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Has financial statement information become less relevant? Longitudinal evidence from Denmark

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Summary
Is financial statement information, such as earnings, assets and the book value of equity, still useful to investors in the "new economy age", or should serious efforts be made by e.g. managers and researchers to improve the current financial reporting model or develop alternative reporting forms? This study investigates whether financial statement information in Denmark has become less value-relevant to investors over time. The study provides evidence from an accounting system which is based on both EU accounting directives and an "economic-substance-over-legal-form" philosophy throughout the investigated period. Overall, our results do not indicate that the value-relevance of accounting information has decreased over the investigated period (1983–2001), which is otherwise implied by some critics of "traditional" financial reporting. Rather, the results indicate that the value-relevance of accounting information is unchanged over the period.
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Introduction

This paper addresses the concern of both Danish academics and the financial press that financial statements prepared in accordance with generally accepted accounting principles have lost much of their relevance to investors' decisions (e.g. Bestyrelsesugebrevet, 2004, p. 3; Nielsen, Bukh, Mouritsen, Rosenkrands Johansen & Gormsen, 2006; Statens Samfundsvidenskabelige Forskningsråd, 1998, p. 8; Wejse, 1999). Critics of "traditional" financial reporting are concerned about the unsuitability of the financial reporting model for "new economy" companies, and that changes in information and management technologies are resulting in competing and more timely information sources, e.g. sophisticated analysts' reports, video conferences with company management, interactive company web pages, intellectual capital statements, etc. Similar arguments have been put forward in other countries (in the US, see, for instance, Amir & Lev, 1996; Francis, Schipper, & Vincent, 2002). If the critics are right, more efforts should be made to improve the current financial reporting model or develop/improve alternative reporting forms, e.g. intellectual capital statements, green (environmental) accounting statements, social and ethical reporting, etc.

This paper investigates whether the value-relevance of financial statement information has changed over time. The sample is based on non-financial companies listed on the Copenhagen Stock Exchange in the period 1983–2002.

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Since Danish accounting regulations are based on the EU's Accounting Directives, a study of changes in the value-relevance of Danish financial accounting information over time might be relevant to other EU countries where the EU Directives are mandatory and the accounting philosophy is the same.[1] Denmark is an interesting context to study changes in value-relevance over time, because it has the longest experience of operating under the EU accounting directives—and thus the largest number of years available for analysis.[2] Furthermore, the accounting system used in Denmark under this regulation is based on an investor-oriented accounting philosophy where financial reporting is disentangled from tax reporting. In this respect Denmark may be representative of European countries following an Anglo-Saxon financial reporting tradition. The following literature review shows that we lack European returns-based evidence from a similar setting; previous European evidence is either from a country that implemented the EU Directives without changing its tax-linked accounting philosophy (German evidence by Harris, Lang, & Möller, 1994) or from a country that changed its accounting philosophy during the period from a tax-oriented model to an Anglo-American investor-oriented model (Norwegian evidence by Gjerde, Knivsflå, & Sættem, 2007). Finally, innovations in Danish accounting legislation and standard setting have been more evolutionary than revolutionary over the investigated period. Thus, from an accounting perspective, Denmark represents a rather stable setting.

Previous research has investigated the relation (explanatory power) between prices or returns and financial statement information. In this study, we use a research methodology based on returns, where we measure the total market-adjusted stock return that could be earned from an investment strategy based on foreknowledge of different key financial statement variables. We scale the accounting-based returns by perfect foresight returns and answer the following question: are investments based on selected financial statement information able to capture progressively less, over time, of all information impounded in security returns?

Returns-based evidence from the US indicates that value-relevance has decreased over time (Lev & Zarowin, 1999; Ryan & Zarowin, 2003). Conversely, the scarce European evidence indicates unchanged (Harris et al., 1994) or even increased value-relevance (Gjerde et al., 2007). The different findings may be due to several factors: different time periods, differences in the amount of value-relevant non-accounting information available to investors (over time), differences in market efficiency (over time), differences in innovations in accounting legislation and standard setting (over time), and shifts in accounting philosophy in European countries to more investor-oriented financial reporting (over time).

The remaining part of the paper is organized as follows: first the study's interpretation of value-relevance is explained; the next section looks at previous research; the subsequent section describes specific features of the Danish accounting environment and the hypothesis derived both from these features and previous literature; the following section describes the relevance measures used in the study in more detail; the next section describes the sample selection process; the penultimate section presents the primary results and robustness checks. Finally, the last section presents the conclusions.

Interpretation of value-relevance

Our analysis examines changes in the value-relevance of financial statement information over time. However, the *relevance,* or even *value-relevance,* of financial statement information is an ambiguous term. Different user groups may have different views on what relevant information is, and even for valuation purposes, investors can have different interpretations of value-relevance (see Francis & Schipper, 1999, who list four possible interpretations).

This study builds on the following interpretation of value-relevance: financial statement information is value-relevant when there is a statistical relation between accounting information and market values or returns. According to this interpretation, a financial statement does not have to be the source of information to be value-relevant, it could merely capture or summarize information from other more timely sources, and "with the audit function, impose a credibility-enhancing discipline on other information disclosed during a reporting period" (Francis & Schipper 1999, note 8). What is important here is that, for the *information* in the financial statements to be value-relevant, it must be correlated with information used by investors, and thus be associated with market values or returns from the stock market, regardless of whether they received the information from the financial statements themselves or from other sources.

The study focuses on the relevance of financial statement information to investors for valuation purposes, ignoring both other potentially important uses, such as the stewardship function, and other important users, such as creditors and employees. Value-relevance is operationalized by measuring the total market-adjusted stock return that could be earned from an investment strategy based on foreknowledge of different key financial statement variables—i.e. we use a portfolio returns test similar to Francis and Schipper (1999). A later section describes the relevance measures used in the study in more detail.

Previous research on changes in value-relevance over time

As stated above, this study is based on value-relevance as indicated by a statistical relation between accounting information and market returns calculated over long windows.

[1]In 2002, EU regulation (EC) 1606/2002 made it mandatory for publicly traded companies to prepare consolidated financial statements in accordance with endorsed international financial reporting standards (IFRS). The study suggests empirical measures to calibrate the value-relevance of reported numbers under the pre-IFRS reporting system, which in the future can be used as an empirical basis for assessing whether the change to the new alters value-relevance (see Francis & Schipper, 1999, p. 320).

[2]Denmark was the first country to implement the EU's Fourth Directive in 1980 (Walton, Haller, & Raffournier, 2003, p. 15), resulting in a new accounting law effective for financial statement years beginning on or after Feb. 1, 1982.

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