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Abstract

The issue of loss incidence among listed firms has been a much researched issue in the academic literature in recent times. Two extensions that arise from this phenomenon are: what causes these losses to occur and what is the impact of this phenomenon on equity valuation? The aim of this study is threefold. First, it aims to document the incidence of losses in Australia, a different reporting environment to the US. Second, it aims to determine the role accounting conservatism plays in explaining loss incidence. Finally, it aims to assess the impact that accounting losses have on the value relevance of accounting information. Specifically, under loss-making circumstances, the study predicts that investors will resort to the probability of loss reversal as a summary measure of the projected performance of the firm in question. After explicitly modeling the probability of loss reversal and making several improvements to the existing literature in this regard, the study predicts that as the probability of loss reversal increases (decreases), investors place more (less) reliance on earnings (book values).
1. Introduction
The issue of loss incidence among listed firms has been a much researched issue in the academic literature in recent times. Recent US research has documented an increase in the incidence of losses over time, with the number of firms reporting negative earnings markedly increasing especially over the last decade (Hayn 1995, Givoly and Hayn 2000). Two logical extensions that arise from this phenomenon are: what causes these losses to occur and what is the impact of this phenomenon on equity valuation?

The purpose of this study is threefold. First, it aims to document the incidence of losses in Australia, a different reporting environment to the US. Second, it seeks to examine reasons espoused in the literature for loss incidence by formally testing for their role in explaining loss incidence. Specifically, it examines the role of accounting conservatism in explaining loss incidence. Some prior research (Klein and Marquardt 2004) notes that accounting conservatism does not play a role in explaining loss incidence; however, Givoly and Hayn (2000) note that conservatism does in fact play a role in explaining loss incidence. The issue of the significance of conservatism in explaining loss incidence thus becomes interesting. Finally, it aims to assess the impact of loss incidence on the value relevance of accounting information. Prior research has noted differing circumstances when the value relevance of accounting information may be skewed away from earnings towards other summary accounting measures such as book values: deterioration of financial health thus creating a liquidation option (Barth, Beaver and Landsman 1998), negative earnings being a transitory phenomenon (Collins, Pincus and Xie 1999, Hayn 1995, Lipe, Bryant and Widener 1998) and the presence of leverage and growth opportunities (Martikainen 1997). However, in the presence of negative earnings, given that they are usually a transitory phenomenon, the value relevance of accounting information hinges on expectations of earnings reversals, expressed by the probability of loss reversal. Hence examining the value relevance of accounting information under differing probabilities of loss reversals becomes of importance.

2. Potential Contribution
The study contributes to the literature in the following ways. First, it is the first study to document the incidence of losses in Australia and will thus determine if this phenomenon is idiosyncratic to the US or whether it is internationally prevalent. Second, by examining the role of accounting conservatism in explaining loss incidence, it aims to solve the mixed evidence on this issue. Third, it adds to the growing body of literature that examines differing circumstances under which the value relevance of accounting information is accorded differing degrees of importance. Although Joos and Plesko (2004) consider this issue to a certain extent, they do not consider the role of accounting conservatism in understanding earnings reversal patterns and also use a potentially mis-specified value relevance test. This study aims to resolve the issues in their paper while also extending a consideration to the role of book values in the value relevance of accounting information under the case of loss incidence.

3. Structure
Section 4 undertakes a literature review in the area and also develops the hypotheses. The review is undertaken separately for each of the three aims espoused in the study. Section 5 outlines the proposed method used to address the research question(s). Section 6 concludes.

4. Literature Review and Hypothesis Development
4.1 Documenting the Incidence of Losses in Australia
The issue of loss incidence is an intriguing one – especially given the challenges it poses for the usefulness of accounting information in providing guidance on the future viability and performance of the entity in question. Surprisingly, the issue did not receive much attention till the publication of Hayn (1995), who documented the incidence of losses in the US. She found that losses in the US are fairly common, occurring 19.6% of the time on average based on her sample. The literature then extended her cross-sectional analysis to a time series one, with the...
publication of Givoly and Hayn (2000). They documented that the percentage of firms documenting losses has increased significantly from 2-3% in the 1950s and 1960s to almost 35% in the late 1980s and 1990s. Qualitatively similar statistics are reported by Collins, Maydew and Weiss (1997), Klein and Marquardt (2004) and Joos and Plesko (2004), signifying that loss incidence in the US is now a phenomenon in itself. It should be noted that purely documenting the incidence of losses in a reporting environment different to the US is an interesting issue in isolation. The reason behind this is that a longstanding argument from the literature has been that accounting conservatism has been increasing over time, and is largely responsible for the increasing occurrence of losses over time. However, different reporting environments entail differing levels of conservatism (Taylor and Taylor 2004) which makes the study of losses in a different reporting environment to the US quite interesting.

Several stylized reporting practices exist in Australia which make its accounting standards differentially conservative to the US. For instance, under most circumstances, it is not necessary to expense R&D expense. Also, it is possible to revalue intangibles to fair value – both upwards and downwards but goodwill impairment tests do not exist. Finally, there is a continuous disclosure regime in Australia that renders the reporting cycle and environment different from the US. All these factors could have an effect on the impact of accounting standards on losses. Note that this impact is independent of economic circumstances and managerial discretion to recognize losses. Differing institutional environments also render these factors to differ, making the documentation of losses in Australia an interesting issue.

As the analysis involved in documenting Australian loss incidence is predominantly exploratory and descriptive, no hypotheses are proposed in this regard.

4.2 Explaining the Incidence of Losses in Australia

The literature has moved from purely documenting loss incidence as a phenomenon to actually providing explanations for the phenomenon, particularly to explain the rise in loss incidence during the 1980s and 1990s. One of the most common reasons documented in the literature has been accounting conservatism. Accounting conservatism refers to exercising caution in financial reporting. Most studies adopt a definition used by Basu (1997), which centres on the notion that conservatism implies asymmetry in the timely recognition of economic news into earnings, with bad news being incorporated in a more timely fashion than good news. However, this definition does not account for the fact that there are two types of conservative practices: one induced by accounting standards – “news independent” conservatism and the second induced by managerial discretion to voluntarily recognize bad news earlier than good news into earnings – “news dependent” conservatism. The literature has found it extremely difficult to segregate the two effects while explaining loss incidence. Hence most studies in the area have to be read in light of these limitations.

In a comprehensive study that considered the time-series properties of losses over a long time period, Givoly and Hayn (2000) documented that rising accounting conservatism explained much of the rising incidence of losses over time, using increasing negative non-operating accruals, declining profitability and other tests to infer rising conservatism causing the rising incidence of losses. However, they report their findings based on inferences and not on formal tests.

Conflicting evidence has emerged in the literature, with other studies documenting different reasons for the incidence of losses. A recent working paper by Klein and Marquardt (2004) finds that there exist three possible reasons why loss incidence exists: economic and business cycle factors, sampling biases on Compustat and accounting conservatism. They find that economic and business cycle factors explain most of the time-series trend in loss incidence, and that when these are controlled for, sampling biases and conservatism hardly play a role in explaining loss incidence in the US over time.
A key weakness in all the above studies is that no formal tests are undertaken to relate loss incidence and reporting conservatism, except for Klein and Marquardt (2004). However, their economic and business cycle variables have endogeneity problems and thus make their results inconsistent in certain instances. It is thus proposed in this study that a formal test will be undertaken to relate conservatism and loss incidence, to examine the role that conservatism plays in explaining loss incidence. Given the fact that this study uses Australian data, this will also serve to examine this issue in a different institutional environment to the US, thus adding to the growing literature on international differences / similarities in conservatism (Ball, Kothari and Robin 2000).

The only study to comprehensively document conservatism in Australia is Taylor and Taylor (2004), who find that Australian firms are in fact conservative in their reporting practices, with there being a timelier recognition of bad news over good news. However, no attempt has been made as of yet to relate conservatism to loss incidence. It is proposed in this study that conservatism does have a role to play in explaining loss incidence. The rationale for this is as follows. Losses are an interaction between two effects: economic factors which cause a loss in the first place, and managerial discretion to reflect adverse circumstances in earnings. Given the finding from Taylor and Taylor (2004) that bad news is in fact timelier than good news to be reflected in earnings, and the rising incidence of “big bath” type losses (Collins, Maydew and Weiss 1997), it is possible that conservatism does play a role in accentuating a loss. The first hypothesis follows on from this rationale:

**Hypothesis 1: Conservatism plays a role in explaining loss incidence.**

### 4.3 The Valuation Impact of Loss Incidence in Australia

Loss incidence poses significant valuation issues to investors, as it impedes the ease with which future earnings power can be forecasted from the current earnings measure. Investors can assess the future viability of the firm in two ways: first, predict that the company will liquidate or second predict that the loss is transitory and that given the going concern assumption, the loss in question will eventually reverse.

Given this problem and the two potential predictions that can arise from loss incidence, traditional value relevance studies on accounting information now distinguish between loss and profit making firms. The seminal paper in this area was by Hayn (1995). She posited that as shareholders have a liquidation option, they have a put option on the future cash flows of the firm by being able to sell their shares at a price at least equal to or greater than the net assets of the firm. This combined with the going concern assumption that losses are transitory leads to a scenario where a loss is temporary and thus shareholders will not place as much value on a loss as they will on a profit. Hayn (1995) found that eliminating loss firms from her value relevance sample almost tripled a one year return-earnings coefficient and the explanatory power of a regression involving annual earnings and returns. Similar predictions were also made by Basu (1997). Similar advances have been made in improving return-earnings coefficient estimation and thus the explanatory power of the return-earnings coefficient equation – by identifying non-linearities in the earnings-returns relation (Freeman and Tse 1992), by undertaking firm-specific estimation (Collins and Kothari 1989) or by a combination of all the above (Lipe, Bryant and Widener 1998).

The literature then moved on to recognize that under the case of negative earnings, the value relevance of earnings was replaced to a large extent by book values as they represent the net assets of the firm and are thus a proxy for the liquidation option that the shareholders can exercise (Barth, Beaver and Landsman 1998). There is now, however, a stream of literature which recognizes different circumstances under which the value relevance of earnings vs. book values differs. Several circumstances have been modelled – financial health deterioration (Barth, Beaver and Landsman 1998), negative earnings (Collins, Pincus and Xie 1999), and the increasing incidence of special and one-time items (Collins, Maydew and Weiss 1997). For instance, Barth, Beaver and Landsman (1998) note that as financial health deteriorates
(improves), investors would presume that such firms are approaching (not approaching) liquidation values, due to which the weight on book value will increase (decrease). Similarly, Collins, Pincus and Xie (1999) note that under negative earnings, the traditional returns-earnings capitalization model is mis-specified unless book value of equity is included in the valuation equation. Several other studies have corroborated these findings in international settings – Kallunki, Martikainen and Martikainen (1998) in Finland and Sin and Watts (2001) in Australia.

All the above studies do not make the distinction between those firms that are expected to survive, i.e. their losses are transitory and book values are value irrelevant and those firms that are expected to liquidate / go bankrupt, i.e. their losses are transitory and book values are value relevant. The summary measure that incorporates this effect is the probability of loss reversal. Jenkins (2003) models earnings reversals using a random-walk revenue based approach. However, he does not consider the loss history of the firm or its demographic characteristics.

A recent working paper by Joos and Plesko (2004) overcomes these limitations by explicitly modeling the probability of loss reversal and examining the value relevance implications of differing probabilities of loss reversal. Joos and Plesko (2004) note that investors, when confronted with a loss, assess the probability of loss reversal and price earnings conditional upon that probability. They model the ex ante probability of loss reversal and use the estimated reversal probability to classify observations into a persistent or transitory sample. They predict that firms in the persistent sample will have a lower probability of loss reversal and hence the return-earnings coefficients will be insignificantly different from zero. In contrast, they expect return-earnings coefficients for the transitory sample to be positive and significant, as investors place reliance on earnings given that their liquidation option is not as valuable. For the transitory sample, they find that in line with their expectations, the return-earnings coefficients are in fact positive and significant. However, for the persistent sample, they find that against their expectations, the return-earnings coefficient is actually negative and significant.

They then further explore this anomaly by decomposing earnings separately into a cash flow and accruals component, and an R&D and special items component. When they re-estimate the return-earnings coefficients, they find that the negative coefficient for the persistent sample is driven by a highly significant and negative coefficient on R&D items. For the transitory sample, this coefficient is not significantly different from zero. Joos and Plesko (2004) thus conclude that 1) investors look beyond aggregate earnings and aggregate cash flows and accruals when they value loss observations as they reward firms with higher R&D expense (which translates into lower operating cash flow); and 2) the presence of a growing R&D component in persistent losses implies persistent losses have become a weaker indicator of the likelihood of exercising the abandonment option.

This study takes exception to the above conclusions and notes two significant limitations in Joos and Plesko (2004). First, with regards to conclusion 2, in the US, the practice of expensing and not capitalizing R&D expense leads to lower operating cash flow. If investors assess the future benefits in terms of earnings power through incurring R&D expense, they see through the contemporaneous negative cash flow effects and instead reward such a firm through positive stock price reactions. Note however that this practice is consistent with reporting conservatism, i.e. asymmetrically recognizing bad news in preference to good news. It is thus entirely possible that when assessing the ex ante probability of loss reversal, investors see through the extent of conservative reporting and instead accord a probability of loss reversal that factors the extent of conservatism into account. Joos and Plesko (2004), however, do not consider how the extent of conservatism assists investors in determining the ex ante probability of loss reversal. It is expected that controlling for this effect will improve the specificity of the loss reversal model. Stated differently, it is possible that because Joos and Plesko (2004) do not control for the extent of conservatism in their loss reversal model, the specificity of the model may be called into question and hence firms may be classified as persistent loss-makers even though investors may assess their probability of loss reversal as
being higher. Hence it does not come as a surprise that in their paper, investors actually reward firms that report conservatively (have higher R&D expense). It is hypothesized that controlling for this effect will lead to a better classification of firms as persistent or transitory loss-makers and hence lead to return-earnings coefficients in line with expectations.

Both the FASB in the US and the AASB in Australia note that one of the aims of the financial reporting process is to produce earnings estimates that assist in equity valuation through predicting future cash flows. Whether or not investors look beyond aggregate earnings / cash flows / accruals is ultimately an empirical question. It is expected that after improving the specificity of the loss reversal model, one would be in a better position to determine whether or not conclusion 1 above holds.


All in all, it is expected that as the probability of loss reversal increases, more reliance will be placed on earnings and less on book value and vice versa. This is because, as the probability of loss reversal increases, shareholders are less concerned about the loss-making phenomenon as it is almost purely transitory. For such firms, it is not prudent to focus on liquidation values when the assets have high earnings power in place. Thus it is not expected that there will be as much reliance on book values compared to firms for which the probability of loss reversal is low. This leads to the second hypothesis:

**Hypothesis 2**: There is a positive relation between the probability of loss reversal and the weight placed on earnings and a negative relation with the weight placed on book values.

### 5. Proposed Method

The method is outlined in accordance with the three purposes of the study as follows:

#### 5.1 Documenting the Incidence of Losses in Australia

In order to document the incidence of losses in Australia, the sample of firms will be drawn from the Aspect database from 1993-2003. The time period is chosen because cash flow data is readily available from the Statement of Cash Flows mandated in Australia thus avoiding measurement errors as per Hribar and Collins (2002). The sample will be winzorized by 1% on total assets. Loss incidence is measured as the percentage of firms reporting losses as part of the sample. Losses are defined as such if Operating Profit after Tax (item 100) is less than zero. Two samples will be used: a full sample, consisting of the full sample of firms in any given year and a constant sample, which consists of the sample of firms that have survived for seven years. Sensitivity checks are also run with Net Income (item 104) as the measure for losses. Two other summary statistics are also included for each year: the mean and median M/B ratio and a proxy for the sampling bias induced by the Aspect database. As the population of firms covered by the Aspect database has steadily increased over time to include firms that are smaller in size, there is a concern that increasing loss incidence could be driven by a sampling bias. The measure for sampling bias used is in line with Klein and Marquardt (2004) and is measured as the coefficient of variation of the log of total assets, measured as the standard deviation of the year's log of total assets divided by the year’s mean.

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1 The seven year requirement is imposed in order to identify firms that satisfy some of the data requirements covered in subsequent tests.
5.2 Explaining the Incidence of Losses in Australia

In order to test Hypothesis One, three tests will be run. Again all data is available on Aspect with price data available from the SPPR database.

5.2.1 Test 1

A test incorporating demographic characteristics of the sample in question will be run, by documenting the time-series means and medians of operating profit after tax, cash flow from operations and return on assets for both the full sample and the constant sample. The purpose behind documenting these measures is to examine conservatism as an explanation for loss incidence in line with Givoly and Hayn (2000). Although this does not serve as a formal test for conservatism as an explanatory factor for loss incidence, declines in all the values except for Cash Flow from Operations will be consistent with reporting conservatism causing loss incidence. The time-series mean and median market-to-book ratio will also be documented to see whether it increases over time. The rationale behind this is that as firms become more conservative, book values are depressed. Assuming market efficiency, the disparity between book values and market values increases as reporting conservatism rises.

5.2.1 Test 2

A Basu (1997, JAE) reverse regression is run with operating profit after tax as the dependent variable (deflated by beginning of period market value of equity) and share returns as the independent variable. The premise behind this regression is that if earnings is timelier for bad news than for good news, controlling for this effect should improve the contemporaneous relation between earnings and stock returns. The formal regression is as follows with the interaction term the main variable of interest:

\[ X_t = \alpha_0 + \alpha_1 DR_{it} + \beta_0 R_{it} + \beta_1 DR_{it} \cdot R_{it} \]

(1)

Where: X = Operating Income after Tax (Item 100 on Aspect) deflated by beginning of period MVE
R (Fiscal) = Share Returns from the first trading day to the last trading day of the financial year adjusted for the All Ordinaries Index over the same period (Market Adjusted Fiscal year Returns) (Proxy for news)
R (Inter-Announcement): Share Returns from three months after the previous fiscal year to three months after the current fiscal year adjusted for the All Ordinaries Index over the same period (Proxy for news)
DR = Dummy Variable which takes the value of 1 if R<0; 0 otherwise

The above regression is run for the loss sample and for a control sample using two market-adjusted returns measures. Results will also be reported for a year-by-year estimation. The loss sample and control sample are selected in order to test for differential levels of the coefficient from the interaction term from the above regression. The control sample is selected based on 2 criteria: that the firm makes a profit and be matched by industry and by size. In order to prove that conservatism is an explanatory factor in loss incidence, it is expected that the coefficient from the loss sample on the interaction term will be higher than the coefficient from the control sample. This is because this would imply that loss firms are more conservative than profit-making firms and are thus more timely in recognizing bad news into earnings. Vuong tests are run to determine differences. A limitation of this procedure must be noted. Given the difficulties faced by researchers in determining a firm-specific proxy for reporting conservatism, if the results from the above test are in line with expectations, it still does not imply that conservatism causes loss incidence. The only conclusion that can be drawn is that loss making firms are differentially more conservative than profit making firms and report earnings consistent with differentially higher reporting conservatism than profit-making firms.

5.2.3 Test 3

The final test is from Basu (1997) which involves the notion of earnings persistence. Given the asymmetric timeliness of bad news in its reflection in earnings, one would expect bad news to reverse and good news to persist. It is expected that the reversal process for bad news and the
persistence for good news would be even stronger for loss firms than for profit-making firms, if Hypothesis One holds. The following formal regression is employed to test for this:

$$\Delta X_{it} = \alpha_0 + \alpha_1 DX_{it-1} + \beta_0 \Delta X_{it-1} + \beta_1 DX_{it-1} \Delta X_{it-1}$$

(2)

Where:

- \(DX\) = Dummy Variable which takes the value of 1 if \(\Delta X_{it-1} < 0\); 0 otherwise
- All other variables are defined above and the test is run separately for the loss sample and for the control sample. Results will also be reported for a year-by-year estimation. It is again expected that the \textit{absolute} value of the coefficient on the interaction term will be higher for the loss sample than for the profit sample. Again, Vuong tests are run to determine differences across coefficients. Once again the limitation noted in the prior section holds in this case.

5.3 The Valuation Impact of Loss Incidence in Australia

5.3.1 The Probability of Loss Reversal Model

In order to understand the valuation implications of loss incidence, it becomes necessary to model the probability of loss reversal and examine whether value relevance differs in accordance with the probability of loss reversal. The model to be used in this study is an adaptation of Joos and Plesko (2004) and is as follows. An attempt has been made to maintain parsimony:

$$y_{t+1} = X_{t+1} \beta + \epsilon_{t+1}$$ (Logit)

(3)

Where \(y = 1\) if the firm becomes profitable in the subsequent year; 0 otherwise

- \(X\) = Information Variables of the Model as defined below

Given that theories on the probability of loss reversal have not been advanced in much depth, it becomes necessary to consider a range of different information variables in order to ascertain the probability of loss reversal. In line with Joos and Plesko (2004), three broad categories of variables are considered: the loss history of the firm, demographics and past profitability and dividend paying behaviour.

5.3.1.1 Past Loss History

- FIRSTLOSS: An indicator variable equal to 1 if this year’s loss is the first in a sequence, 0 otherwise. It is predicted that the coefficient on this variable will be positive because it is highly likely that the loss is transitory in nature.
- LOSSSEQ: A count of the number of losses in the sequence over the past five years. A negative relation is hypothesized as the greater the number of losses in a sequence, the more difficult it is for the firm to revert back to profitability.

5.3.1.2 Demographics and Past Profitability

- ROA: Return on Assets. A positive relation is expected as better performing firms have a higher probability of loss reversal\(^2\).
- SIZE: Size is measured by the log of market value of equity. \textit{Ceteris Paribus}, larger firms will have a higher probability of loss reversal as they are usually financially stronger than smaller firms. Hence a positive relation is predicated.
- SALESGROWTH: Percentage growth in sales for the current year. No prediction is made for sales growth as it could signify growing firms in the sample that may have a lower probability of loss reversal. Alternatively, higher sales growth could signify healthy firms ready to return to profitability.
- EBITDA: It is predicted that higher values of EBITDA will lead to a higher probability of loss reversal, thus leading to a prediction of a positive relation.
- M/B: The M/B ratio is the proxy used for conservatism at the firm level as it measures the disparity between book value and market value, part of which could be caused by reporting conservatism that causes depressed book values. Note that this measure

\(^2\) Joos and Plesko (2004) also consider the usage of Past ROA, defined as return on assets over the past five years. They find, however, that the loss history variables, when controlled for, render Past ROA to be insignificant. It is hence dropped from the analysis.
could also signify growth opportunities; however controlling for sales growth serves to control for growth opportunities. Nevertheless, the results have to be read in light of this limitation. The next measure serves as a sensitivity check to this problem. A positive relationship is predicted in this case.

5.3.1.3 Dividend Paying Behaviour

- DIVDUM: An indicator variable equal to 1 if the firm is paying a dividend and 0 otherwise. If a firm continues to pay dividends, it signifies that it expects the firm to survive into the future and eventually return to profitability; thus a positive relation is predicted.

- DIVSTOP: An indicator variable equal to 1 if a firm stopped paying dividends and 0 otherwise. Here a negative relation is predicted as if a firm stopped paying dividends, it could signify a deterioration of financial conditions leading to potential concerns with the going concern assumption.

5.3.2 The Value Relevance Equation

After determining the probability of loss reversal for each firm as per the above logit regression, the sample is split into four quartiles in an ascending order of the probability of loss reversal. This assists in lining up the sample in order of the probability of loss reversal in order to test Hypothesis Two. The first quartile consists of persistent losses and the fourth quartile consists of transitory losses. Further analysis is restricted to these two quartiles.

Having undertaken this step, as an aside firstly an OLS value relevance regression is run for the loss sample and for a control sample as defined above. The purpose of this exercise is to examine if the findings of Collins, Pincus and Xie (1999, TAR) still hold in a different institutional setting. The regression to be run is as follows and is in line with Collins, Pincus and Xie (1999, TAR) which is an adaptation of the traditional capitalization of earnings equation of Ohlson (1995, CAR).

\[
P_t = \beta_0 + \beta_1 X_{it} + \beta_2 BV_{it} + \epsilon_{it}
\]

Where:
- P = Price per share at year-end
- X = Operating Income after tax deflated by end of period MVE
- BV = Book Value of Equity deflated by end of period MVE

Given the findings of Collins, Maydew and Weiss (1997, JAE) that investors are placing less reliance on “bottom line” earnings, sensitivity checks will also be run with EBIT or EBITDA as a substitute for operating income.

Having run the above test, the above OLS regression is run for the transitory and persistent quartiles and Vuong and t-statistics are used to determine whether the differences in coefficients across the quartiles are in line with Hypothesis Two. Once again, sensitivity checks will be run using EBIT or EBITDA as measures of earnings instead of operating profit after tax. It is not considered relevant to split earnings into components for two reasons. First, R&D expense in Australia is mostly capitalized and not expensed. Second, testing for sub-components of earnings assumes that investors do not place much reliance on the earnings figures. As noted above, this is ultimately an empirical question and any further analyses will be undertaken conditional on the findings from the value relevance equation.
6. Conclusion

This study attempts to document the incidence of losses in Australia, explain the factors that cause this phenomenon and understand the valuation implications of this phenomenon for the capital market. This study could have broad implications for future research. First, one of the most pressing issues facing academic research is the valuation of loss firms. By providing insights into how the market prices loss firms, this study could generate future research on this area, particularly to value loss-making unlisted firms. Second, the probability of loss reversal summarizes information for investors especially for assessing the future earnings power of the assets in place. This measure, if developed further by future research, could have commercial applications, especially for regulators, investors and stock exchanges to assess the future viability of a firm.

Finally, the study could have implications for standard-setting, especially through the insights provided by the value relevance equation. By documenting which form of earnings has greater value relevance, the study could have far-reaching consequences in this area.
7. References