DECISION-USEFULNESS IN FINANCIAL REPORTS

RESEARCH REPORT NO.2

RELEVANCE OF ALTERNATIVE PERFORMANCE MEASURES AND NON-FINANCIAL INFORMATION FOR INVESTOR DECISION MAKING IN AUSTRALIA

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1.0 EXECUTIVE SUMMARY

This is the second in a series of reports commissioned by CPA Australia and is based on academic research to establish whether financial reports remain useful to Australian investors. The first ***report*** 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.

The availability of a substantial amount of more timely, forward-looking information from alternative sources, and concerns about the timeliness of financial reporting, have been provided as key reasons why financial reports may not be as useful for investor decision making purposes[1].

It has been argued that competing information sources (for example, non-GAAP financial information) pre-empts financial statement information and acts as a potential substitute 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 a company's share price.

Given the increasing availability of more timely forward-looking information from alternative sources, in this report we examine the relevance of non-GAAP financial information and other non-financial information for investor decision making in Australia. In particular, we will be specifically looking at the decision-usefulness of different performance metrics, including statutory profit (i.e., net income), earnings before interest and tax (EBIT) and earnings before interest, tax, depreciation and amortisation (EBITDA), as well as the usefulness of other non-financial information, to equity investors for investment purposes.

This second report commissioned by CPA Australia finds that non-GAAP financial information is more relevant for equity investor decision making in Australia than statutory performance measures. Further, a broad range of non-financial information is utilised by investors in making investment decisions both as a 'screen' and for valuation purposes.

1 Francis and Schipper (1999)

2.0 INTRODUCTION

The objective of this report is to examine what types of information other than financial reports are considered decision-useful (i.e. relevant) for equity investors in making investment decisions. The research that forms the basis for this report 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 and that the availability of a substantial amount of more timely forward-looking information from alternative sources (i.e. non-GAAP financial information) is one of the key reasons for this decrease in relevance.

To examine the research question of what types of information other than financial reports are considered decision-useful for equity investors in making investment decisions in Australia, a team of Australian academics adopted a mixed method research approach comprising two methods.

First, the authors examined the value relevance of primary accounting variables versus non-GAAP performance measures to determine whether there has been a change in the relevance of Australian companies' financial reports for capital market decisions. Consistent with prior studies, the primary variables that are examined are net income, EBIT and EBITDA. These are key accounting amounts and non-GAAP performance measures traditionally synonymous with evaluating company performance. The Australian academics follow prior research and examined time-series trends in value relevance. This was achieved by examining the association each year between share price and key performance metrics. This archival method is based on the annual financial statements of ASX-listed companies over a 24-year period, spanning 1992-2015 and resulted in 29,838 observations, which is, on average, 1,243 listed firms per year. This method enables the authors to determine whether, and the extent to which, non-GAAP performance measures are decision-useful for equity investors in Australia.

Second, to gain an understanding of how and why statutory profit, non-statutory performance measures and other non-financial information are 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) yielding nearly 70,000 words of transcript. 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[2], 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 and other non-financial information. 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 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.

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

3.0 RELEVANCE OF OTHER INFORMATION FOR INVESTOR DECISION MAKING – NON-GAAP FINANCIAL INFORMATION

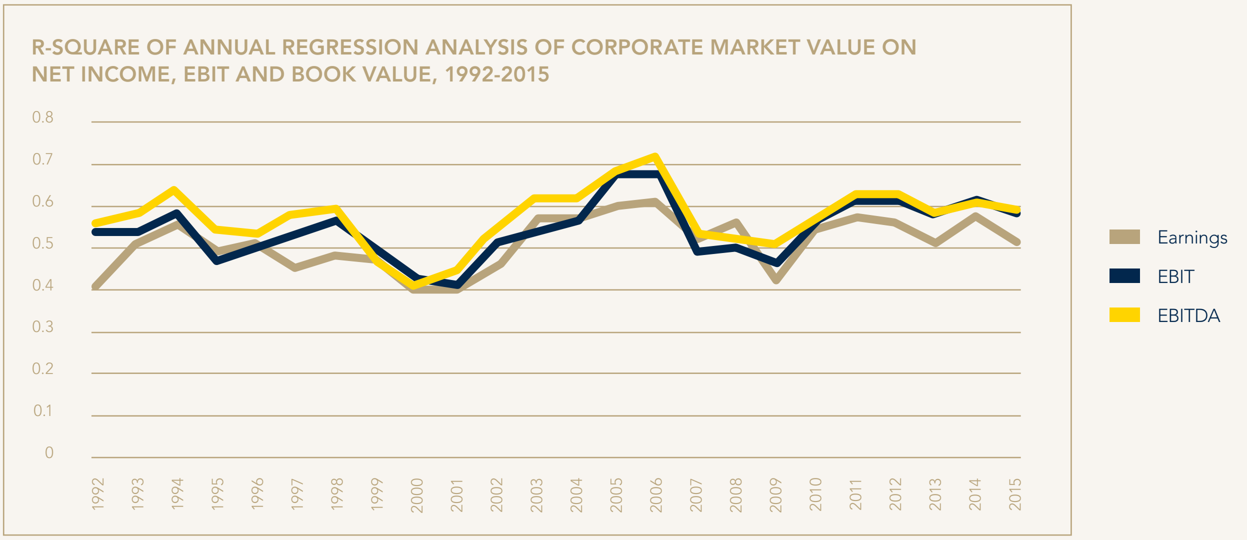
As outlined in Report 1, net income is value relevant, and consistently so over time, to equity investors. The focus of this report is on comparing the value relevance of net income, which is a statutory profit measure, with our proxies of non-GAAP earnings, namely EBIT and EBITDA. Figure 1 shows the results where we analyse the comparative effect on share price of reported net income, EBIT, and EBITDA, on an annual basis.

Our results from our archival analysis in relation to EBITDA show that the mean Adjusted R-square is 57 percent, which means that over the sample period a company's EBITDA explains, on average, 57 percent of a company's share price. The mean Adjusted R-square for EBIT is 54 percent, meaning that EBIT explains, on average, 54 per cent of a company's share price from 1992-2015.

This indicates that EBITDA and EBIT are relevant for equity investors in making investment decisions in Australia. Moreover, compared to the mean Adjusted R-square reported earlier for net income (52 percent), EBITDA and EBIT seem to be more value relevant than net income in explaining variation in company share prices.

Interestingly, Figure 1 shows the trend in value relevance of EBITDA, EBIT and net income is comparable over the sample period. That is, the change in value relevance over time for all performance metrics correspond, suggesting that statutory profit and non-GAAP earnings are complementary and not substitutes.

FIGURE 1:
POWER OF NET INCOME, EBIT AND EBITDA IN EXPLAINING SHARE PRICES.



4.0 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 financial information relates to statutory financial information (for example, net income).

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).[3] 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 P and L [profit and loss]. Obviously, the concept there is trying to get to an operating or … recurring [earnings number]. 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 or 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 financial information is confirmatory, even though much of the non-GAAP financial information provided is historical in nature (e.g. EBITDA).

Further, a number of interviewees noted that non-GAAP financial 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)

3 As detailed in Report 1, 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 purposes.

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…. (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.

5.0 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, 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 looked 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……. (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.

6.0 CONCLUSION

Following on from our first report showing that financial reports remain relevant for equity valuation in Australia, in this report our findings highlight that investors view non-GAAP and other non-financial information as complementary, rather than as substitutes, to financial reports. Investors take the measures into consideration as a bundle for decision making purposes as demonstrated by archival findings, and supported by evidence from field interviews with investors, regulators and practitioners.

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 complementary 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.

The next report (Report 3) in this series focusses on the effect of industry on the relevance of information for investment decision making in Australia.

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8.0 GLOSSARY

ASX	Australian Stock Exchange
EBIT	Earnings Before Interest and Taxation
EBITDA	Earnings Before Interest, Taxation, Depreciation and Amortisation
GAAP	Generally Accepted Accounting Principles
R-square	The extent to which variation in the dependent variable is associated with variation in the explanatory variables.
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)

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