Are Financial Statements Providing Useful and Relevant Information, Beyond Compliance?

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> *"Annual shareholder letters and other communications to shareholders are too often backwards-looking and don't do enough to articulate management's vision and plans for the future..."*

(Fink, 2016, page 1)

One of the criticisms often levelled at financial statements is that they are often backward looking. Several studies have investigated whether accounting information in financial statements, due to its backward-looking nature, have lost some of their relevance. Whilst there is a growing focus on earnings forecast or other relevant forward-looking statements (e.g. business development in the pipeline, future M&A activities, key material contractual relationship), the key question for which we provide some thoughts on in this write-up is as follows: "Are financial statements still useful and relevant, beyond their compliance function?".

Ball and Brown (1968), pioneers in this area of research, presented strong empirical evidence that there is information content in earnings numbers. A recent study conducted by CPA Australia provides strong statistical and interview-based evidence on the relevance and usefulness of financial statements. This study by CPA Australia emphasised the trust shown by investors in audited financial statements.

When it comes to reporting seasons and market updates, analysts and the broader investment community are often patiently waiting for forward-looking statements in the earnings announcements. Earnings announcements and forward-looking statements attract significant attention from investors and often, stock price is impacted by such updates. In fact, many of the financial and valuation techniques out there are biased towards future cash flows and future information. If we look at the premise on which valuation tools like NPV, Dividend Discount

Model, Forward PE ratio work, they all look at **future cash flows**. There is so much focus nowadays in forecast earnings that in recent years a whole body of accounting research is focusing on this area. Interestingly, Baginsky et al (2019) argue that one of the key reasons companies often release forecasts with their firm's earnings announcement is to **offset bad current earnings announcement news**.

So, why is past performance not always a good predictor of future performance? A change of strategy is not new in the corporate world. In fact, history has shown that companies which do not evolve (notable examples being Kodak and Nokia) find it difficult to survive. With this recent COVID-19 pandemic, there is little doubt that many companies will have a shift in their strategy. For example, airline companies and industries associated with tourism may have to evolve their business model. In the new 'decarbonised' world, many resource companies will shift their priorities. Particularly for companies going through a change in strategy, **the market will be attentively looking for the "forward-looking" statements**. However, forward looking statements are also not foolproof. There are so many different inputs you need to estimate into the future.

There remains an important and critical value in financial statements – the past performance and track record can be very powerful in providing a compass on the future orientation of companies. In recent years, the content and structure of a company's financial statements have undergone significant changes. With the constantly evolving macro and micro economic environment, the methodology of accounting and reporting are also dynamically changing. The issues of reforming financial statements of a company are constantly discussed at international congresses of accountants and other professional forums. The discussion is focusing on how to prepare financial statements that are more valuable and relevant as an information base for decision making.

Financial reporting will need to be expanded, hence the ever growing call for integrated reporting – a framework embedding a range of information including organisational overview, strategy, performance, risk management and ESG orientation. Also, **to look forward, it is important to know the baseline which is derived from looking back**. So, one feeds the other.

We finish by concluding that forward-looking information in isolation is not the 'be all and end all' – Financial Statements still have a role to play in the financial and investment community. It is the integration of backward-looking information and forward-looking information which will remain the backbone of reporting for a long time.

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Kaveen is a qualified MBA academic with a progressive finance career spanning over 15 years. His experience is based on a variety of roles across geographies as well as several years of formal qualifications and trainings. In his current role, Kaveen is the Head of the Finance function for Glencore's zinc business in Australia.