

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



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Research Questions and Methodologies Employed

Research Questions

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

Archival Methodology

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

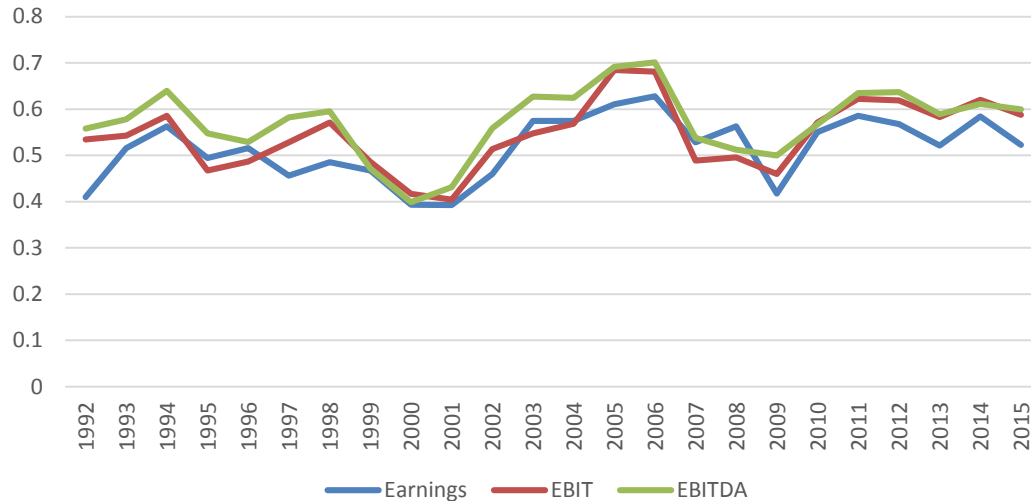
Field Interview Methodology

We conducted 17 interviews with professional investors (7), regulators (5) and practitioners (5)

- Interviews transcripts amounted to over 69,000 words and 107 pages

IFRS & Non-GAAP Earnings Relevance: Archival Evidence

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



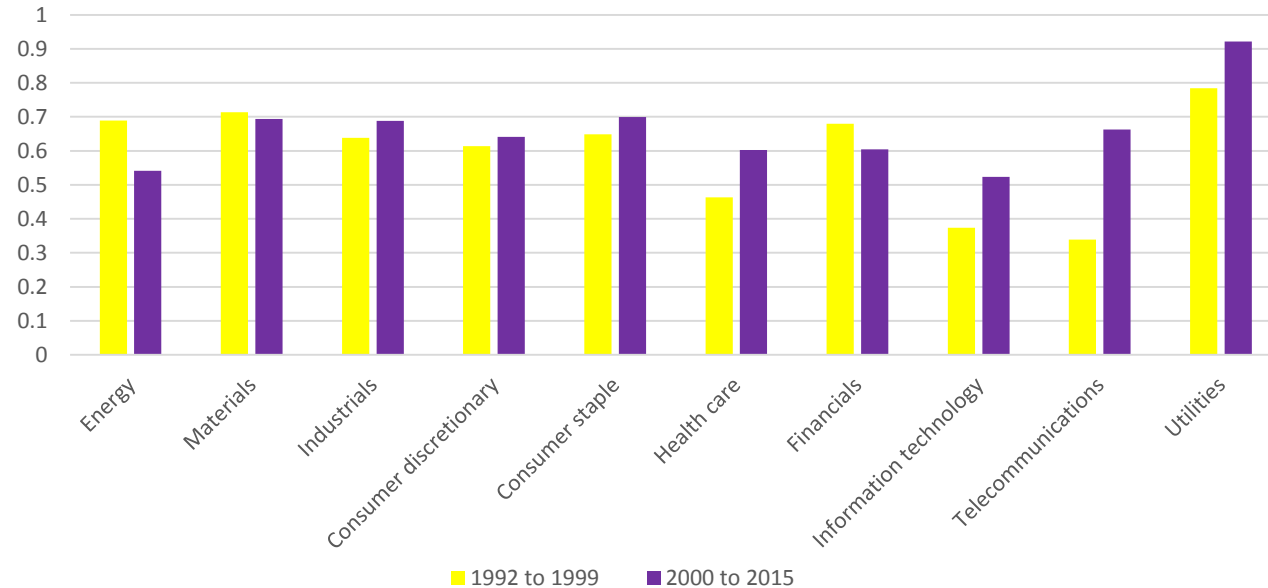
- On average, a company's EBITDA, EBIT and earnings (NPAT) are associated with 57, 54 and 52 percent of their share price, respectively
- Investors view those items that comprise NPAT but not EBITDA or EBIT as less relevant for valuation purposes
- Trend in relevance of EBITDA, EBIT and NPAT is comparable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

IFRS & Non-GAAP Relevance: Interview Evidence

- IFRS financial statements are both confirmatory and the starting point for modelling and projections:
The financials ... are the thing that give us confidence (Investor 2)
projecting financial statement information in the form of projections of cash flows often derived from accounting information would be fairly typical, I would say (Investor 3)
we look at a range of metrics which we derive directly from historical financial data (Investor 6)
- 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:
the problem... with the non-GAAP measures is that how they’re constructed is sometimes a bit of a black box (Investor 1)

Relevance of Financial Statements Based on Industry: Archival Evidence

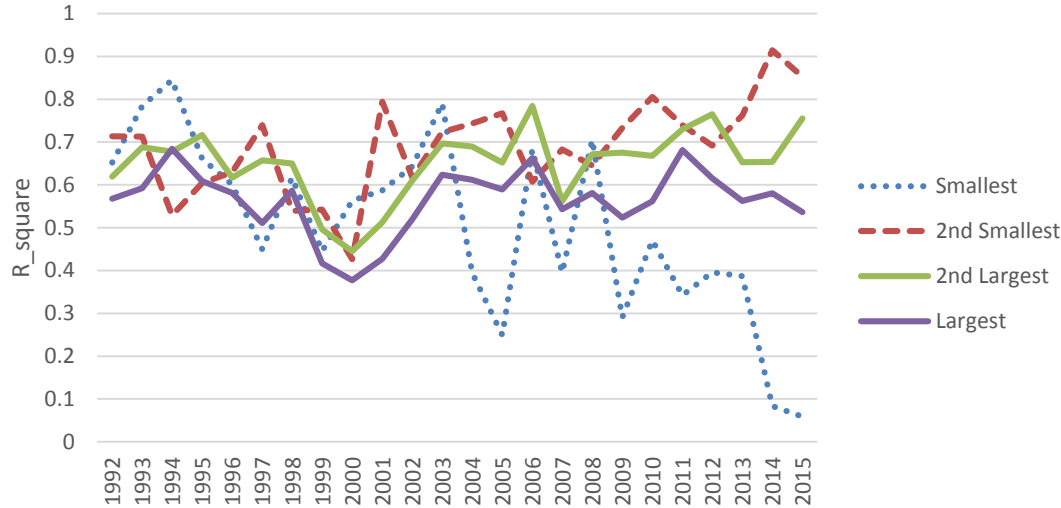
Average R-square of regressions of corporate market value on reported net income and book value by industry across 1992-1999 and 2000-2015



- Other than for sample firms in the energy or financials sectors, the relevance of NPAT and shareholders' equity has either stayed constant or increased across the two time periods
- The industry sectors which experienced the most dramatic increase in financial statement relevance are telecommunications, information technology, healthcare and utilities, respectively

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 appears to be a downward trend in relevance of NPAT and shareholders' equity across time
- This may, however, be a reflection of share prices of small firms being a noisy measure of relevance

Research Implications

- Evidence that financial reporting is still an effective information tool for equity investors:
 - 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 important input to investor valuation models
 - Counters skepticism of management assumptions and projections
- Statutory financial reporting is 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 part of the ‘Better Communication in Financial Reporting’ suite of projects:
 - Primary financial statements: whether to introduce additional subtotals, such as EBIT, into the statement of financial performance
 - Principles of disclosure: how to improve the information provided to financial statement users