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A Review on the Literature of Value Relevance of Non Financial Variables or Information

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Abstract: Capital Markets is the most significant source to reach the optimized allocation of society resources. It mobilises and channelizes the savings into productive activities. It is the foundation of an economy and plays a vital role in the economic growth of a country. It links the savers and investors and promotes growth on a sustained basis. In capital market, information plays a very important role, may it be financial information or non financial information.

The 1980's witnessed an explosive growth of the securities market in India, with millions of investors suddenly discovering lucrative opportunities and hence information assuming the important role in decision making.

The switch over of Indian economy from production to knowledge based economy and the growth of software & IT, financial services, business outsourcing, media, healthcare, pharmaceutical industries etc. have focussed on the increasing investments in intangible assets and with this transformation non financial information has gained a lot of importance. Intangible assets such as intellectual property, brands, customer relationship and talent hold much more value than tangible 'visible' assets such as capital, land, buildings, machinery etc. in a knowledge based economy.

In such a dynamic scenario, before taking investment decisions, investor is looking for wide range of information. The financial and non financial information plays a significant role in Investors decision making. The companies are also realizing the need for more disclosure of non financial information with that of the financial information.

Various studies have focussed on the value relevance of financial information but there is dearth of literature on the non financial information.

Keywords: Value Relevance, Financial Information, Non financial Information, Intangible assets, Intangibles, capital markets.

I. INTRODUCTION

There have been various pragmatic and rational studies recently which have shown that accounting information has lost its relevance to investors. For financial statements to be value relevant, they should be accurate and transparent so that it provides the right picture to stake holders about the position of the business. The fact that investor's decisions are affected by number of factors and wide-ranging information has an impact on the Investor's decision; the role of information has assumed a lot of importance. With the transformation in economy the focal point is not only financial information but also the non financial information.

Non financial information (NFI) comprises all quantitative and qualitative data on the policy pursued, the business operations and the results of this policy in the form of output or outcome without a direct link with a financial registration system.

Much of the information on social performance and effects is of a non-financial nature. It does not concern uniform measurable monetary units, but indicates behaviour or systems and processes. Unlike reporting on financial information, reporting of non-financial effects is still comparatively new and no generally accepted principles are yet available. Moreover, data diversity is very considerable and the information is more difficult to measure and assess if the information is more qualitative (NIVRA, 2008).

At a meeting held on May 2001 of the committee, ((FASB), 2001) and FASB members recommended that an assessment of the academic research associated with non financial measures may prove to be helpful in planning, discussing and pondering on the reporting of performance. The committee suggested that there should be directives for disclosure of non financial performance measures. It also mentioned that when literature is reviewed non financial measures are found to be relevant. There is some evidence that non financial measures can improve the value of financial measures and found sufficiently reliable and investors perceive such measures to be reliable and relevant.

In addition to published accounting information, there is something called market sentiment and speculative events which affect the investor's decision. However all such information is not reflected in the financial statements and hence accounting information has lost its relevance over the past few decades.

Various studies have talked about the lost relevance of financial and accounting information and various reasons cited for it in general are change in technology, changing business environment, transformation of industrial economy to knowledge based economy and the growth in service economies has also led to increase in the intangibles which are not adequately disclosed or recognised in the financial statements and hence becomes the major reason for the loss of value relevance of financial statements as emphasized by Ball and Brown (1968), Oyerinde (2009).

This belief also developed in response to claims of traditional financial statements losing relevance because of the move from an industrialized economy to a high-tech, service oriented economy as mentioned by Collins, Maydew & Weiss (1997).

Studies take two approaches to examine and document the relevance of nonfinancial information: (1) establish a direct link between nonfinancial measure and equity values and (2) demonstrate a link between current nonfinancial measures and future financial information, indicating that nonfinancial information should be useful to investors and creditors as revealed by Laureen et al (2002). The first category typically is referred to as value relevance tests, while the second category is termed predictive ability tests.

Various studies by AICPA (1994); Boulton, Libert, & Samek (2000); Norton (2000); Eccles, Herz, Keegan, & Phillips, (2001), Lev(2001) highlighted that individuals are asking for more disclosure of non financial information. These individuals have argued that traditional financial measures have diminished relevance as there are changes in business models (i.e., the "new economy") and considered financial measures as backward looking and does not provide insights into a company's future performance.

Canibano & Sanchez (1992) stated that the "traditional accounting model is not sufficient because innovative activities are not considered as strategic variables. Technological development is a challenge for accounting not only in the area of financial reporting, but also in the realm of management control."

On the subject of the relevance of the information produced by financial accounting for companies with a high concentration of intangible assets, Lev (1997) and Lev and Amir (1996) argued that this information is of partial utility to appraise companies in the technology and services sector (telecommunications and high-tech), as these companies invest significantly in intangibles, such as research and development, human capital and trademark development.

The Researchers have tried to find the impact of intangibles on growth, productivity and competitiveness. The data supports the fact that the effect of intangible assets on the macro economy is growing. Expenditures on intangibles are usually investments since they are made in anticipation of future benefits as advocated by Fisher (1930).

Various studies have been done on intangible assets in the U.S. and Japan in the recent years. The Brookings Task Force on Intangibles published a report in Blair & Wallman (2001), emphasized the importance of intangible assets. Lev and Zarowin (1999) clarified that the reported earnings, cash flows, and book (equity) values have been losing usefulness over the past 20 years as the business environments is drastically changing because of R&D and other factors.

Some researchers like Dempsey, Gatti, Grinnell, & Cats Baril believed that non financial measures are used in evaluating the long-term performance of a firm.

Amir and Lev (1996) addressed the value relevance of reported financial information for fast changing science based companies and the value relevance of non financial information incremental to financial information. The article concluded that financial accounting information is only value relevant after the inclusion of the non financial information and that the non financial information is value relevant in itself and has incremental value. In the value relevance of non financial information – A discussion by (Shevlin, 1996) , the results were that the reported financial accounting information is irrelevant but if non financial information is added, both the information has value relevance. Intangibles become a major part of the Non financial Information.

As per Webster (1999), expenditures on intangibles are important because the stock of physical resources is finite and economic activity can only be sustained by the application of intellectual inputs. He also mentioned that intangibles enable the firm to operate the tangible plant and equipment to produce revenues. This emphasised the need for value relevance of the firm's expenditures on intangibles and the non- financial information. The expenditure on intangibles is motivated by two goals:

- To build internal competencies that enable the firm to take advantage of emerging opportunities and meet profitability goals (Cohen & Levinthal, 1989)
- To differentiate the firm to make the firm's resources and routines hard for rival firms to imitate as indicated by Webster (1999).

Grilches (1994), advocated expenditure on intangibles is not just confined to R&D, but utmost emphasis is given on R&D because this is the only expenditure on which data is available in a long time series. Intangible assets contribute to earnings and intangibles are successful elements of the firm's differentiation strategies as advocated by Brown & Kimbrough, (2011). Non Financial information is not just confined to Intangible assets.

Various research have examined varied non financial measures like Amir and Lev examined two nonfinancial measures related to the cellular telephone industry: total population in a service area, which is a measure of potential growth, and the ratio of subscribers to total population, which measures operating and competitive success. They found the positive relationship between the variables and the share price. They also found that the financial and non financial variables are complimentary.

In a paper by Liang & Ming (2005) the balanced scorecard, intellectual capital, and intangible assets were studied and reasons for the difference between the corporate market value and book value are analyzed. They also explored the impact of both financial and nonfinancial perspectives on the corporate value. They found that the traditional financial performance Measurement, the net income did not provide significant explanatory power in terms of the corporate value. However, when the net income was decomposed, the explanatory power significantly increased. They found that EVA and RI are emerging financial performance measurements and provides significant incremental explanatory power in relation to corporate value.

II. OBSERVATION FROM REVIEW REPORT

The most studied variables in value relevance literature of non financial information are impact of intangible assets, Research and development, advertising expenditure, and brand value.

The studies done by Hirschey M (1982), Amir and Lev (1996), Lev and Sougiannis(1996) have focussed on the variables like R&D, advertisement, advertisement intensity and R&D intensity.

Studies like Amir and Lev (1996), Ittner and Larcker (1999) and Deng, Lev and Narin (1999) have explained the reason for the differences between corporate market value and book value.

These studies revealed that there is a considerable difference between book value and market value due to the firm's innovative and marketing activities. The other reason given for this is the intellectual capabilities of the company and its human costs. There is a shift from tangible to intangible assets.

Wong and Zhang, Trueman, Franco, & Xiao (2000) viewed frequency of a webpage (internet usage) as an important non financial measurement. Hughes (2000) studied the relationship between the air pollution index and the value of an electric power company. Kaplan & Norton (1996) used the framework of the balanced scorecard approach focussing on the four perspectives – financial, customer, internal process and learning and growth.

There is a dearth of information of intangibles and thus complicates the decision of investors as financial statements show only a small part of the total assets of an organization but the fact is the intangible assets are more important than its tangible assets.

Many have argued that there is a significant decline in the relevance and the usefulness of financial statements is due to the non recognition of intangible assets in the Balance sheet. Economic transformation, growth of intangibles, human and intellectual capital complicates and hence the financial reporting model is insufficient to capture the value of the company as it ignores the various non financial intangible factors as put up by Helen,(2006).

In a study by Chiung-Juliang and Liyao Ming (2005) intangible assets and knowledge management are considered as key factors for success in the industry and therefore, the study mentions tangible assets are incapable of fully evaluating the value of the company and mentions it as the major cause for difference in the market value and book value.

There are studies put forward by Sougiannies(1994), lev and zarowin (1998), lev (2004) who have argued that accounting indicators for intangible investments are useful, informative and value relevant even though they are incomplete and inaccurate.

III. CONCLUSION

No doubt, the financial statements of listed companies are the major medium of communication for the various stake holders and therefore the stock market regulators and accounting standard setters try to improve the quality of financial statements in order to increase the transparency of financial reporting but with the transformation of economy, these statements are losing their value relevance and there is a increased inclination towards the non financial variables.

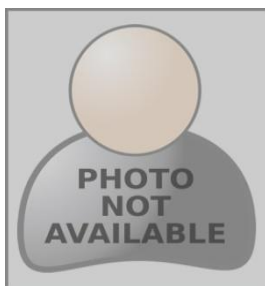
Investor's focal point is non financial information and short term capital gains. In addition to published accounting information, there is non disclosed non financial information, market sentiment and speculative events which affect the investor's stock market decision. However all such information is not reflected in the financial statements and hence accounting information has lost its relevance over the past few decades.

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