

DECISION- USEFULNESS IN FINANCIAL REPORTS

RESEARCH REPORT NO.3

THE EFFECT OF INDUSTRY ON THE
RELEVANCE OF FINANCIAL REPORTS
FOR INVESTOR DECISION MAKING

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TABLE OF CONTENTS

1. EXECUTIVE SUMMARY	4
2. INTRODUCTION	5
3. RELEVANCE OF INDUSTRY – SHARE PRICE EVIDENCE	6
4. RELEVANCE OF INDUSTRY – EVIDENCE FROM FIELD INTERVIEWS	9
5. CONCLUSION	10
6. REFERENCES	11
7. GLOSSARY	12
8. AUTHORS	13

1.0 EXECUTIVE SUMMARY

The first two reports in this series highlighted that, while financial reports have been criticised for increasingly not meeting the needs of users, recent Australian evidence indicates they are still of relevance to investors. While the results suggest there is room for improvement, the findings do not mark the end of accounting as we know it, as has been the call from some industry and academic writers.

In this report, we examine the effect of industry on the relevance for investor decision making in Australia. It has been argued that an increase in importance of a knowledge-based economy is a reason why financial reports may not be as useful for investor decision making purposes.

Our results show that financial reports remain relevant for investors, and that financial reporting is consistently relevant over time, regardless of industry. This is demonstrated by archival findings and supported by

evidence from field interviews. Our archival findings demonstrate that only two of eight industries experienced a decline in financial reporting relevance, namely the energy and financial industries. Of the remaining industries, information technology (IT) and telecommunications firms experienced the most dramatic increase in financial reporting relevance, despite being intangibles-intensive. While telecommunications firms experienced greater volatility in the relevance of their financial reports than IT firms, overall the findings indicate that financial reporting remains decision-useful in intangibles-intensive industries.

2.0 INTRODUCTION

The objective of this report is to examine the effect of industry on the relevance of financial reporting for investor decision making in Australia. The research is motivated by the significant criticism over the past decade regarding the decision-usefulness of financial statements for equity valuation, as well as the conflicting international evidence, particularly across Europe and the United States, as to whether financial statements are still relevant to equity investors. Frequent assertions have been made that traditional financial reports have lost their relevance for investor decision making and that an increase in the number of knowledge-based and service-orientated firms, and a corresponding increase in intangibles, is one of the key reasons for this decrease in relevance. If this is the case, we would expect to see a decline in financial reporting relevance to be more pronounced in intangibles-intensive industries.

To examine the research question of the effect of industry on the usefulness of financial statements for equity investors in Australia, a team of Australian academics adopted a mixed method research approach comprising two methods (quantitative and qualitative).

First, the authors examined the change in the combined relevance of net income and shareholders' equity for firms classified by industry to determine whether there has been a change, if any, in the relevance of Australian companies' financial statements for capital market decisions. Firms were classified into one of eight identified industries using the two-digit Global Industry Classification Standards (GICS) Standard & Poor's industry sector codes. To assess the relevance, the authors examine the association between company share price and key performance metrics, namely reported net income and shareholders' equity, across two time periods: 1992-1999 and 2000-2015. The authors split the sample period into pre- and post-2000, as post year 2000 corresponds with a significant rise in intangible investments, an indicator of a shift to a more knowledge-based economy. This archival method is based on the annual financial statements of ASX-listed companies and resulted in 29,838 observations split across both time periods and eight industries.

Second, to gain an understanding of how information is useful for investor decision making the authors conducted a series of interviews with investors, regulators and practitioners.

A total of 17 interviews were conducted across investors (7), regulators (5) and practitioners (5). Interviewees had experience across a broad range of industries, ensuring all eight industry sectors were covered by multiple interviewees. Commonalities across the different stakeholder groups provide strong evidence from which conclusions can be drawn.

The authors developed a semi-structured interview protocol drawing on prior literature and consultation with experts in the practice of financial reporting and regulation. The interview protocol was pilot-tested with experienced representatives from stakeholder groups to reach a stable and well-functioning protocol. Consistent with good research practice for interview-based research, the authors 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 helped to ensure that the interviewees were not unduly prompted or primed to focus on a particular source of information (for example, financial statements). Only later in the protocol did the authors narrow to address specific questions about the role of alternative performance measures, including industry-specific non-financial measures. Importantly, both in the use of broad open-ended initial questions, and in subsequent more specific questions, the protocol was worded so as not to bias responses either for or against the role of any particular type of information in investor decision making.

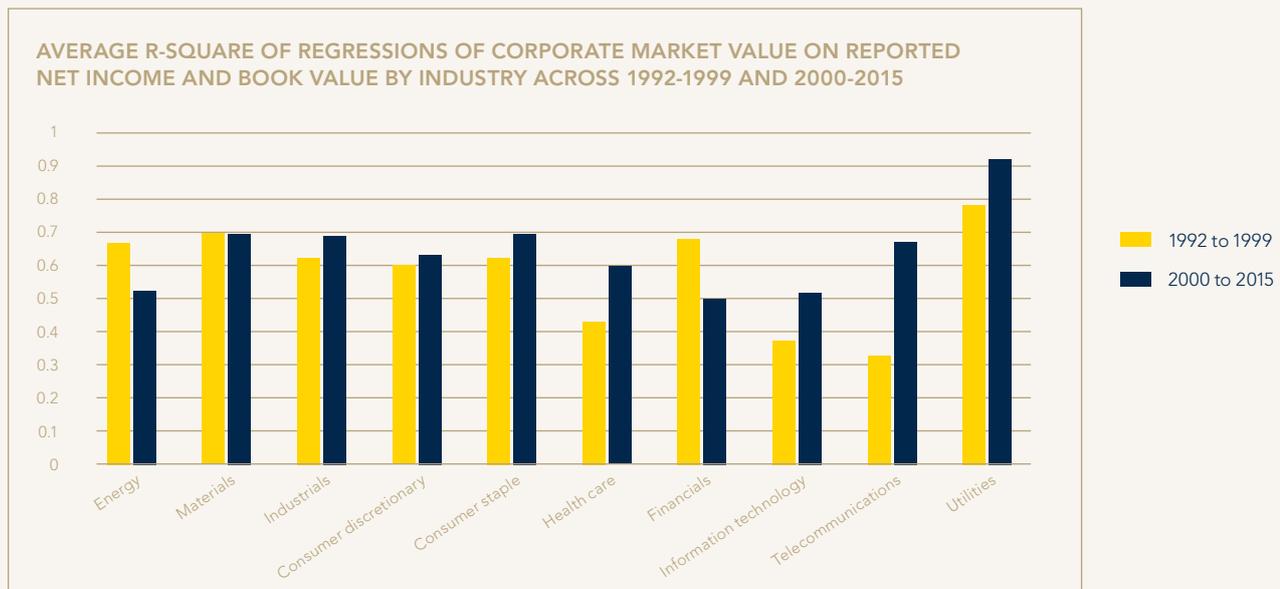
The use of a standard protocol ensured there was a base set of questions that were asked of all interviewees. The protocol comprised seven main questions, with prompts to ensure elaboration by the interviewee on issues of concern. The conduct of the interview bore out the appropriateness of the protocol, as the natural progression of the interviewees' unprompted discourse often pre-emptively mirrored the order of our questions.

3.0 RELEVANCE OF INDUSTRY – SHARE PRICE EVIDENCE

If, as asserted, a decrease in value relevance is due to an increase in importance of a knowledge-based economy for which it is alleged the traditional reporting model is not relevant, we would expect the decline in relevance to be more significant in these types of industries.

To do this, we split our sample period into two distinct periods; pre- and post-2000, and examine if there has been any change in the decision-usefulness of financial reporting in any of the eight industries. The results are reported in Figure 1.

FIGURE 1:
POWER OF NET INCOME AND SHAREHOLDERS' EQUITY COMBINED IN EXPLAINING SHARE PRICES BY GICS INDUSTRIES ACROSS TWO TIME PERIODS: 1992-1999 AND 2000-2015.



As evident from Figure 1, the relevance of net income and shareholders' equity has, in general, increased across the two time periods. Specifically, while the relevance of financial reporting declined across time for sample firms in the energy and financials

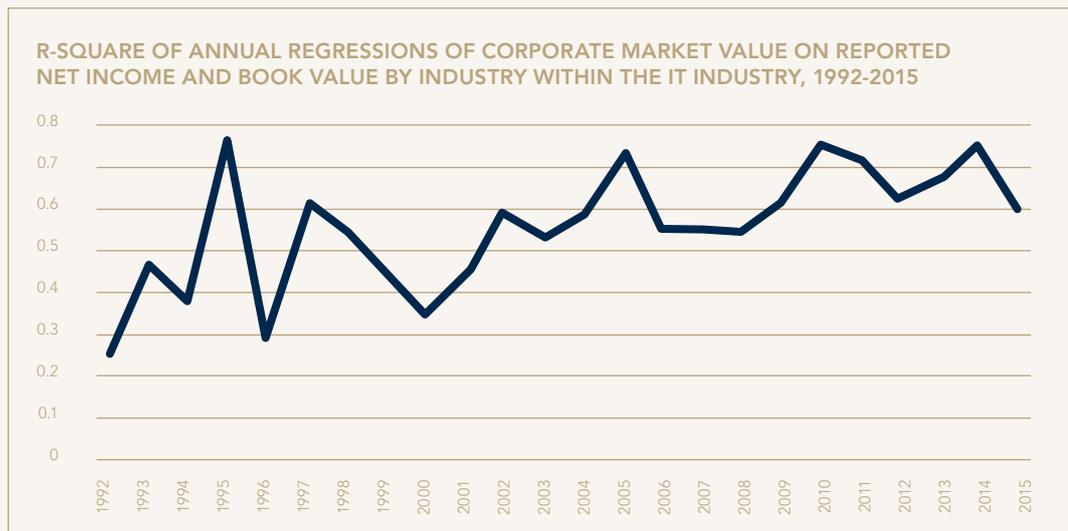
industries, and remained relatively constant in the materials industry, the decision-usefulness of financial reporting for firms in all other industries improved over time.

Interestingly, the industries that experienced the most dramatic increase in decision-usefulness of financial reporting are the intangibles-intensive information technology (IT) and telecommunications industries. For example, from 1992-1999 reported net income and shareholders' equity combined explained, on average, 37 percent of a company's share price in the IT industry and 34 percent of a company's share price in the telecommunications industry. From 2000-2015, this increased to 52 percent in the IT industry and 66 percent in the telecommunications industry. This indicates that, despite concerns that financial reporting

does not adequately capture corporate value derived from investments in intangibles, financial reporting remains decision-useful in intangibles-intensive industries.

As further analysis, we examine the time series trend in relevance of reported net income and shareholders' equity for both the IT and the telecommunications industries. To do this, we examine the association each year between share price and these two key accounting numbers over the entire sample period (1992-2015). The results for the IT industry are reported in Figure 2.

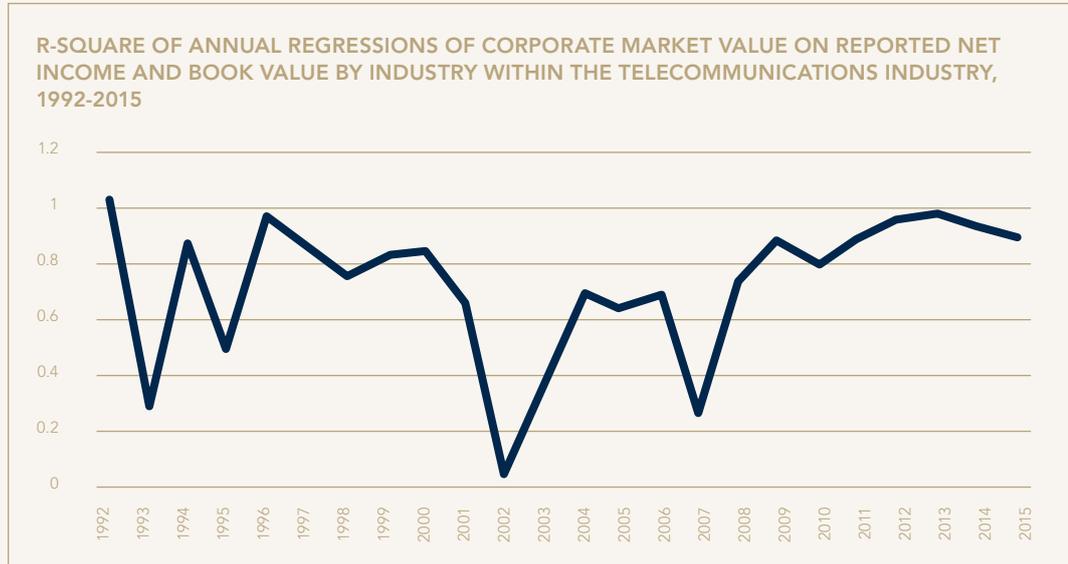
FIGURE 2:
POWER OF NET INCOME AND BOOK VALUE COMBINED IN EXPLAINING SHARE PRICES OF IT FIRMS.



Our results from the industry analysis show that financial statements of IT companies are decision-useful for equity investors in making investment decisions, albeit slightly less than the full sample of firms. As indicated in Report 1, 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 for the full sample of firms. For firms in the IT industry, however, the mean adjusted R-square is 56 percent, meaning that 56 percent of an IT firm's share price is explained by their financial performance and position. Looking at Figure 2, it is evident there is a gradual

increase in the decision-usefulness of the financial reports of IT firms over time with a dramatic rise occurring, interestingly, in year 2000. The combined value relevance of net income and book value of equity has ranged, over the sample period, from a high of 76 percent in 2010 and 2014 to a low of 23 percent in 1992. For 2015, which is the most recent year examined, an IT company's financial performance and position explains, on average, 62 percent of their share price, which is higher than the long-term average and reflects the recent increase in decision-usefulness of financial reporting in the IT industry. Figure 3 reports the results for the telecommunications industry.

FIGURE 3:
POWER OF NET INCOME AND BOOK VALUE COMBINED IN EXPLAINING SHARE PRICES OF TELECOMMUNICATIONS FIRMS.



As evident from Figure 3, there appears to be greater volatility in the ability of net income and shareholders' equity reported by telecommunications firms to explain their share prices. The most dramatic declines in the decision-usefulness of financial reporting in the telecommunications industry were in 2002 and 2007, when reported net income and shareholders' equity explained, on average, 10 percent and 27 percent, respectively, of telecommunications firms' share prices. This time period corresponds with a number of macroeconomic events that impacted share prices beyond the accounting numbers, thereby creating disconnect between share prices and financial performance and position. The year 2002 corresponds with the dotcom bubble burst, with telecommunications firms being hit hard, while the year 2007 corresponds with the subprime mortgage crisis, which precipitated a stock market crash. As Figure 3 indicates, there was an increase in the relevance

of telecommunications firms' financial statements following both macroeconomic events. In particular, following 2007 the ability of reported net income and shareholders' equity to explain telecommunications firms' share prices ranges from 73 percent in 2008 to 97 percent in 2013. This contributes to an overall average of 72 percent, indicating that over the entire sample period, net income and shareholders' equity reported by telecommunications firms explains, on average, 72 percent of their share price. This is higher than that experienced by IT firms and the full sample of firms.

4.0 RELEVANCE OF INDUSTRY – EVIDENCE FROM FIELD INTERVIEWS

The evidence from the field interviews provides insight into the role industry plays in investor decision making, and the use of financial reports. While consistent with the archival evidence that financial reports are decision-useful across industries, how reported information is used or interpreted varies across industries. For example, 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)

Within the financial statements how information is interpreted varies by industry. For example:

I'm covering the retail sector, I want to account for the fact that some firms have off-balance sheet debt in the form of operating leases, some have it on balance sheet and so I want to go to the footnotes to basically do a lease adjustment ... so it, again will vary by industry what kinds of footnotes that I go to. (Investor 3)

Depreciation for a mining company is different to depreciation for an IT company and what is one-off depreciation versus ongoing depreciation's different by industry. (Investor 2)

The field interviews also recognised that while an essential starting point to investor analysis, financial reports are general by nature, rather than tailored to specific industry requirements. As one investor noted:

It's difficult to capture the nuances of every industry, every company, what drives that company in a single set of comprehensive but yet usable you know reasonably short-form financial statements. (Investor 4)

Unsurprisingly, therefore, industry-specific (non-GAAP) measures (e.g., revenue per user for telecommunications companies; load factors for airlines) were considered informative. However, interviewees also expressed skepticism as to the reliability of industry-specific (non-GAAP) measures. Interviewees saw these measures as complements, rather than substitutes, to the traditional financial statements.

More broadly, the interviews also highlighted that industry-specific factors such as environmental and social information are considered by investors, particularly as part of the process of initial screening of companies prior to further in-depth analysis.

5.0 CONCLUSION

Following on from the first two reports in this series showing that financial reports remain relevant for equity valuation in Australia, and that investors view non-GAAP and other non-financial information as complements, rather than substitutes, to financial reports, our results show that financial reports remain relevant for investors regardless of industry. This is demonstrated by archival findings, and supported by evidence from field interviews.

Our results also show that, as a whole, financial reporting is consistently relevant over time. In particular, our archival findings demonstrate that only two of eight industries experienced a decline in financial reporting relevance, namely the energy and financials industries. Of the remaining industries, IT and telecommunications firms experienced the most dramatic increase in financial reporting relevance, despite being intangibles-intensive. While telecommunications firms experienced greater volatility in the relevance of their financial reports than IT firms, overall the findings indicate that financial reporting remains decision-useful in intangibles-intensive industries.

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 across industry. Our research provides a basis from which standard-setters and other regulators can respond to some of the criticisms levelled at financial reporting, as the findings indicate that despite claims that traditional financial reporting is unable to cater for an increase in the importance of a knowledge-based economy, and a corresponding rise in investments in intangibles, reported financial performance and financial position are still decision-useful to equity investors.

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7.0 GLOSSARY

ASX	Australian Stock Exchange
GICS	Global Industry Classification Standards (GICS), which are industry sector codes issued by Standard and Poor's
Regression analysis	A statistical technique that examines the correlation between a dependent variable (e.g., share price) and one or more explanatory variables (e.g., net profit and shareholders' equity)
R-square	The extent to which variation in the dependent variable is associated with variation in the explanatory variables.

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