

DECISION-USEFULNESS IN FINANCIAL REPORTS

RESEARCH REPORT NO.5

THE DECISION-USEFULNESS OF FINANCIAL REPORTS
AND THE FUTURE OF (FINANCIAL) REPORTING

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TABLE OF CONTENTS

EXECUTIVE SUMMARY	4
INTRODUCTION	5
POLICY IMPLICATIONS	6
WHAT IS THE FUTURE OF (FINANCIAL) REPORTING?	7

EXECUTIVE SUMMARY

This is the final report in a series of five reports based on a research study that explores the decision-usefulness of financial reports of Australian listed companies. The first four reports in this series emphasised that, despite recent criticism that financial reports are increasingly not meeting the needs of users, recent Australian evidence indicates they are still of relevance to equity investors. While the results suggest financial reports are not sufficient in isolation to meet the information needs of investors, there is no indication of a decline in the decision-usefulness of financial reports in Australia, contrary to research findings internationally.

This report details the policy implications of these findings and provides recommendations about the future direction of financial reporting. In particular, based on the findings documented in the previous four reports the following recommendations are provided:

1. To prescribe the inclusion of subtotals such as EBIT and EBITDA into the statement of financial performance to enhance its informativeness;
2. To permit the continued disclosure of firm and industry-specific non-GAAP performance metrics, with regulators to consider a framework offering guidance on the preparation and salience of these alternative performance metrics within firm disclosures;
3. To foster Australian firms adopting a broad perspective of reporting that coalesces financial and non-financial information;
4. To reconsider segment reporting requirements with the aim of enhancing the consistency, comparability, and comprehensiveness of segment-related disclosures; and
5. To consider the impact of any proposed changes to financial reporting on the relevance and faithful representation of audited financial statements.

INTRODUCTION

The objective of this report is to discuss the policy implications of key findings documented in the previous four reports of this five-report series, and to provide evidence-based guidance and recommendations on the future direction of financial reporting. Motivated by recent criticism regarding the decision-usefulness of financial reporting, in conjunction with conflicting international evidence as to whether financial reports are still useful to investors, a team of academics from the University of Melbourne and Monash University have undertaken academic research, with the support of CPA Australia, to establish whether financial reports remain useful to Australian investors. Contrary to findings elsewhere, the Australian study establishes that financial reports are useful to investors, and remain so over time.

The authors adopted a mixed method approach to examine this issue. First, the authors undertook archival analysis by examining the statistical association between accounting information and share prices over 1992-2015 to see the impact of accounting information on capital markets. Second, the authors interviewed professional investors, regulators and auditors about the use of financial reports for investment decision-making purposes.

The key findings from the previous reports can be summarised as follows:

- Financial reporting has not declined in relevance in Australia, with annual financial statements remaining decision-useful for investment decision-making purposes. In particular, key accounting amounts, namely reported net income, shareholders' equity and operating cash flows, are important inputs to the valuation models investors use for investment purposes. Financial statements are the foundation for investor decision-making and are a necessary, but not sufficient, basis for predicting future performance of an entity.
- Financial statements provide confidence for investors to invest, where such confidence stems from the financial statements providing an audited record of firm performance. Moreover, the usefulness of financial statements stems from its confirmatory role in assessing firm performance, whereby it confirms investors' forecasts and estimates of firm performance;
- Non-GAAP accounting information is more relevant for equity investor decision-making in Australia than statutory performance measures,

with EBITDA and EBIT outperforming, albeit slightly, statutory profit in being able to explain a company's share price. This seems to be attributable to non-GAAP accounting information being better able to communicate firm performance to investors. In particular, non-GAAP reporting allows firm and industry-specific performance metrics to be conveyed to investors, which statutory reporting cannot capture;

- A broad range of non-financial information such as environmental, social and governance information is considered at two levels of the investment process. Firstly, as a 'screen' for assessing which companies to consider for investment and, secondly, as an input in the valuation of a company;
- Post-2000, financial reporting has improved in decision-usefulness across a majority of industries, including intangibles-intensive industries;
- While financial statements have maintained their decision-usefulness for large and medium-sized ASX-listed companies, there appears to be a disconnection between small ASX-listed companies' share prices and reported accounting information;
- Financial statements, particularly statutory profit and book value of equity, are important in explaining a profitable company's share price. However, equity investors consider other inputs in the valuation of loss-making companies; and
- The decision-usefulness of financial reporting has improved post-IFRS.

In addition, while it was not an issue specifically targeted in the research or within the scope of the previous reports, nearly all interviewees, without prompting, raised segment reporting as an area where they saw opportunities for enhancing decision-usefulness. Interviewees noted that the current requirement that segments should be consistent with how management operate the business was problematic. First, it detracted from comparability and consistency as different firms in the one industry could adopt different approaches, and across periods the same firm could change its segment approach as a matter of management discretion. Second, it provides an incomplete picture for informing judgments of risk exposure, future earnings potential, and ultimately valuation. Specifically, investors were seeking segment reports from more than one perspective, e.g., both market geography and product segments.

POLICY IMPLICATIONS

Our results show that financial reports remain relevant for equity valuation, 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 decision-useful over time. Our findings also document the decision-usefulness 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 standard-setters, regulators and practitioners by providing empirical evidence to explain the role that accounting information plays in investor decision-making. Our research provides a basis from which the IASB, national standard-setters and other regulators can respond to some of the criticisms levelled at financial reporting.

The results will help inform the IASB's current focus on the 'Better Communication in Financial Reporting' suite of projects. Our research will help inform the Primary Financial Statements project on improvements to the structure and content of the primary financial statements, including whether to introduce additional subtotals, including EBIT, into the statement of financial performance. In particular, our findings lend support to the inclusion of such subtotals in the statement of financial performance, given their documented relevance to equity investors.

In addition, our research is relevant to the Principles of Disclosure project addressing principles governing financial statement disclosure and improving the information provided to users of financial statements. Specifically, the findings of this study indicate the usefulness of non-financial disclosures for investment decision-making purposes, as such information is becoming an increasingly important input into investor valuation models.

These findings, therefore, make an important contribution to the ongoing debate on the decision-usefulness of financial reporting 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.

WHAT IS THE FUTURE OF (FINANCIAL) REPORTING?

In conclusion, in response to the question of whether financial reports are still useful to investors, the evidence presented in this five series report would indicate that 'yes', accounting information still matters to investors.

While there has been an expansion in the availability of alternative sources of information for investors, this does not detract from the usefulness of financial reporting. Accounting information is used as an input to investor valuation models, and financial reports play an important confirmatory role in investor decision-making.

Yes, non-GAAP accounting information is useful for investor decision-making. However, it appears to complement, rather than substitute, statutory accounting information. The types of accounting information investors demand may have evolved in recent times. The accounting profession, including standard-setters and regulators, must adapt to meet the changing needs of users, including investors, to ensure financial reporting continues to remain useful into the foreseeable future. To achieve this, the following recommendations are provided:

- First, the inclusion of additional subtotals, such as EBIT and EBITDA, will enhance the informativeness of the statement of financial performance by providing additional firm performance metrics viewed by investors as decision-useful;
- Second, continue to allow firms to disclose firm and industry-specific non-GAAP performance metrics, as these do not detract from statutory reporting requirements, but rather complement statutory reporting. Regulators should, however, give consideration to developing a framework on the preparation and salience of these alternative performance metrics within firm disclosures;
- Third, encourage more Australian firms to explore a broader view of reporting that enables the unification of financial and non-financial information (e.g., environmental, social and governance information), both of which are important inputs into investor valuation models;
- Fourth, revisit the current approach to segment reporting with a view to addressing concerns about consistency and comparability, and the possibility of reporting from a broader range of segment perspectives; and
- Finally, recognise that fundamentally the usefulness of audited financial statements is a joint product of both relevance and faithful representation. Enhancing the relevance of financial reports (e.g., by recognising intangibles and a broad application of fair value approaches) must ensure that the underlying reliability of the reported information is not unduly sacrificed. As a result, much of the opportunities to enhance the usefulness of financial reports likely lies in developing complementary disclosures rather than replacing traditional metrics.

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Dean Hanlon holds a PhD in accounting from Monash University and has over 20 years' experience in academia. He has been recognised for his pedagogy at the faculty, university and national level as the recipient of several teaching excellence awards. Dean's current research interests are in taxation and financial reporting. He has been invited to present his research at numerous international and domestic conferences, having won best paper awards on several occasions, as well as for several standard-setting bodies including the Australian Accounting Standards Board, the International Accounting Standards Board and the Accounting Standards Board in Canada. He has been the recipient of several competitive industry-based research grants and has published extensively in both international and domestic peer-reviewed journals including *Accounting and Finance*, *Auditing: A Journal of Practice & Theory*, *Australian Tax Forum*, *Australian Tax Review*, *Journal of Accounting and Public Policy*, *Journal of Contemporary Accounting and Economics*, and *Pacific-Basin Finance Journal*.



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Matthew has a significant amount of past and ongoing direct engagement with industry including, most recently, involvement in the audit industry with issues associated with fees setting and low-balling and with CPA Australia in developing models to estimate greenhouse gas emissions (supported by a large ARC Linkage Grant). Matthew is also involved in teaching financial accounting across the undergraduate, post-graduate, and research higher degree programs.

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