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Chapter II

Information Systems Expenditures and Firm Value:

Further Evidence from Financial Services Industry

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ABSTRACT

This chapter examines the value relevance of disclosures about IT expenditures. Using information about the amount of consulting fees paid to the incumbent auditor by their clients for designing and developing a financial information system (FIS), the study examines whether there is an association between market value of equity and IT expenditures. Since the financial services industry is an intensive user of IT and often relies on IT as a source of competitive advantage, the study uses a sample of firms from the financial services sector. This chapter contributes to our understanding of the importance of disclosures about IT expenditures in assessment of firm

value. The results show positive association between investments in IT and market value of equity. Overall, the findings support the notion that investors perceive investments in IT as value-relevant.

INTRODUCTION

Until recently, IT spending by organizations has been significant and these organizations have made large investments in information systems. The investments in IT has enabled businesses to improve operational efficiency, introduce new products and services with greater ease, obtain greater decision support while planning operational and business strategies and in improving brand image, product quality, and customer loyalty (Keen, 1981; Ives and Learmouth, 1984; McFarlan, 1984; Cash and Konsynski, 1985; Porter and Millar, 1985; Cash et al., 1988). While managers rightfully consider the IT investments as a strategic necessity and a key to improving competitive strengths, they are still under pressure to prove that the IT investments add value to their organizations (Linderholm, 2001; Bharadwaj et al., 1999; Bharadwaj, 2000). This study examines and reports on the association between disclosures about IT expenditures — consulting fees paid to auditors for developing a financial information systems (FIS fees) — and market value of a firm.

For managers, a greater understanding of the current and future value of IT investments is very important. When investing in IT, managers must evaluate both the operational benefits and the strategic necessity and, eventually, the impact on the bottom line (Cash and Konsynski, 1985; Clemons and Row, 1988; Jarvenpaa and Ives, 1990; Parsons, 1984; Porter and Millar, 1985). When the IT investment is of strategic importance (for example, in the financial services industry, IT investments are a strategic necessity), managers must look at the "totality of the firm" and make IT decisions based from a "totality of the firm" perspective (Clemons and Row, 1993) and the impact on the future value of the firm (Dos Santos, 1991). However, as Brynjolfsson et al. (1998) point out, estimating the long term economic impact of IT investments is difficult because of measurement problems, lag between IT investments and impacts, and redistribution of outputs within an industry.

The value of IT investments can be examined from three perspectives: (1) improvements in operational and other quantifiable performance measures; (2) strategic improvements such as first mover advantages or customer service improvements; and, (3) firm performance reflected through market variables (Dehning and Richardson, 2002). In this chapter, we use the firm performance alternative and examine whether disclosures relating to investments in information technology (IT) are relevant to investors in assessing the market value of equity. Earlier studies that provided evidence that IT leads to corporate success or provided long-term value was mostly anecdotal and consisted of ex post

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