Is Forward-Looking Quantitative Information Really Predictive?

Empirical Evidence in Italy

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Abstract

The topics of voluntary disclosure of firm is an open debate. Literature has been variously focused on different path take into account the Stakeholder Theory (Freeman, 1984). In this paper we deal with an emerging issue related to the IASB document "Management Commentary. A framework for presentation". In particular, objective of the research is to provide evidence on the potential relations between financial and governance-related variables with measures of the existence and quality of forward-looking information in the Annual Reports. Adopting a content analysis approach with the help of statistical analysis, we considered annual disclosure reports of a sample of 218 Italian industrial listed firms in the period 2006- 2010. We found positive correlations between forward looking related variables and other debt related, asset related, profit and loss related and governance variables.

The Contest

Over the years, academics, accounting standard setters, professional bodies and other international organizations (AICPA 1994, ACCA 1999, OECD 2011, CICA 2001, ICAEW 2000, FASB 2001, IASB 2010, NZICA 2011, FASB 2012) have devoted significant efforts into trying building some degree of consistency between mandatory and voluntary disclosures (including corporate social responsibility disclosures), trying to discipline in particularly the voluntary information contained in the MD&A reports in order to make information disclosed, voluntary and mandatory, more useful for each class of stakeholders. Particularly, literature on voluntary disclosures has investigated, on one hand, how different levels of disclosures – both in terms of volume and quality – are driven by entity-specific factors and stakeholder-management policies; and, on the other hand, what is the relationship between these disclosures and analysts forecasts and future earnings. In the context of Stakeholder Theory (Freeman, 1984), the presence of voluntary disclosures is a signalling element that may suggest how an entity addresses the requests of the different interested parties it deals with. The basic concepts of this theoretical framework, especially for what concerns social and environmental disclosures, were further elaborated into the Legitimacy Theory (Suchman 1995) which holds that entities are bound to the broader community they belong to by a social contract which they need to comply with and which influences their disclosure policies. In general terms, voluntary disclosures include two macro categories of information sets:

1. Disclosures which are *included in regulated annual reports statements* (financial statements, footnotes, MD&A, etc.); and
2. Disclosures provided through *voluntary investor communication*, such as analysts' presentations, press releases and other non-regulated corporate reports.

In this work, we focus our attention on the former group of above mentioned disclosures. Looking at Annual Reports, instead of press releases or other sources of voluntary corporate communication, is consistent with the approach taken in main stream literature (Botosan 1997, Lang and Lundholm 1993) where Annual Report MD&A disclosures have proved to be consistent with other disclosure communication means. Moreover, using Annual Reports ensures that voluntary information is consistent – at least in general terms – with the audited financial statements.

Particularly, in this paper we consider the voluntary content of mandatory disclosures by analysing quantitative forward-looking information of Italian listed firms reported in the section of the annual MD&A statement. In this section, top management discusses the "foreseeable evolution of the business" (translation of "Evoluzione prevedibile della gestione" as reported in Italian financial statements). This is somehow a peculiarity in the 'world' of voluntary disclosures: Italian legislator asks to top management to provide information on the future prospects of the business. Nevertheless, he does not provide any guidelines on 'how' to say it nor 'what' to disclose. Due to this uncertainty on the minimum content to provide in order to be compliant with Italian mandatory disclosure framework, and in order to map the "state of the art", we analyzed the characteristics of firms providing differing levels and types of disclosures in this section of the MD&A report. So that, our research follows the path of previous literature which generally focuses on searching the main drivers of forward looking voluntary disclosures.

Objective of the paper

Given the above, the paper presents the "state of the art" on the disclosure provided in the MD&A Report. We considering a five year period before the issuance of the IASB document "Management Commentary. A framework for presentation". In particular, the main objective of the research is to provide evidence on the potential relations between financial and governance-related variables with measures of the existence and quality of forward-looking information in the Annual Reports of a sample of Italian firms listed in the period considered. Even if it there's no compulsory ways to provide this kind of information for Italian listed companies, this MD&A section represents a useful framework to orient the content of management report.

Literature Review and Hypothesis Development

In the existing literature, voluntary disclosure statements are generally assessed not only in terms of 'word counts', but also by means of weights indicating the degree of disclosure quality (Botosan, 1997; Botosan and Plumee, 2002; Bozzolan et al., 2003; Beretta and Bozzolan, 2008), whereas higher weights are generally assigned to forward looking information (as opposed to historical or backward-looking voluntary disclosures). This is because, companies disclosing voluntary forward looking information – especially when they are listed – do so with the aim of adding value to their communication with their stakeholders in order to reduce the degree of information asymmetry between managers and investors and benefit from a lower cost of capital (Lundholm and Van Winkle 2006). Moreover, forward looking voluntary disclosure have a signaling power as they let disclosing entities be potentially perceived by their stakeholders as being confident (with respect to the credibility

of voluntary disclosures, and to the risks associated with unfaithful statements in the US, see ex multis Johnson et al. 2001) in their capabilities to foresee the future prospects of the business so that they do not mind sharing this information with them.

Secondly, focusing on forward looking disclosures included in the MD&A report is particularly important also when considering the broader field of corporate financial reporting. In fact, although financial statements, depending on the extent to which current measurements are used in corporate accounts, might embed a variable amount of forward-looking information which are built in the figures presented in the statements, forward looking narratives may help 'putting some colour' around these hidden prospective information. On the other hand, financial statements may underestimate some items because accounting standards do not allow for their proper recognition and measurement and therefore, because of this underestimation, financial statements may not ultimately provide relevant prospective information to their stakeholders. In this case, forward looking information and other voluntary disclosures make up for this lack of relevance in the financial statements by providing what is necessary to know in addition to the raw accounting figures (this is particularly true when looking at specific sectors – such as high technology ones – where the value relevance of financial statements, as measured in terms of the explanatory power of book values with respect to market values, is limited because of the absence of proper intangible assets accounting, see ex multis see Amir and Lev 1996). In other words, forward looking information, especially when they are expressed in quantitative terms (Guthrie and Pettie, 2000), may provide important information to understand the context in which current measurements are performed in the mandatory statements and, by this means, assess to what extent past performance may be indicative of future performance (SEC 1989, IASB 2010).

Several Authors have considered under a number of different viewpoints the role of forward looking information in the economics of disclosures. Some have focused their efforts on trying assessing the ability of forward looking information to explain future earnings. For example, as reported, Beretta and Bozzolan (2008) consider forward looking information on a sample of Italian firms. They provide evidence that the change in analysts' forecasts on the firms being surveyed is significantly and positively associated with the quality of such information and that, therefore, these disclosures are useful for users of companies' financial reports. Lundholm and Myers (2001) find evidence that a trade-off exist between the informative power of accounting earnings and the volume of voluntary disclosures with respect to market returns of stocks.

Some authors have put efforts in trying identifying the determinants of voluntary forward looking disclosures. For example, Miller and Piotroski (2000) show that firms with stronger and more persistent earnings news are more likely to provide forward-looking disclosures during the turnaround period. They also show that firms operating in high litigation industries, with strong institutional ownership, having greater stock option-based compensation and facing larger non-equity stakeholders are more likely to provide disclosures. Menicucci (2013) considers the association between firms' characteristics and the level of forward-looking information as measured in terms of word count of forward looking statements, in management commentaries of 40 Italian listed companies for fiscal year 2010. This Author considers as explanatory variables for the level of disclosure of the sample, book value on total assets as a proxy of firm size, the return on equity as a measure of profitability and the debt to equity ratio as a measure of the financial leverage of the firm. This study shows a significant negative association between the volume of forward looking information and profitability, while other variables present insignificant correlations.

Beattie et al. (2004) found an association between quantity and quality of disclosures and built a valuation framework for voluntary disclosures which includes a measure of the

extent to which disclosure are spread among different topics. Beretta and Bozzolan (2008), moving forward from Beattie's framework (2004), build a new system to estimate the qualitative and quantitative characteristics of corporate voluntary disclosures by building up a multidimensional index and applying it to a sample of 85 industrial Italian listed companies over a three-year period.

Research Design and Data Collection

Research Question

At this stage of the research, we focused on financial and governance related characteristics of those Italian listed firms which provide (and to the extent they do) forward looking quantitative information. In our opinion, trying to identify financial and governance related determinants – if any – of a comprehensive index of voluntary disclosures (and especially of forward looking information) is necessarily a second step of a broader analysis which relies, in the first place, on a preliminary assessment of the characteristics of firms which generally provide different types of such information with some evidence that the information provided is somehow reliable.

For what concerns financial characteristics of firms, we consider three dimensions: (A) income variables, (B) debt related variables and (C) asset variables. For governance related characteristics (D) ownership variables and (E) board of directors variables have been considered.

Stated that, research questions can be summarized as follows

RQ1: Are there any correlations between the existence and quality of forward looking disclosures and A, B and/or C factors?

RQ2: Are there any correlations between the existence and quality of forward looking disclosures and D and/or E factors?

Methods used in previous research

This analysis covers disclosures in the financial statements of a sample of Italian listed firms between 2006 and 2010 following the idea of Evans and Taylor (1982), who recommend in-depth examination of published financial statements to measure the degree of disclosure. This multi-period analysis permits a more comprehensive picture of the implementation process and also the various methods used.

This study adopts a content approach similar to both Linsley et al. (2006) and Woods et al. (2009). Linsley et al. (2006) used a sample of nine pairs of UK and Canadian banks, selected according to asset value, to highlight the differences in banking risk disclosure between the two markets and isolate differences that are country-specific. Woods et al. (2009) used the top 25 banks of the world in terms of market capitalization. Their cross-country investigation, conducted on the Annual Reports of banks in three different time intervals ("start (2000), mid (2003), end (2006)", p. 11), highlighted "changes in disclosure practices over time" (p. 15); unlike, Linsley et al. (2006) did not investigate on changes over time.

The analysis applied in this paper is different from other content researches because at this stage the paper limits the sample only to firms adopting IAS-IFRS principles in order to observe the quality of disclosure of a group of entities which are homogeneous in terms of the reference disclosures framework and to find out whether "discretional responses" to the requirement to disclose forward looking information in the MD&A report are correlated with economical and governance related elements.

Annual reports from the five-year period (2006-2010) of a sample of 218 Italian listed firms have been considered to investigate the nature and characteristics of "Forward-

Looking" disclosures in the Italian market. The period selected has been chosen in order to comprehend some years before financial crisis in 2008 and some years after.

Data set

Data have been collected from Annual Report of each company, once the firms of the sample released the financial document. So that, most accounting data are related to December 31 of each year observed (2006-2010), while the few remaining are related to September 30 or June 30 (according to the different publication date of annual reports).

Sample

The final sample is made up of 218 Italian industrial companies all listed as of 2011, December 31, regarding their reporting data since 2006 to 2010. The total observation figure is 933. As we are working with an unbalanced sample, some data are incomplete or missing. Some of the firms, in fact, have not always been listed in the period 2006 – 2010; therefore, they have been included in the sample since their listing date. Even if for those companies data are incomplete, we believe that their reporting can still be of help in order to highlight on the practices adopted in disclosing "forward looking" information before the adoption of the IASB "Management Commentary". Entities belonging to the financial sectors, such as banks and insurance companies, pure holding companies and all companies which as of year-end 2011 (December, 31) are no longer listed have been excluded from the investigation.

Variable description

Forward Looking, dummy variable: the existence of any quantitative forward looking information per year, whatever the information type is. In Appendix 2 some descriptive elements concerning yearly distribution of outlooks are shown.

P: the sum of yearly forward looking information concerning asset elements (R&D, Investments, and so on)

R: the sum of yearly forward looking information concerning income elements and configuration of income (such as sales, revenues, EBITDA, EBIT, net profits, and so on)

F: the sum of yearly forward looking information concerning financial structure related elements (Net Financial Position, Debt, and so on)

OUT_REL (Outlooks Reliability): the reliability of outlooks is calculated in terms of their potential to effectively predict actual results in the next fiscal year.

The index is calculated as the sum of following factors:

- 1 if the outlook fits actual results;
- 0.8 if outlook is worse than the actual results;
- 0.6 if the outlook is better than the actual results, but the latter is above 70% of the former;
- 0.4 if the outlook is better than the actual results, but the latter is between 30% and 70% of the former;
- 0.2 if the outlook is better than the actual results, but the latter is lower than 30% of the former;
- 0 if there is no outlook information.

In any case, if a firm provides more than one outlook information in the same year, the index is the weighted average of the numbered indexes.

Table 1 – Variables and meanings

Variable		Meaning	
Name	**Type**	**1**	**0**
IND	*Dummy*	Industrial industries	otherwise
CONS	*Dummy*	Commercial Goods industries	otherwise
SERV	*Dummy*	Service industries	otherwise
ICT	*Dummy*	ICT industries	otherwise
GOV	*Dummy*	Public Sector	otherwise
Size	*Dimension*	Total Asset	
Rec&Inv	*Risk*	Sum of receivables and inventories, divided by total assets	
EBITDA/S	*Profitability*	EBITDA, as a proxy of the cash generating attitude of the firm, on Sales	
ROA	*Profitability*	EBIT on Total Asset	
NFP/E	*Leverage*	Net Financial Position on Shareholder Equity	
Foreign Funds	*Dummy*	Presence of Foreign funds in Equity	otherwise
Foreign Funds (%)	*Foreign Funds*	% of Ownership of Foreign Funds	
OD%	*Outside Directors*	% of Outside Directors in the Board	

Results

Descriptive Statistics and Pearson Statistics on Test Correlation

Table 2 shows some descriptive statistics concerning the yearly distribution of outlook reliability (expressed in terms of a triple qualitative option, “fit”, “worse”, “better”).

Table 2 - Yearly distribution of outlook reliability

Yr	2006	2007	2008	2009	2010	Tot
Fit	11	14	7	4	9	45
Worse	20	27	31	16	23	117
Better	18	20	22	30	22	112
All	*49*	*61*	*60*	*50*	*54*	*274*

Table 3 shows main descriptive statistics (mean, median, minimum, maximum and first and third quartiles) of the untransformed variables used in the analysis.

Table 3 - Descriptive Statistics

Variable	Mean	Minimum	Q1	Median	Q3	Maximum
Forward Looking (Y/N)	0.1318	0	0	0	0	1
P	0.0418	0	0	0	0	2
R	0.211	0	0	0	0	4
F	0.0268	0	0	0	0	2
OUT_REL	0.09297	0	0	0	0	1
IND	0.3012	0	0	1	0	1
CONS	0.2294	0	0	0	0	1
SERV	0.3387	0	0	1	0	1
ICT	0.1308	0	0	0	0	1
GOV Y/N	0.07931	0	0	0	0	1
SIZE	13.136	7.292	11.946	12.796	14.25	18.94
REC&INV	0.4095	0.02857	0.25717	0.39668	0.53862	4.96136
EBITDA/S	0.0641	-50.3273	0.0611	0.1143	0.1921	4.3535
ROA	0.03642	-0.5871	0.00224	0.04326	0.07801	0.85805
NFP/E	1.876	-45.17	0.06	0.462	0.929	761.036
FOR_FUNDS Y/N	0.5981	0	0	1	1	1
FOR_FUNDS %	0.08912	0	0	0.0283	0.1004	0.95
OD%	0.37447	0	0.25835	0.3333	0.45825	0.9

Table 4 presents Pearson correlations between the transformed variables. P-values associated to statistics are shown in Italics.

Table 4 – Pearson correlation among the variables

	Forward Looking Y/N	P	R	F	OUT_REL	IND	CONS	SERV	ICT	Gov Y/N	LN TA	REC& INV	EBITDA /S	ROA	NFP /E	Out Funds Y/N	Out Funds
P	0.522																
	0.000																
R	0.837	0.304															
	0.000	*0.000*															
F	0.395	0.358	0.406														
	0.000	*0.000*	*0.000*														
OUT_REL	0.958	0.516	0.806	0.381													
	0.000	*0.000*	*0.000*	*0.000*													
IND	**-0.076**	**-0.122**	-0.044	0.006	**-0.067**												
	0.020	*0.000*	*0.175*	*0.847*	*0.039*												
CONS	0.059	-0.012	0.058	0.048	0.046	**-0.358**											
	0.073	*0.720*	*0.075*	*0.145*	*0.156*	*0.000*											
SERV	0.036	**0.086**	-0.013	**-0.084**	0.041	**-0.047**	**-0.390**										
	0.275	*0.009*	*0.691*	*0.010*	*0.216*	*0.000*	*0.000*										
ICT	-0.020	0.060	0.006	0.050	-0.023	**-0.255**	**-0.212**	**-0.278**									
	0.550	*0.065*	*0.853*	*0.128*	*0.482*	*0.000*	*0.000*	*0.000*									
Gov Y/N	**0.085**	**0.172**	0.045	**0.069**	**0.099**	-0.020	**-0.113**	**0.201**	**-0.114**								
	0.009	*0.000*	*0.168*	*0.036*	*0.002*	*0.546*	*0.001*	*0.000*	*0.000*								
LN TA	**0.199**	**0.236**	**0.201**	**0.246**	**0.220**	-0.020	**-0.077**	**0.210**	**-0.171**	**0.255**							
	0.000	*0.000*	*0.000*	*0.000*	*0.000*	*0.537*	*0.019*	*0.000*	*0.000*	*0.000*							
REC&INV	0.000	**-0.091**	0.025	0.005	-0.004	0.057	**0.142**	**-0.206**	0.033	**-0.145**	**-0.301**						
	0.996	*0.005*	*0.443*	*0.868*	*0.895*	*0.082*	*0.000*	*0.000*	*0.311*	*0.000*	*0.000*						
EBITDA/S	-0.074	0.018	-0.034	0.008	-0.056	0.031	0.011	-0.051	0.016	0.025	**0.103**	0.006					
	0.024	*0.580*	*0.305*	*0.802*	*0.087*	*0.344*	*0.749*	*0.122*	*0.631*	*0.442*	*0.002*	*0.856*					
ROA	0.061	0.022	**0.072**	0.002	**0.086**	**0.116**	0.033	**-0.096**	**-0.065**	0.057	**0.178**	0.040	**0.156**				
	0.064	*0.495*	*0.027*	*0.962*	*0.009*	*0.000*	*0.311*	*0.003*	*0.047*	*0.083*	*0.000*	*0.217*	*0.000*				
NFP/E	-0.016	-0.009	-0.014	-0.006	-0.017	-0.035	-0.017	0.054	-0.007	-0.017	-0.048	0.005	0.005	-0.015			
	0.616	*0.791*	*0.662*	*0.856*	*0.604*	*0.292*	*0.595*	*0.100*	*0.832*	*0.612*	*0.142*	*0.867*	*0.881*	*0.655*			
Foreign Funds	**0.067**	0.039	**0.092**	**0.101**	**0.070**	0.014	0.016	**-0.088**	**0.085**	**-0.083**	**0.241**	-0.020	0.047	**0.178**	-0.042		
	0.039	*0.233*	*0.005*	*0.002*	*0.033*	*0.669*	*0.633*	*0.007*	*0.010*	*0.011*	*0.000*	*0.534*	*0.151*	*0.000*	*0.205*		
Foreign Funds	-0.061	-0.045	-0.036	-0.011	-0.058	0.032	**-0.067**	-0.031	**0.083**	**-0.120**	0.060	-0.053	0.019	**0.070**	-0.018	**0.471**	
	0.062	*0.166*	*0.273*	*0.735*	*0.079*	*0.331*	*0.042*	*0.345*	*0.011*	*0.000*	*0.066*	*0.103*	*0.554*	*0.033*	*0.581*	*0.000*	
OD%	**0.094**	**0.089**	**0.086**	0.061	**0.096**	**-0.150**	0.033	**0.137**	-0.029	**0.344**	**0.266**	**-0.106**	**0.089**	0.048	-0.009	0.052	-0.004
	0.004	*0.006*	*0.009*	*0.064*	*0.003*	*0.000*	*0.311*	*0.000*	*0.379*	*0.000*	*0.000*	*0.001*	*0.006*	*0.143*	*0.778*	*0.115*	*0.914*

Pearson test correlation provides evidences to support several theoretical evidence from previous literature.

As Table 4 shows very clearly, many are the correlations between different variables. We decided to highlight columns regarding elements of interest, in fact only the first five columns, named Forward Looking, P, R, F and OUT_REL are of our main stake for this analysis.

First of all, we have to underline that for what concerns the sector columns any of the observed variables presents some positive and/or negative correlation. The descriptive relevance of these issues make us avoid any comment, but few words may be useful to highlight that ICT sector seems to be no correlated with any of outlook-related variables. So, we can conclude by saying that except this latter sector, the industry membership presents quite different correlations with the forward looking disclosures attitude.

Forward Looking: this dummy variable is positively correlated with the public sector ownership (and this broadly consistent with the hypotheses of Eng and Mak, 2003), the size of companies (Cerf, 1961; Cooke, 1991), the presence of Foreign Funds among the owners (not with the higher percentage of those) and with the percentage of outside directors in the Board (Eng and Mak, 2003). These links seem to be also strongly consistent with several theoretical hypotheses: when governance is built consistently with best practices, or is impacted by the presence of foreign professionally structured investors and/or public sector empowered probably you can find a wider voluntary disclosure, especially about forward looking elements.

P: this variable is positively correlated to the existence of public sector inside the ownership, to the firm size and to the growing presence of outside directors, while it is negatively correlated to the Rec&Inv variable (proxy for a degree of riskiness of financial statement) (consistently with Ferguson et al., 2002 which consider a similar risk indicator, i.e. liquidity ratios)). For former correlations we already argued while commenting Forward Looking results previously. For the latter, otherwise, we note that when current assets are proportionally higher among other total assets, firms do not favorably disclose asset-related

forward looking information. On one hand, this is consistent with the general caution principle that traditionally Italian annual report preparers comply with, on the other hand this element shows a particular element of weakness: as current assets are higher, asset related information should be more crucial, so that forward looking ones have to be possibly disclosed.

R: this variable is positively correlated to firm size, the existence of Foreign Funds among the owners (Naser et al., 2002) and the percentage of outside directors in Board of Directors. Moreover, an interesting element is useful to be noted: the positive correlation between R-index and Return on Assets. This seems to be particularly meaningful: the greater the operating profitability of the company, the higher its willingness to disclose income-related forward looking information (in contrast to Aljifri & Hussainey, 2007).

F: this variable is positively correlated to the public-sector ownership, the presence of foreign funds among shareholders, and the wider presence of outside directors in the Board; moreover, F-index is negatively correlated to SERV sector.

OUT_REL: this variable (discrete, not dummy) is positively correlated with several governance-related elements: the public sector ownership, the existence of foreign funds among qualified shareholders and the greater presence of outside directors; it's also positively correlated to firm size as well to return on assets. The correlation between firms profitability and their ability to fit previous forward looking targets seems to be coherent with the management general ability to achieve objectives and to predict future evolutions, both market evolution and firm's results evolution.

Conclusions, Implications and Further Research

We note that only 132 firms have disclosed forward looking information in five surveyed years. Those disclosing furthermore provide only few forward looking elements, and they often do not disclose again in following years the same information previously disclosed. This result underlines that listed firms in the Italian Stock Exchange tend to provide only limited volume of information about future in terms of forecast and performance expected. It seems that MD&A Report of Italian listed firms is still not completely addressed to disclose useful information for external investors. It still suffers of opacity, since firms probably prefer to hide any specific data on range of profit and cash flow expected.

As the Tables provided clearly show, there are several positive correlations between Forward looking related variables and other debt related, asset related, profit and loss related and governance variables.

We believe that the most useful information concern the positive correlations of several of Forward looking related variables and corporate governance related factors, such as Government ownership, outside directors percentage and foreign funds presence among shareholders. These correlations seem to provide a still incomplete, but clear picture of the necessary road map to increase and strengthen voluntary disclosures (both for what concerns non mandatory information, and the discretionary content of information compulsorily required by laws or self-regulation codes).

Further research can analyze if this increasing path has progressed, and if there are reasonable effects over economic fundamentals, or a reduction in the volatility of stock prices and returns and level of exchanged volumes.

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