence that value relevance has decreased across time⁴. While these studies have examined if accounting information prepared in accordance with U.S. GAAP has changed in decision-usefulness over time, no study has investigated the value relevance of financial reports over time in Australia⁵.

¹ An accounting measure is said to be value relevant if it has a consistent association with equity market values (Barth et al 2001). The focus of the paper is on the relevance of financial reports to investors for valuation and we thus ignore the other possible uses of accounting information for stewardship and other possible users such as employees and creditors.

² Collins et al (1997), Francis and Schipper (1999), Lev and Gu (2016).

³ See, for example, Lev (1997), Ramesh and Thiagarajan (1995), Lev and Zarowin (1999), Francis and Schipper (1999), Core et al (2003), Balachandran and Mohanram (2011), Lev and Gu (2016).

⁴ Collins et al (1997), Ely and Waymoire (1996), and Francis and Schipper (1990), Barth et al (2017).

⁵ There are Australian studies, however, that examine the impact of IFRS adoption on the value relevance of accounting information, with inconclusive findings. For example, Goodwin et al (2008) find that A-GAAP reported net income and book value of equity are more value relevant than IFRS-based net income and book value of equity, On the other hand, Chalmers et al (2011) find that the value relevance of net income increases post-IFRS and the value relevance of book value of equity remains constant over the pre and post IFRS periods, while Clarkson et al (2011) find no change in the value relevance of either net income or book value of equity post-IFRS. As our focus is on

Accordingly, it is not known whether the US-based findings are generalisable to an Australian setting.

1.1 Relevance of financial statements to investor decision making

Our results from the archival analysis show that financial statements are decision-useful for equity investors in making investment decisions in Australia and that financial reporting by Australian listed companies has not declined in relevance over the period studied. The results show that, on average, a company's financial performance and position, measured as reported net income and shareholders' equity respectively, explain 64 percent of a company's share price.

The evidence from the field interviews provides further insight into how and why financial statements remain value relevant to investor decision making. The field evidence supports the results from the archival analysis in that all interviewees noting that financial statements have an important role to play as the foundation for investor decision making. Interviewees typically viewed the financial statements as having a confirmatory role in assessing performance, and that the historical basis provided the initial input to the investment models investors developed. Overall, financial statements are considered a necessary, but not sufficient, basis for predicting future performance of an entity.

1.2 Relevance of net income and shareholder's equity to investor decision making

Having established that the combined relevance of net income and shareholders' equity has not declined in Australia, we next examine whether each of net income or shareholders' equity are important for investor decision making, and whether the importance of these elements has changed over time. Our results from the archival analysis show that both shareholders' equity and net income are decision-useful for equity investors in making investment decisions in Australia. The results show that, on average, a company's financial position alone, measured as book value of equity, explains 60 percent of a company's share price, while financial performance alone, measured as net income, explains 52 percent of a company's share price.

The evidence from the field interviews is consistent with the archival results. Although financial statements are considered important for investor decision making, there was no strong preference for whether the balance sheet or profit and loss (net income) is more important for investment decision making.

1.3 Relevance of other information for investor decision making – non-GAAP financial information

Our results from our archival analysis in relation to EBITDA show that the mean Adjusted R² is 57 percent, which means that, on average, a company's EBITDA explains 57 percent of a company's share price, and EBIT explains 54 percent of a company's share price. This indicates that EBITDA and EBIT are relevant for equity investors in making investment decisions in Australia. Moreover, compared to the mean Adjusted R² reported earlier for net

changes in the annualised value relevance of reported net income and book value of equity over an extended time period, rather than changes in value relevance due to a macroeconomic event such as IFRS adoption, the impact of IFRS adoption on the value relevance of net income and book value of equity is beyond the scope of this study.

income (52 percent), EBITDA / EBIT seem to be more value relevant than net income in explaining variation in company share prices. Further, the shift in value relevance of the two measures corresponds over the time period examined, suggesting that statutory profit and non-GAAP earnings are complements rather than substitutes.

The evidence from the field interviews shows 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).

1.4 Relevance of cash flows to investor decision making

Our results from the archival analysis show that, in Australia, operating cash flows are associated with equity valuation. The results show that the mean Adjusted R^2 is 49 percent, which means that, on average, a company's operating cash flows explain 49 percent of a company's share price. This compares with EBITDA, EBIT and net income explaining 57, 54 and 52 percent of share prices, respectively. This implies cashflows from operations as a performance metric has the lowest association with share prices⁶.

The evidence from the field interviews provides interesting insight into the role of cash flows in investor decision making, and how the different financial reporting stakeholders perceive the role of cash flows in investor decision making versus how investors indicate they use cash flows in investment decision making. The majority of the interviewees commented that cash flow was an important aspect of investment decision making. However, most investors did not identify the cashflow statement as more important than other aspects of the financial statements (for example, balance sheet and income statement).

1.5 What other information do investors find useful for investment decision making?

To complement the analysis of the role of financial information (both statutory and non-GAAP) to investor decision making, field interviews were used to provide evidence of the role that other, non-financial, information plays in investor decision making. A number of interviewees noted that there is, necessarily, a strong relationship between the financial information and non-financial information, and the information sets are not used in isolation. Importantly, non-financial information was seen by a number of interviewees as a leading indicator for future financial performance. It was clear from the interviews that information is considered at two levels of 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.

1.6 Contribution

This research makes a number of contributions to the existing literature. First, we present

⁶ More generally, because cashflows from operations are correlated with net income and EBITDA the documented association may not arise from investors directly using cash flows from operations for equity valuation. If investors directly using either net income or EBITDA for equity valuation then in turn this gives rise to an implicit association with cash flows from operations. The fields interviews are consistent with this explanation. Furthermore, an examination of the incremental value relevance of cash flow from operations for equity valuation, after controlling for net income, shows that it only explains 1.5% of share prices.

evidence that the value relevance of financial reports has not declined across time in Australia. This evidence contrasts with much of the existing US literature on this issue. We further support this evidence with field interview evidence from investors, regulators and practitioners that provide further insights into how and why financial reports are used in investment decision making. This evidence confirms that financial reporting information is an important, or critical, contributor to investor decision making, with a focus on the role of financial information as ‘confirmatory’ to investor decision making, and as an input to investor models

Second, we provide evidence that non-GAAP financial information, proxied by EBIT and EBITDA, is more relevant for investor decision making than net income across time in Australia. However, the trend in the relevance of non-GAAP financial information corresponds with the trend in relevance for net income, indicating that the measures are complements rather than substitutes. The field interview evidence supports this result and highlights that, although non-GAAP financial information is considered important for investor decision making, primarily to assist with predicting the future performance of a company, it is not seen to be a substitute for financial information, but rather as a complement to statutory financial information. These results are expected to be of interest to the IASB in helping to inform their current project considering additional subtotals, including EBIT, for the statement of financial performance.

Third, we provide insights as to the additional information that investors may use for investment decision making. The evidence from field interviews highlights that the key (company-specific) other factors that investors focus on in their investment decision making include the governance of the entity, strategy and risk. Other factors were considered industry-specific, including the importance of environmental and social information.

These findings, therefore, make an important contribution to the ongoing debate of the relevance of financial reporting in Australia and highlight that different forms of reporting may not necessarily be substitutes to financial reporting, but rather act as complements to each other with synergies that provide investors with the authentication of information they need to be able to make useful decisions. These insights can further help regulators understand the other types of information investors are likely to use, outside the financial statements, to help focus future regulatory resources⁷.

2. Related Literature and Predictions

As part of the growing debate about, and concern over, the usefulness of financial reporting, academics both in Australia and overseas are undertaking research to provide evidence on whether the relevance of financial reports to investors have declined over time, with interesting findings.

⁷ There are two caveats in the interpretation of the archival evidence. First, we simply document an *association* between financial reports and share prices and do not provide direct evidence that the investors use of financial reports are *causing* share price changes. For example, investors may be getting this information from other sources such as management sales forecasts and this information is in turn incorporated in the final reports (the confirmatory role). Second, all the financial accounting variables (net income, EBITDA, BVE) that we examine are highly correlated and we report results without controlling for this correlation.

There are a number of prior studies in the US that examine the value relevance of financial reports across time, with mixed evidence. While some studies find a decline in the combined value relevance of net income and book value of equity⁸, others find no evidence that value relevance has decreased across time⁹. Due to the ambiguity about the value relevance of financial reports across time, this study aims to help resolve the uncertainty by examining this issue in an alternative setting, namely Australia.

In their recent book titled “*The end of accounting and the path forward for investors and managers*”, Baruch Lev and Feng Gu paint a bleak future for financial reports. The authors investigate whether there has been a deterioration in the relevance of financial reports as an input to the investment decisions of equity investors. To do this, the authors undertake regression analysis and calculate, over time, the extent to which companies’ share prices incorporate reported net income and shareholders’ equity – two key accounting numbers contained within financial reports.

As depicted in Figure 1 below, their findings show a significant decline in the relevance of these numbers to equity investors, as their incorporation into share prices (the R^2) falls over time. For example, while, on average, in the 1950’s reported net profit and shareholders’ equity explain over 90 percent of share price information, whereas by 2013 reported net profit and shareholders’ equity only explain approximately 50 per cent of a company’s share price. The authors attribute these findings primarily to those reasons given below, and call for a revamp in the type of report prepared to communicate information to users.

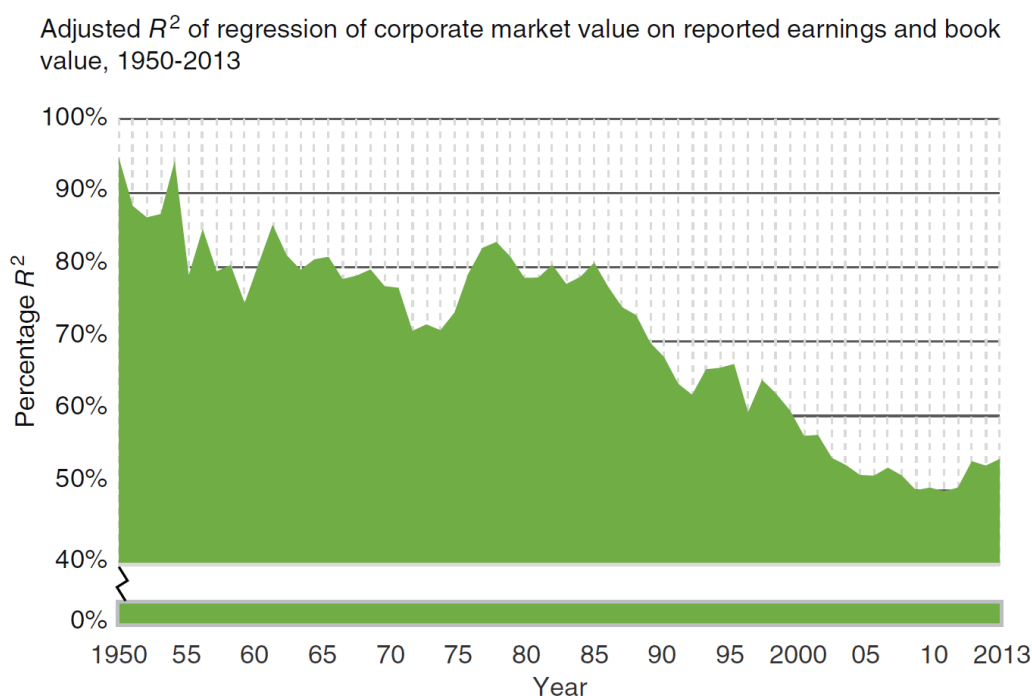


Figure 1: Relevance of US companies’ financial reports over time

Various reasons have been given for this perceived decline in usefulness, including:

⁸ Lev and Zarowin (1999), Balachandran and Mohanram (2011), Lev and Gu (2016).

⁹ Collins et al (1997), Ely and Waymoire (1996), Francis and Schipper (1990), Barth et al (2017).

1. **The availability of a substantial amount of more timely forward-looking information from alternative sources, and concerns about the timeliness of financial reporting¹⁰.**

It is proposed that competing information sources (for example, non-GAAP financial information) preempts financial statement information that act as potential substitutes to statutory information provided in financial reports. As a consequence, financial statements do not capture value relevant events in the same time period as they are reflected in share returns.

2. **The increase in the occurrence and reporting of one-time (or non-recurring items) and a decrease in current matching between revenue and expenses.**

Collins et al (1997) find in the US an increasing frequency of the reporting of one-time items. Dichev and Tang (2008) find mismatching between revenue and expenses in the US has increased across time. Non-recurring items are less persistent than earnings before non-recurring items ('underlying earnings') and can lead to less weight on earnings in relation to share price. This would, therefore, imply earnings becomes less value relevant.

3. **The decline in earnings quality due to the shift from an industrialised economy and the emergence of new economy type firms which derive value from intangible assets (e.g. high-tech, service oriented).**

The basic argument put forward by Lev and Gu (2016) and others is that traditional financial reporting is of limited benefit to valuing these types of firms because accounting standards only allow recognition of intangible assets in restricted circumstances (e.g. purchased intangibles). Evidence consistent with this explanation is provided by Lev and Zarowin (1999) and Srivastava (2014) who find firms with intangible assets have a greater decrease in earnings quality and a weaker association between financial reports and share prices.

3. Research Design

This study will first examine the value relevance of annual financial statements for equity investors by addressing the following research questions:

1. Are annual financial statements decision useful (i.e. relevant) for equity investors in making investment decisions, and has this changed across time?
 - Are **net income and shareholders' equity** relevant for valuation, and has their relevance for valuation changed across time?
 - Are **operating cash flows** relevant for valuation and has its relevance for valuation changed across time?
2. What other types of information are considered decision useful (i.e. relevant) for equity investors in making investment decisions?

¹⁰ Francis and Schipper (1999).

- Is **non-GAAP** information relevant for valuation (proxied by EBITDA), 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?

3.1 *Value relevance*

We examine the value relevance of primary accounting variables over our sample period from 1992 to 2015. Consistent with prior literature¹¹, the primary variables that we examine are net income and shareholders' equity given these are key accounting amounts traditionally synonymous with evaluating company performance and position. We follow prior research and examine time-series trends in value relevance of annual financial reports by examining the association each year between share price and these two key accounting amounts. Further detail is provided in Appendix A to this paper.

3.2 *Interviews*

We respond to recent calls for financial reporting researchers to “enter the field”¹². To gain an understanding of the types of information that are considered decision-useful for investor decision making we conducted interviews with investors, regulators and practitioners. We sought to both triangulate and contrast the perspectives of the different stakeholder groups¹³. Commonalities across the different stakeholder groups provide strong evidence from which we could draw conclusions. We expected differences to emerge that would provide insights on directions for practice interventions to develop a common understanding across stakeholders, and thus more effective financial reporting. Somewhat surprisingly there was very little substantive difference across stakeholder groups that have bearing on our research questions.

Development of the interview protocol

We developed a semi-structured interview protocol drawing on prior literature and consultation with experts in the practice of financial reporting and regulation. We pilot-tested the interview protocol with experienced representatives from our stakeholder groups to reach a stable and well-functioning protocol. Consistent with good research practice for interview-based research¹⁴, we began with broad open-ended questions (e.g. “What is the process you undertake to evaluate a company for investment purposes? What information do you use in this process?”). This ensured we would not unduly prompt or prime our interviewees to focus on financial statements. Only later in the protocol did we narrow to address specific questions about the role of financial statements. Importantly, both in the use of broad open-ended initial questions, and in subsequent more specific questions regarding financial statement, the protocol was worded so as not to bias responses either for or against the role of financial statements in investor decision making.

The use of a standard protocol ensured we had a base set of questions that were asked of all interviewees. The protocol comprised seven main questions, with prompts to ensure

¹¹ Lev and Gu (2016).

¹² Kenno et al (2017).

¹³ Eisenhardt and Graebner (2007).

¹⁴ Yin (2013), Galletta (2013), Schultze and Avital (2011).

elaboration by the interviewee on issues of particular concern. The conduct of the interview bore out the appropriateness of the protocol, as the natural progression of the interviewees' unprompted discourse often pre-emptively mirrored the order of our questions.

Conducting the interviews

Interviewees were identified through a range of direct and indirect sources. Since the purpose of the interviews was to gain insight to how and why investors use financial statements, complementing the value relevance archival analysis, we did not seek a statistical representative sample. Rather, the purpose of our sampling was to ensure we solicited a diverse range of views from the relevant stakeholders. We did not explicitly determine the number of interviews to be conducted, but maintained a rough balance across the different stakeholder groups as we progressed. By completion of 17 interviews, it was evident that we had reached saturation, with negligible incremental insight from additional interviews. Interviews were held in person, at a location of the interviewee's choosing, during the second half of 2017. Substantive interview discussions averaged 28 minutes, and ranged from 14 to 55 minutes. All interviews were attended by at least two of the researchers, and one researcher attended all interviews. All interviews were recorded and professionally transcribed for subsequent analysis. Transcripts amounted to over 69,000 words and 107 pages. To guard against bias in interpreting the interview data we analysed the transcripts using LIWC 2015¹⁵ text analysis software. The result revealed that our interviewees, while somewhat guarded in their responses (Authenticity = 47.87), were overall positive in their tone (tone = 64.52), and spoke with authority and expertise (Clout = 67.30), and were informal, personal, and narrative in communication style (Analytic = 38.29)¹⁶.

4. Sample and Data

Companies

Our archival sample consists of 29,838 firm-year observations from 1992 to 2015¹⁷. Table 1(a) provides descriptive statistics (Panel A) and correlations (Panel B) for our primary accounting variables. As Panel A of Table 1 indicates, our sample firms are, on average, profitable firms that generate positive cash flows from operations (CFO) that exceed reported net income but not EBITDA. Panel B shows that, whether in the context of Pearson (above the diagonal) or Spearman (below the diagonal) correlations, there is preliminary evidence of the association between key accounting numbers contained within a company's annual financial statements and their share price. In particular, there is a significant positive correlation between a company's share price (P) and shareholders' equity (BVE), net income, EBITDA, and cash flows from operations. Not surprisingly, there are significant positive correlations between the accounting items themselves, particularly the correlations between net income and EBITDA and between EBITDA and cash flows from operations.

¹⁵ Pennebaker et al. 2015.

¹⁶ See Appendix C for further details.

¹⁷ We begin in 1992 because this is the year that Aspect-Huntley began comprehensive coverage of Australian firms.

TABLE 1(a) Primary Accounting Variables**Panel A Descriptive Statistics**

	Price	BVE	Net Income	EBITDA	CFO
Mean	1.03	0.60	0.03	0.11	0.07
Median	0.23	0.15	0.00	0.00	0.00
Std	2.28	1.08	0.15	0.28	0.21
Max	75.25	10.56	1.46	2.41	2.13
Min	0.00	-0.09	-0.55	-0.27	-0.35

Panel B Correlations

	Price	BVE	Net Income	EBITDA	CFO
Price	1	0.73	0.71	0.76	0.68
BVE	0.73	1	0.68	0.8	0.7
Net Income	0.71	0.68	1	0.85	0.72
EBITDA	0.76	0.8	0.85	1	0.85
CFO	0.68	0.7	0.72	0.85	1

Interviews

Our sample consists of 17 interviewees, with backgrounds as investors, regulators and practitioners. Table 1(b) outlines the demographic information for the interviewees.

TABLE 1(b): Demographic information for interviewees

		Number	Percentage of sample
Classification	Investor	7	41%
	Regulator	5	29%
	Practitioner	5	29%
Gender	Male	15	88%
	Female	2	12%
Years of experience	>10	3	18%
	11-20	3	18%
	21-30	7	41%
	<30	4	24%
	Mean	21.8	
Highest qualification	Bachelor degree (including Honours)	11	65%
	Masters / MBA	5	29%
	PhD	1	6%
Professional certifications ¹⁸	CPA/CAANZ/Other equivalent international designation	11	65%
	AICD	2	12%
	Other	3	18%
	None	4	24%

¹⁸ Total is > 17 as some interviewees hold more than one qualification.

5. Findings

5.1 *Relevance of financial statements to investor decision making*

Value relevance of financial statements over time (combined net income and shareholders' equity)

Our results from the archival analysis show that financial statements are decision-useful for equity investors in making investment decisions in Australia. The results show that the mean Adjusted R^2 is 64 percent. This means that, on average, a company's financial performance and position, measured as reported net income and shareholders' equity respectively, explain 64 percent of a company's share price.

As shown in Figure 2¹⁹ below, this result for the combined value relevance of net income and book value of equity has remained relatively constant over time in Australia, ranging from a high of 73.2 percent in 1994 to a low of 48 percent in 2001. For 2015, the most recent year examined, on average, a company's financial performance and position explains 61 percent of a company's share price, which is consistent with the long-term average.

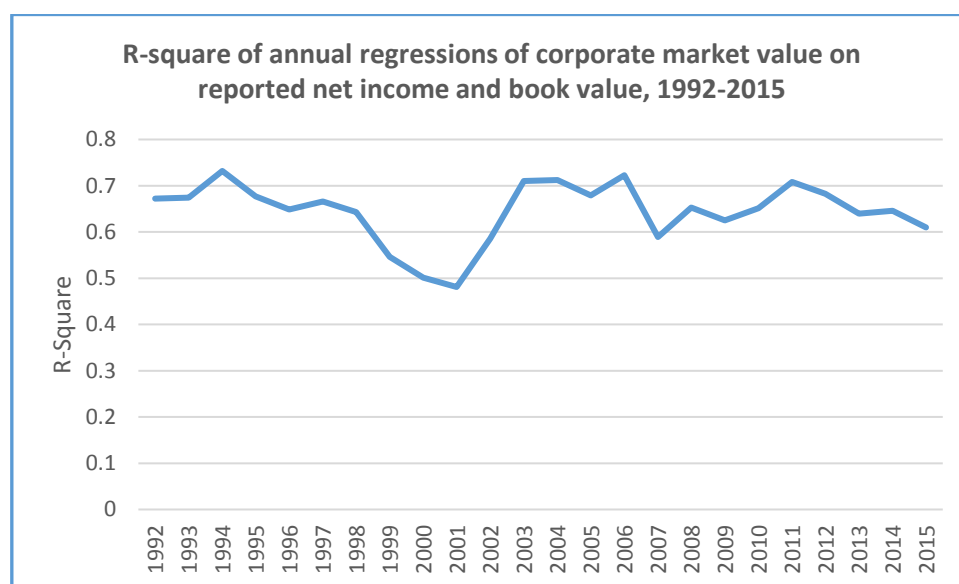


Figure 2: Power of net income and book value combined in explaining share prices.

Overall, the archival results show that financial reporting has not declined in relevance in Australia over the period studied.

Accordingly, in contrast to much of the prior literature that finds a decreasing trend in the combined value relevance of earnings and book value of equity²⁰, we find no evidence that value relevance has decreased across time for net income and book value of equity combined.

¹⁹ The number of observations has increased significantly across time implying the underlying population may not be comparable. Therefore, as preliminary robustness measure for the baseline result, we estimate equation (1) across a sub-sample of firms that were in the sample for more than 80 percent of the total time period. The results reported in Panel C of Table 2 are consistent with the full sample.

²⁰ See for example Lev and Zarowin (1999), Balachandran and Mohanram (2011) and Lev and Gu (2016).

This result is particularly interesting given the significant increase in available information for investors over the time period studied.

This result suggests that the limitation of the timeliness of the release of financial information is not as important for investor decision making as has been previously argued.

Relevance of financial statements – Evidence from field interviews

The interview data provides explanations of how and why financial statements are used in investor decision making, and how they remain value relevant to investor decision making. Interviewees were uniformly unwilling to make investments without audited financial statements, except in the (extremely rare) situation where the investor had first-hand connections with the entity. For example, as a seed investor of a start-up company, and therefore could directly secure information to meet their needs.

Interviewees typically viewed the financial statements as having a confirmatory role in assessing performance, and that the historical basis of these statements provided the initial input to the investment models investors develop and use for investment purposes²¹.

As comments from investors revealed:

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. The audited financials are the thing that give us confidence that debts will be repaid, that there are sustainable earnings that will fund future dividends and capital growth... It's the thing that gives us confidence to invest. So, I think the entire system is crucial to us forming a view on the fair value of an investment that we might make. (Investor 2)

Regulators and auditors had views consistent with those of the investors:

If I had to put a percentage on [the role of the financial statements], it's three-quarters confirmatory. But... to me that doesn't diminish its role because I think if there were audited financial statements the users might say they don't look at them and they just go to investor briefings, but that's where all the numbers come from. (Regulator 1).

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)

While recognising the foundational role of audited financial statements, investors are not naïve as to their limitations:

Audited financial statements are the go-to It's the best we have. It's an imperfect world ... but they're a critical part of what we use. (Investor 7)

²¹ While our interview extracts are largely positive towards financial statements, this is not simply a function of selection bias. As noted earlier, text analysis confirmed an overall positive tone in the transcripts.

Likewise, issues around the backward-looking focus and timeliness were echoed by auditors and regulators, but did not seem to detract from the critical role played by financial statements:

So, it is a little bit backward looking because, by definition, it's the historical financial statements. It's not next year's financial statements so investors obviously are looking more at future cash flows and value. So, I see it mainly as a confirmation... But it provides a pretty good way to explain the business. I think a lot of decisions and professional investors ... are going to be based on understanding the track record that companies or management have demonstrated in the past. So, I think it's quite important. (Auditor 2)

The financial report is a point in time. Yes, it's historical and by the time it comes out you know it is a bit of a lag ... but, in the end, it's a true point in time – it's got the independent assurance... It's all about confident, informed markets and investors. And the way I look at it is a key component of that is the financial report. (Regulator 4)

Indeed, financial statements were recognised as going beyond a confirmatory role, to facilitating forward extrapolation:

...more than just confirming their view, but also, it's the additional information which they are not going to get from other sources... they are really looking for the next level of detail to be able to both confirm their existing decision, but also to update their models or investment frameworks for the next forward looking cycle. (Regulator 3)

Although all interviewees expressed the importance of financial statements for investor decision making, some contrasting views were expressed in relation to whether financial statements were the *most* important information used by an investor in their decision making. For example, one auditor, although noting that financial statements are 'base level' confirmatory for a company, suggested that it is not the 'primary information that they [investors] use' (Auditor 3). The reason provided for this view is that:

...it would maybe not be the company's accounts or annual report, but more the other information they provide to analysts, whether that be forecast information, things from their analyst briefings and presentations, information they've provided for modelling purposes around their assumptions and the future forecasts... I don't think they're probably as timely as a lot of information that's unaudited can get out there to the market and it's obviously very backward and historical looking. But I think they play an important role in adding credibility to the other information that the companies will put out there. (Auditor 3)

Interestingly, this view was not expressed by any of the investors interviewed as part of this study.

The interview evidence supports a consistent view across the stakeholder groups that the financial statements are the foundation for investor decision making, a necessary, but not sufficient, basis for predicting future performance of an entity.

5.2 Relevance of net income and shareholder's equity to investor decision making

Value relevance net income and shareholders' equity over time (analysed separately)

Having established that the combined relevance of net income and shareholders' equity has not declined in Australia, we next examine whether this finding is driven by net income or shareholders' equity (or both) maintaining value relevance over the sample period. That is, to examine whether the importance of these elements has changed over time.

Figure 3 shows the results where we analyse the effect on share price of reported net income and shareholders' equity separately, on an annual basis.

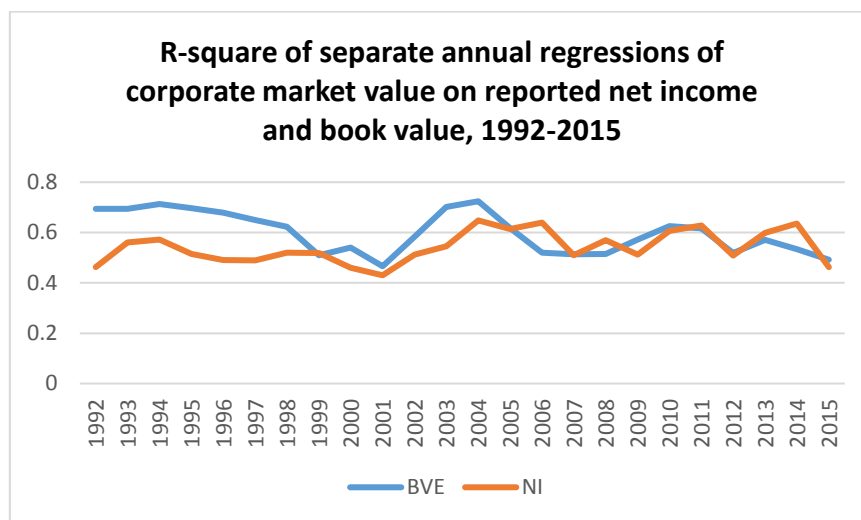


Figure 3: Power of net income and book value individually in explaining share prices.

Our results from the archival analysis show that both shareholders' equity and net income are decision-useful for equity investors in making investment decisions in Australia. The results show that the mean Adjusted R^2 for book value of equity is 60 percent, and for net income the mean Adjusted R^2 is 52 percent. In other words, on average, a company's financial position alone, measured as book value of equity, explains 60 percent of a company's share price, while financial performance alone, measured as net income, explains 52 percent of a company's share price²².

As shown in Figure 3 above, the association between a company's share price and reported shareholders' equity has declined over the sample period, as reflected in its reduced ability to explain company share prices. However, the association between a company's share price and reported net income has remained relatively stable over time.

²² The decision-usefulness of the financial position for equity valuation as measured by explanatory power of 60 percent could be overstated. Current share prices are a positive function of past earning growth. This past earning growth is included in current retained earnings and therefore a mechanical relation will arise between current book value of equity and current share price due to the use of earnings in the past to value a share.

Figure 3 also shows that the greater predictive ability of shareholders' equity to explain company share prices is declining over time to a level comparable with that of net income. In fact, there is no discernible difference between these two items in 2015. In 2015, shareholders' equity explains 49 percent of the share price and net income explains 46 percent of share price. This indicates that both elements are similarly important for investor decision making.

Overall, our archival findings indicate that reported net income and book value of equity are important inputs in explaining a company's share price. Moreover, in more recent times these accounting numbers are becoming similarly important, perhaps suggesting that investors rely equally on these accounting numbers for decision making purposes.

Relevance of net income and shareholders' equity – Evidence from field interviews

The evidence from the interviews provide further insight into the role of net income (profit and loss) and shareholders' equity (balance sheet). Consistent with the archival research the interviews evidenced that, at least for investors, the profit and loss statement and the balance sheet were seen as similarly important for investment decision making. Most interviewees commented that investors would use all aspects of 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)

Indeed, as one investor noted the interdependencies require consideration of all the financial statements:

I don't see how people could use any one statement in isolation of the others. (Investor 4)

Notably, investors used the different financial statements to inform themselves about different aspects of a business. For example:

The profit and loss gives us a good sense of a company's ability to pay its future debts, ... but the balance sheet gives us a good sense of whether there are assets that we are a little nervous about like stranded assets or things like that. (Investor 2)

Furthermore, investors noted that the relative importance of the balance sheet or profit or loss would be industry dependent, and driven by the characteristics of individual companies. For example:

...in the end game, you're forecasting cash flows and valuing those, but generally you'll do that via the income statement. This changes when you have a balance sheet driven business so for banking, insurance, to a large degree, firms that generate value from fair value to equity investments.... you'll tend to focus primarily on book value rather than income statement. (Investor 1)

In contrast, regulators and practitioners were of the view that investors would focus more on the profit and loss rather than balance sheet of a company when making investment decisions, for example:

I suspect the focus is on ... performance rather than a particular point in time. And that partly reflects the fact that the balance sheet is old by the time you look at it, it was at a point in time, whereas at least the profit and loss gives [the] flow over a year and you can compare it with what was in the previous year. (Regulator 2)

It probably varies, depending by industry but as a general rule I would say [investors focus on] profit and loss. (Auditor 3)

[Investors] focus on probably the whole profit and loss... profit and loss gets an unhealthy level of focus because ... the profit and loss is seen as the score card. (Auditor 1)

Investors, however, are not as narrow in their focus as auditors and regulators appear to think, with one clearly explaining how the marketplace had learnt from experience of a narrow focus:

The whole industry learnt some pretty hard lessons through the GFC about ... not being focused on capital structure. That's always been an important one for us so we look at a range of metrics which we derive from historical financial data around leverage ratios and interest coverage ratios... (Investor 6)

All three stakeholder groups recognised that the focus in the financial statements was moderated by the nature of the investment decision, e.g., long-term versus short-term:

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)

Overall, evidence from the field interviews indicates that both the income statement (net income) and the balance sheet (shareholders' equity) are seen to have a key role in investor decision making. This is consistent with the archival results which indicate that both statements are becoming similarly important for investment decision making purposes.

5.3 *Relevance of cash flows to investor decision making*

Value relevance of cash flows over time

Our results from the archival analysis show the relevance of operating cash flows for equity investors in making investment decisions in Australia. The results show that the mean Adjusted R^2 is 49 percent. This means that, on average, a company's operating cash flows explain 49 percent of a company's share price.

As shown in Figure 4 below, this result for operating cash flows are less stable than reported net income, ranging from a high of 62.2 percent in 2004 to a low of 28.6 percent in 2000. For 2015, the most recent year examined, on average, a company's operating cash flows explain 48 percent of a company's share price, which is consistent with the long-term average.

As Figure 4 depicts, it seems that since 2004 operating cash flows have increased in value relevance in Australia. Prior to this date, however, operating cash flows were, on average,

more volatile in explaining, and less able to explain, company share prices.

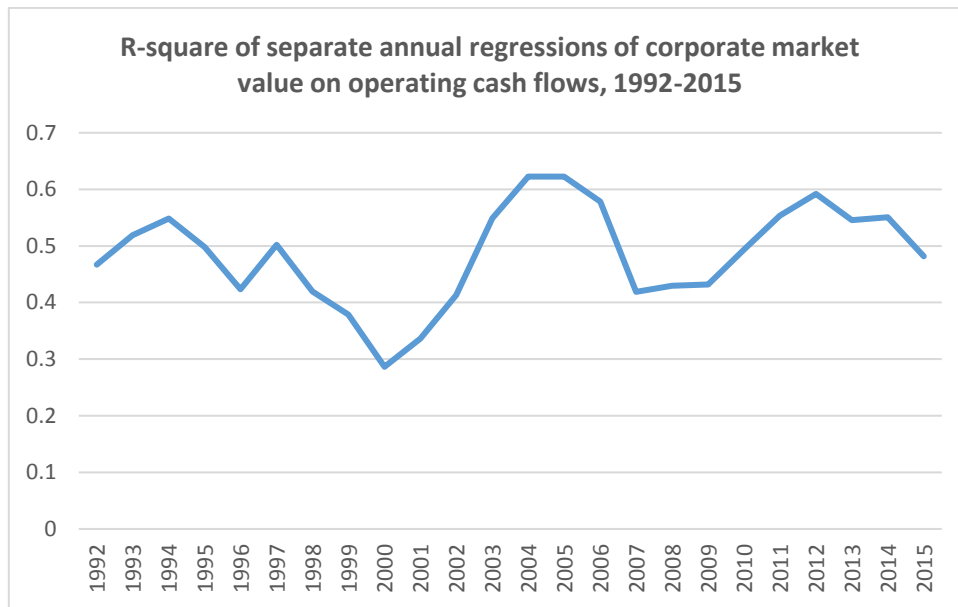


Figure 4: Power of operating cash flows in explaining share prices.

Relevance of cash flows – Evidence from field interviews

While the interview evidence, unsurprisingly, concurs that cash flows are important in investment decision making, it reveals a more nuanced view. Specifically, while cash flows are important it does not necessarily mean that the cash flow statement is as important. For example:

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)

As one auditor succinctly described it:

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)

While investors did not identify the cash flow statement as more important than other financial statements, this was often not how auditors and regulators thought investors would view the cash flow statement. For example:

Cash flows would have to be the thing [investors] look at over and above everything else because they're real. (Regulator 1)

The apparent lack of focus on the cash flow statement was perplexing to one practitioner:

I always think it's funny when in the financial services, [investors] come up with a measure called cash earnings, where there actually is a cash flow statement which is

supposed to show cash earnings. And, so, the fact that people are trying to come up with another form of cash earnings is to me is a bit of a nonsense... Personally, I think that the profit and loss needs the context of a cash flow and I think that the cash flow is under focused on. And the reason for that is because people are trying to adjust their profit and loss to come up with EBITDA. And, when they're coming up with measures like EBITDA, they're trying to come up with a proxy for cash flow and I think the cash flow statement already gives you good information on the cash flows of a firm. Whereas an EBITDA, at the end of the day: taxes – they have to pay them, interest – well the finding is something that has to be paid for... (Auditor 1)

However, the cash flow statement is not without value, for example:

The format of cashflow statements in Australia is a lot better, say, than the US, particularly with... cashflows from operations... We will look at different metrics around cashflows from operations and particularly in terms of how we forecast it. (Investor 6)

The use of “different metrics around cashflows” suggests that the cash flow statement is not seen as the only source of information for predicting future cash flows, and so there is a potential disconnect between the importance of cash flows and the importance of the cash flow statement.

In summary, the interviews support the importance of cash flows in investment decision making, but not exclusively cash flow as reported in the cash flow statement. As a result, there appears to be a misconceived perception amongst regulators and practitioners as to the importance that investors place on the role of the cash flow statement in investor decision making, and the role of cash flows versus the role of the income statement and balance sheet.

5.4 Relevance of other information for investor decision making – non-GAAP financial information

Value relevance of EBIT and EBITDA over time versus net income

Having earlier established that net income is value relevant, and consistently so over time, to equity investors, we next compare the value relevance of net income, which is a statutory profit measure, with our proxy of non-GAAP earnings, namely EBITDA and EBIT. Figure 5 shows the results where we analyse the comparative effect on share price of reported net income and EBITDA and EBIT, on an annual basis.

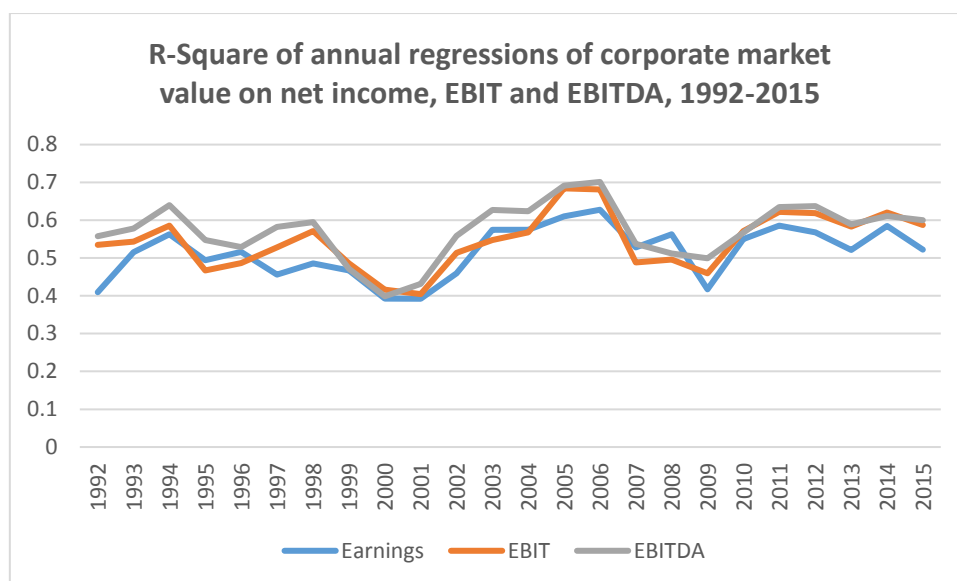


Figure 5: Power of net income, EBIT and EBITDA in explaining share prices.

Our results from our archival analysis in relation to EBITDA, EBIT and net income show that the mean Adjusted R^2 is 57, 54 and 52 percent respectively. This means that, on average, a company's EBITDA, EBIT and net income explains 57, 54 and 52 percent of a company's share price. The mean Adjusted R^2 reported for EBITDA seems to be more value relevant than net income in explaining variation in company share prices. This consistently occurs in each year of the sample period. One potential explanation for this is investors view those items that comprise net income but not EBITDA, such as depreciation, amortisation, interest, and tax, as less relevant for valuation purposes.

Interestingly, the trend in value relevance of EBIT, EBITDA and net income is comparable over the sample period. That is, the change in value relevance over time for both accounting measures correspond, suggesting that statutory profit and non-GAAP earnings are complements and not substitutes.

Relevance of non-GAAP financial information – Evidence from field interviews

The evidence from the field interviews provides insight into the role that non-GAAP financial information plays in investor decision making, and how non-GAAP information relates to statutory financial information (for example, net income).

In contrast to the evidence presented earlier, that the role statutory financial information in investor decision making is primarily confirmatory in nature (see section 5.1 above), when asked about the role of non-GAAP financial information, interviewees highlighted that the measures are often used by investors to help establish what part of current performance is expected to continue into the future (i.e. predictive, sustainable, persistent earnings). One investor specifically commented that 'all the [research] studies show that non-GAAP numbers do a better job of predicting future cash flow and earnings than GAAP measures do'. (Investor 3)

Another investor noted that:

When our [investor's] task is to forecast earnings or cash flows, the most recent period or the growth of the most recent period is a heavily important benchmark... My task ... is trying to discern what part of that recent period I can expect to continue or not – and that's where I think non-GAAP measures become really important. (Investor 1)

Another investor noted that non-GAAP financial information is almost exclusively focused on the profit and loss – ‘you don't tend to see very many investment firms... or brokers and investment banks adjusting balance sheets or cashflows. It's practically always the profit and loss’ (Investor 6). The investor went on to comment that:

Obviously, the concept there is trying to get to an operating or ... recurring. However, you want to [have] ... a starting point to make predictions about future years. In the end we're discounting future earnings and cashflows back to come up with present values to try and figure out what these businesses are worth... Most of our competitors are doing the same thing so everyone's ... focused on trying to get as clean and representative starting point as they can. Which I'd define as ... maybe the last three or four years as a starting point from which to make projections out over the next three, five and ... 10 years and beyond. So that's the sort of concept behind adjusting for one-offs, non-recurring items etc. (Investor 6)

It was also noted:

EBITDA should be the number that most accurately reflects the future prospects of a company. It doesn't always because it seems open to a level of fluctuation of volatility. But, basically, to me, you should be able to look at a set of financials and say – here's our earnings because all the things that we need to take into account have been taken into account. That is, the best picture of your future expectations of what a company is going to generate in earnings. And then we can overlay our own expectations about the future prospects of that company. (Investor 2)

In contrast to the role of financial statements in investment decision making, no interviewees mentioned that non-GAAP information is confirmatory, even though much of the non-GAAP information provided is historical in nature (e.g. EBITDA).

Further, a number of interviewees noted that non-GAAP information is used to ‘better communicate’ the financial results of a company to investors. For example, one investor commented that:

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)

Another interviewee noted that:

My impression is investors want to know what just went on, what did you do in the last 12 months or six months, but they moreover, especially these days, want to get an understanding of what the future holds. And, sometimes, if you can see what's been underlying your statutory profits for the last two or three years that might help management to have a better communication to investors of – “don't focus on that,

it's not really what's going to drive our business' future and our profit, it's this within our results what we're focused on and we think you probably should be focused on too to make your own decisions." (Regulator – M1)

Interviewees also identified several key issues with the preparation and use of non-GAAP financial information, including issues relating to:

- transparency in the development of the information;
- reliability of the measures; and
- consistency both within and between companies in how the measures are calculated.

For example, in relation to non-GAAP financial information, one investor noted that 'I think they're very important, but I think even investors themselves don't realise how ad hoc they can be' (Investor 3). Another investor commented that 'the problem... with the non-GAAP measures is that how they're constructed is sometimes a bit of a black box.' (Investor 1). Similarly, one regulator commented that:

If done properly by the company it can be useful information, but you're not going to have comparability across other companies...Alternative measures of profit, for example, has [sic] the potential to be useful for a specific company. If you can't ... get useful comparative information... I think too many companies ... use it as a way of conveying a profit that they want to convey rather than giving the true... underlying performance of the business. (Regulator 2)

To help alleviate some of the concerns noted above, a number of regulators and auditors mentioned the need for the non-GAAP measures to be properly defined, but not necessarily regulated. A number of interviewees commented that some form of additional disclosure of the calculation methodology would be useful for consistency, comparability and transparency. For example, one regulator noted that:

I think transparency about how [non-GAAP measures are] calculated would be important, such that hopefully, you can get that consistency in calculation from company to company...But, maybe that becomes something that's not necessarily mandated, but rather the disclosure of its calculation is. And then [investors] ... can put pressure on the companies to get that consistency...As a minimum, there should be a reconciliation from anything that's disclosed, non-GAAP, back to what it would be in the financial statements. (Regulator 3)

In addition, investors made comments along the following lines:

...the only way to deal with it is [by] disclosure... So when you utilise a non-GAAP, particularly underlying type number, you should – or perhaps, could have an obligation to then reconcile your construction of that. Otherwise you're again reliant on management for communicating the number in an appropriate way.' (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)

Although, any form of regulatory requirement was noted by some interviewees as being potentially problematic, with one investor noting that:

[Non-GAAP] will vary from year to year and it's almost as if the definition of non-GAAP earnings is not clear until earnings have occurred in practice. And, so potentially there's value in having firms produce measures or definitions and non-GAAP in advance before they actually measure it. I don't know how easy it would be to enforce that kind of thing. (Investor 3)

Another investor also noted that the role of improving the quality of non-GAAP financial information is not limited to the regulators, commenting that:

...it really is companies themselves who are contributing to that information who should play a greater role in ensuring the quality of the information that goes out is consistent, reliable, meaningful information. (Investor 4)

Overall, the evidence from the field interviews highlights that non-GAAP financial information has an important role to play in investor decision making. However, the role is in the context of the financial statements. This is particularly highlighted in the number of interviewees who would like to see a stronger relationship between the statutory financial information and the non-GAAP financial information. From this, we can conclude that there is no evidence to suggest that non-GAAP measures are a substitute for statutory financial measures of performance of an entity (for example, net income), and although annual financial statements have been criticised as being, somehow, replaced by timelier non-GAAP information, the evidence suggests that the two sets of information are more complementary in nature, rather than acting as substitutes.

5.5 Relevance of other information for investor decision making – non-financial information

What other information do investors find useful for investment decision making?

To complement the analysis of the role of financial information (both statutory and non-GAAP) to investor decision making, field interviews were used to provide evidence of the role that other, non-financial, information plays in investor decision making.

The archival analysis above, and the related field interviews, highlight that financial statements and other financial information are relevant for investor decision making. To help understand what other information investors use in investment decision making, as part of our field interviews we asked the interviewees about what information is used in evaluating a company for investment purposes, as well as the role of other (non-financial) information.

The evidence from the interviews provided a rich insight into the role of other information, and how the information is used in investor decision making. Overall, a number of interviewees noted that there is, necessarily, a strong relationship between the financial information and non-financial information, and the information sets are not used in isolation. Importantly, non-financial information was seen by a number of interviewees as a leading indicator for future financial information. For example, one investor noted that:

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)

A number of key themes were evident from the interview responses. Firstly, it was clear from the interviews that information is considered at two levels of 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.

For both aspects of the investment process (i.e. screening and valuation), key elements relating to the company that were highlighted by interviewees included:

- Governance of an entity – including understanding the management personnel.
- Risk information – for evaluation / loss aversion.
- Business model and strategy, including information provided in the operating and financial review, directors report etc.
- Industry factors and competition.
- Environmental and social information.
- Other non-financial information including sales data, brand perception, customer satisfaction.

Environmental, social and governance (ESG) information was often considered as an important screen for investment purposes, with a number of interviewees commenting that investors are considering environmental and social aspects when considering investments, and that this information is becoming more important.

Although, one regulator commented that they thought social and environmental information was ‘a public relations exercise’ (Regulator 1). Another regulator also commented that:

Where they’ve found particularly with some of the environmental and social type reporting, that some have expressed concerns about the basis upon which it’s prepared and whether they understand what that basis is. So, it comes back again to how much of this is really reporting under a framework, or is it just almost a marketing spin. (Regulator 3)

However, another regulator suggested that:

[Investors] should have an environmental conscience, they should have a social conscience, and I’d expect a lot of them do. And they want to make their investment decisions within that context. (Regulator 2)

In terms of governance, one auditor noted that ‘the capital of a company is not just the physical assets...but it’s the quality of the people that it’s got’ (Auditor 4).

One investor noted that:

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. This time, so the companies with the highest scores will rank higher, companies with the lowest scores will rank lower. (Investor 6)

A number of interviewees specifically commented on the importance of understanding and linking the financial and non-financial information relating to a company. For example, one practitioner commented that:

It's important for the investors to do non-financial research but then use the financial statements as the cross-check for all of that and see that it is giving them the right – is it supporting what they're seeing and what they're thinking... I think that the two work hand-in-hand and I think that investors should take a view on the business prospects more broadly and they should be looking heavily on the non-financial because that's what's going to differentiate one firm from the next that they could invest in, but the financial information's also important for them to give a cross-check, if you like, on what they think the revenue of the business of the entity is, I think the financial information helps them do that. (Auditor 1)

This view was shared by a practitioner who noted that:

I think more generally it's becoming increasingly important, and I think a recognition that it has a more direct impact at the end of the day on performance and profitability... increasingly [there is] a more direct link to actual performance. And... from an investor perspective, obviously a lot of funds now are making decisions around the types of companies they will and won't invest in, so it can actually cut out a capital avenue completely if you're not providing the information they want to see. (Auditor 3)

One investor noted that they would like to see non-financial information treated in a similar way to financial information:

We feel the need for more consistent quantitative data that can't be manipulated. We're really pleased that there's been... a move to consistent non-financial information reporting, either within the annual report or as a standalone sustainability report. Some companies are making some really good progress in providing consistent metrics. We think there needs to be more consistency across companies in the same industry reporting the same metrics so that you can compare. And we'd still like to see a little less marketing spin around these. More like when you release the financial statements...(Investor 2)

The above analysis from the field interviews highlights that non-financial information has an important role to play in investor decision making, in conjunction with financial information. There is a strong relationship between the financial information and non-financial information, and the information sets are not used in isolation. Importantly, non-financial information is considered a leading indicator for future financial performance.

5.6 Analysis by industry sector

We examine the change in the combined relevance of net income and shareholders' equity for firms classified by industry using the two-digit GICS S&P industry sector codes. This is motivated by the assertion that a decrease in value relevance is due to an increase in

importance of a service-orientated economy for which it is alleged the traditional reporting model is not relevant. If this is the case we would expect the decline in relevance to be more significant in these types of industries. To make the analysis parsimonious we divide our sample period into two periods which we label pre-2000 (1992 to 1999) and post-2000 (2000 to 2015) and examine if there have been any changes in relevance between the periods. The results reported in Appendix B show no evidence of a decline in relevance of financial reports in these industries typically associated with being service orientated (e.g. consumer discretionary and information technology).

A potential explanation for finding no systematic decrease in value-relevance is that it may be that “new economy” service-orientated type firms may be younger and smaller. We provide a preliminary analysis of this by partitioning firms into four size quartiles from very small to very large. For large and medium size firms, as evident from Figure 6, there is no observable trend in R^2 across time implying that the combined value relevance of net income and shareholders' equity has stayed reasonably constant across time. In contrast, for the very smallest portfolio of firms there is a clear trend downwards in the combined value relevance of net income and shareholders' equity across time. Further analysis shows that the industry sectors most affected in the very small portfolio are consumer discretionary and telecommunications. This finding is very preliminary and further research is required to understand why very small stocks in the consumer discretionary and telecommunication sectors have had a decline in value relevance.

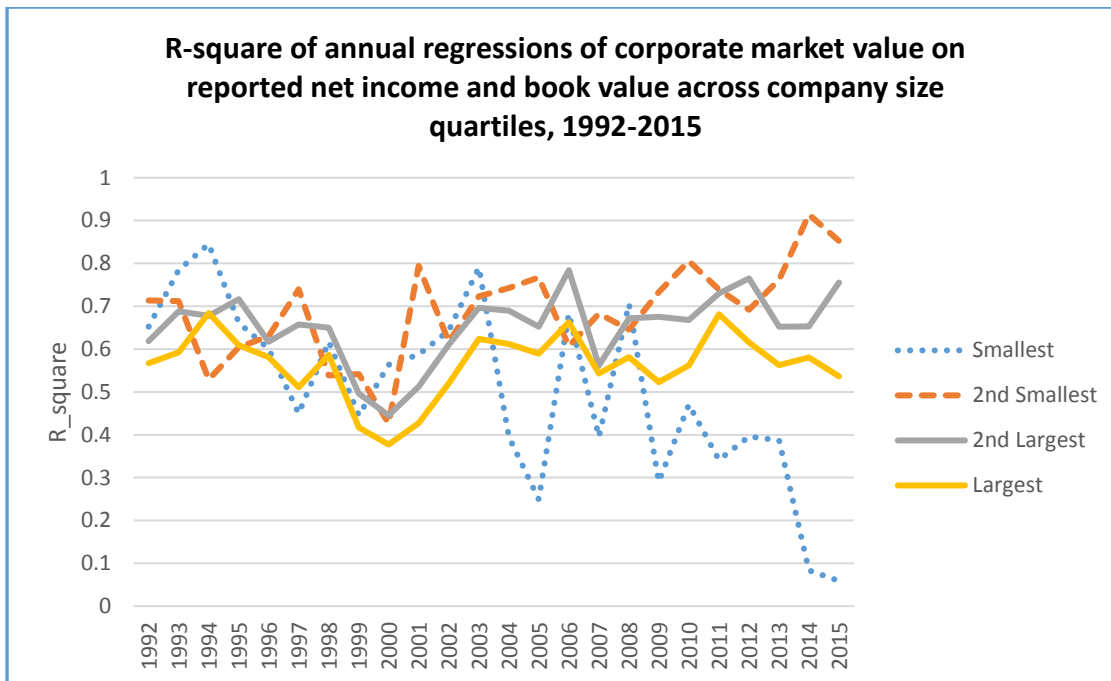


Figure 6: Power of net income and shareholders' equity combined in explaining share prices across company size portfolios.

6. Conclusion

Motivated by claims that financial reports have lost relevance for equity valuation, this study provides evidence on the relevance of financial reporting for equity valuation in Australia and, consequently, whether financial reporting can still be considered an effective information tool for equity investors in Australia.

Our results show that financial reports remain relevant for equity valuation in Australia, as demonstrated by archival findings, and supported by evidence from field interviews with investors, regulators and practitioners. Our results also show that, as a whole, financial reporting is consistently relevant over time. Our findings also document the relevance of specific accounting measures to equity investors, with a focus on traditional metrics, such as reported net income, shareholders' equity, and operating cash flows, as well as contemporary non-GAAP measures proxied by EBITDA and EBIT. In particular, our findings highlight that investors view such accounting numbers as complements, rather than substitutes, and take the measures into consideration as a bundle for decision making purposes.

The results of this study are important for practitioners, regulators and standard-setters by providing empirical evidence to explain the role that financial information plays in investor decision making in Australia. Our research provides a basis from which standard-setters and other regulators can respond to some of the criticisms levelled at financial reporting. In particular, the results will help inform the IASB's current project addressing Primary Financial Statements on whether to introduce additional subtotals, including EBIT, into the statement of financial performance.

These findings, therefore, make an important contribution to the ongoing debate of the relevance of financial reporting in Australia and highlight that different forms of reporting may not necessarily be substitutes to financial reporting, but rather act as complements to each other with synergies that provide investors with the authentication of information they need to be able to make useful decisions. These insights can further help regulators understand the other types of information investors are likely to use, outside the financial statements, to help focus future regulatory resources.

Appendix A: Detailed research design

The association each year between share price and accounting amounts is estimated using the following ordinary least squares (OLS) regression:

$$(1) P_i = \beta + \beta NI_i + \beta BVE_i + \varepsilon$$

Where P is share price for firm i three months after fiscal year, NI is net profit after tax for firm i for the financial year and BVE is book value of equity for firm i measured at financial year end. NI and BVE are both scaled by shares outstanding at year-end to allow comparison with prior research (Collins, Maydew and Weiss, 1997; Lev and Zarowin, 1999). The Adjusted R^2 from this yearly regression provides a measure of the combined value relevance of earnings and net income for equity valuation.

To compare the individual explanatory power that net income and book value of equity have for prices, we follow Lev and Gu (2016) and disaggregate model (1) into two parts: (i) the explanatory power of net income (NI) alone in explaining share prices; and (ii) the explanatory power of book value of equity (BVE) alone in explaining share prices. The respective models for each of these is as follows, where the Adjusted R^2 of each yearly regression using the respective models indicates the ability of NI and BVE to separately explain share prices:

$$(2) P_i = \beta + \beta NI_i + \varepsilon$$

$$(3) P_i = \beta + \beta BVE_i + \varepsilon$$

To examine the explanatory power of alternative accounting numbers, namely cash flows from operations (CFO), $EBIT$ and $EBITDA$ we replicate models (2) and (3) with these alternative accounting numbers. The respective models for each of these is as follows, where the Adjusted R^2 of each yearly regression indicates the ability of CFO , $EBIT$ and $EBITDA$ to explain share prices, respectively:

$$(4) P_i = \beta + \beta CFO_i + \varepsilon$$

$$(5) P_i = \beta + \beta EBIT_i + \varepsilon$$

$$(6) P_i = \beta + \beta EBITDA_i + \varepsilon$$

Appendix B: Industry R-Squared

Changes in value relevance across time based on yearly regressions of price on net income and shareholders' equity across industry classifications

	Observations		Full Model R Squared		Change
	1992 to 1999	2000 to 2015	1992 to 1999	2000 to 2015	
Energy	389	2340	0.6887	0.5409	0.1478
Materials	2703	7985	0.7133	0.6937	0.0196
Industrials	963	2481	0.6377	0.6882	0.0505
Consumer Discretionary	757	2176	0.6139	0.6413	0.0274
Consumer Staple	428	702	0.6488	0.6991	0.0503
Health Care	203	1801	0.4628	0.6024	0.1396
Financials	1099	2393	0.6798	0.6044	0.0754
Information technology	324	1830	0.3739	0.5231	0.1492
Telecommunications	70	447	0.339	0.663	0.3240
Utilities	37	229	0.7841	0.9214	0.1373
		Mean	0.5942	0.6578	0.0636

The Table report the R-Square from estimation of $P_i = \beta + \beta NI_i + \beta BVE_i + \varepsilon$ across industry classifications. Where P is share price for firm i three months after fiscal year, NI is net income and BVE is book value of equity. NI and BVE are both scaled by shares outstanding. Obs are trimmed at 1st and 99th percentile.

Appendix C: Transcript Textual Analysis Results

	N	Word Count	Analytic	Clout	Authentic	Tone
Overall	17	4078.5	38.29	67.30	47.87	64.52
Auditor	5	3355.2	38.68	63.25	53.55	68.64
Investor	7	4195.5	44.72	69.96	43.70	64.14
Regulator	5	4515.4	27.78	64.53	48.48	63.45

Analytic	A high number reflects formal; lower numbers reflect more informal, personal, here-and-now, and narrative thinking.
Clout	a high number suggests confidence and an interviewee speaking from expertise. .
Authentic	Lower numbers suggest a more guarded, distanced form of discourse.
Tone	A higher number is associated with a more positive, upbeat style. A mid- range number suggests ambivalence.

All four measures are on 0-100 scale. Analysis was performed using the LIWC2015 default dictionary.

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