

The Role of Financial Reporting in Capital Markets

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Abstract

The purpose of this article is to comment on the role played by financial reports in capital markets. The decision usefulness view and the fiduciary duty view provide the basis for the importance of financial reports. Proponents argue that the importance of financial reports is mainly reflected in the practical application of efficient securities market theory, rational decision theory, efficient contracting theory and Ohlson's clean surplus theory. In addition to the information transmission function, the roles of financial reports are reflected in alleviating information asymmetries, improving market efficiency, helping investors to update their prior probabilities, reducing poor surplus management and helping companies to contract effectively. However, some critics argue that financial reporting is not as effective as the theory claims. This is reflected in the historical and substitutable nature of the information provided by financial reports. At the same time, the different accounting policies used by different companies reduce the comparability of financial reports. Furthermore, prices are considered to have replaced the role of financial reports in an efficient securities market, reflecting all the information available in the market. In conclusion, the role played by financial reports in the capital markets cannot be ignored, but they need to be further improved in the future.

Keywords

Financial reports; Capital markets; Decision usefulness; Fiduciary duty; Information transmission.

1. Introduction

Accounting is considered as a discipline that records information about an entity's financial transactions in accordance with current standards and policies (Bodnar et al., 2020). It is intended to provide decision-making relevant information to the stakeholders of enterprises. Financial reports provide statements that reflect quantitative information about the financial and operational status of the organization, while providing descriptive reports (Weetman, 2018). It is seen as a 'language' that bridges the communication gap between the business entity and the external environment (Bodnar et al., 2020). Financial reports are believed to help alleviate information asymmetries, improve the efficiency of capital markets, update investors' prior probabilities, reduce poor earnings management and contract effectively. In other words, financial reports contribute to the application of efficient securities market theory, rational decision theory, efficient contracting theory and clean surplus theory. However, there is no lack of skeptics in the development of financial reports. This paper evaluates the role of financial reports in capital markets and explains their controversies. Ultimately, it concludes that the role that financial reports play in capital markets cannot be ignored, although it will need continuous improvement in the future.

Accounting has two main purposes: decision usefulness and stewardship (Scott, 2015). The decision usefulness view proposes that financial statements, although not completely correct

in theory, should provide more useful information to the users. Therefore, it is important to be clear about who the users are and what the needs of them are. Information users mainly include existing and potential providers of capital: creditors and investors (Cascino et al., 2014). They argue that the heterogeneity of different users makes them have different needs for information, so financial reports cannot meet the needs of all users simultaneously. The decision usefulness view is future-oriented as it is used to assess the development prospects of businesses. Therefore, relevance receives extra attention (Scott, 2015). The second view is the fiduciary duty view. In this view, financial reports reflect the past actions of managers to assist in corporate governance (Scott, 2015). This is quite different from the decision usefulness view. The first view is designed to deliver information that helps predict future operational conditions, whereas the latter is past-oriented. Scott (2015) proposes that the purpose of financial reports for stewardship can be achieved through effective contracts. Financial reports provide information that is used to assess management performance, so this concept requires a high level of reliability.

Financial reports facilitate the practical application of efficient securities market theory, rational decision theory, efficient contracting theory and Ohlson's clean surplus theory. Its importance is mainly demonstrated by the following five aspects.

Firstly, financial reports contribute to mitigating information asymmetries which are classified into two categories: adverse selection and moral hazard. Adverse selection means that sellers in the second-hand car market have more inside information about cars than buyers (Akerlof, 1970). Some buyers who have more information have more opportunities for arbitrage at the expense of poorly informed buyers. Adverse selection occurs before contracting, while moral hazard is ex-post. (Klein et al., 2013). Moral hazard is the inability of investors to directly monitor the level of effort of managers who may harm the interests of investors. The ex-post risk is mainly caused by the agency issues that are characteristic of most enterprises, that is, the separation of ownership and operation (Scott, 2015). Financial reports reduce the information advantage of insiders by reliably conveying firms' internal information to external users. Auditors can also help investors to confirm stock quality (Akerlof, 1970). The transmission of financial information creates a more level playing field. In addition, Li (2019) suggests that financial information can be incorporated into managerial compensation and debt contracts to alleviate moral hazard. Compensation contracts are used not only internally to motivate managers to achieve goals through remuneration, but also externally to control managers' behavior through reputation (Scott, 2015). Debt contracts can specify the maximum percentage of debt that is acceptable to creditors to ensure firms' repayment ability in the future. Although the specific measures used to control the two types of risk are different, financial reports play an important role in both. Scott (2015) argues that financial reports can be used by investors to predict firms' future performance, while identifying the drivers of past performance.

Secondly, financial reports improve the efficiency of securities markets. The prices of securities reflect all the information available to the public timely in the semi-strong efficient market (Fama, 1970). There is a paradox of the theory (Scott, 2015). If the prices are fully informed, investors will have no incentive to collect information. In this case, prices would fail to reflect the full range of information. Therefore, the theory does not imply that excess returns are not available in the market, which requires the mean of abnormal returns to be zero (Scott, 2015). Scott (2015) suggests that the information available to the public together with inside information constitutes the firms' fundamental value. Internal information can trigger adverse selection and moral hazard. Financial reports serve as media of information delivery. Interestingly, the cost is so high that financial reports do not provide all internal information (Scott, 2015). Maffett (2012) concludes that the quality of financial reports is negatively correlated with the possibility of excess returns. Namely, the greater volume of information

available in financial reports, the fewer information advantage of insiders. The abnormal returns of insiders are gained at the expense of external investors. Therefore, financial reports can improve market efficiency and safeguard the rights of external information users.

Thirdly, financial reports can be used as additional information to modify investors' prior probabilities, which helps investors make wise decisions. Investors are rational in rational decision theory, that is, they will make rational estimates when facing uncertain situations and choose the behavior that will yield the greatest utility (Scott, 2015). The theory also assumes that investors are risk-averse. Rational investors will achieve as much return as possible within the risk they can tolerate. Financial reports contribute to investors' re-judgement of the probability of events using Bayes' theorem (Scott, 2015). Namely, when investors receive information about a firm's performance conveyed by financial reports, they will revise previous estimates of the firm's future performance under uncertainty. Consequently, rational decision theory helps to understand the role of financial reports in the decision-making process.

Fourthly, financial reports help investors to identify and reduce poor earnings management (EM). EM is the process by which managers adjust accounting policies or take practical actions to achieve targeted earnings on financial statements (Scott, 2015). Motivations for EM include reputation building, career development, compensation incentives, maintaining good credit ratings for the firm, avoiding violation of debt covenants, etc. (Ali and Zhang, 2015; Healy, 1985; Hill et al., 2019; Sweeney, 1994). For example, Healy (1985) proposes that managers exhibit different managerial behaviour in bonus plans. Managers are more inclined to increase earnings when the magnitude of earnings is within a range that is positively correlated with the bonus. Managers have an incentive to adopt income minimization or taking a bath models when earnings exceed the limits of the bonus scheme. EM exists in practice because it can break down blocked communication and effectively convey to investors the difference between earnings expectations and reported earnings (Demske and Sappington, 1987). Its advantages are also reflected in the ability to smooth earnings to mitigate contract rigidity. Long-term covenants are often exposed to changes in norms. It increases not only the risk faced by managers, but also the risk of high default costs faced by firms. Numerous cases show that EM may cause false account issues (Scott, 2015). Indeed, managers often engage in EM for strategic purposes. Financial reports can be seen as a tool of trade-off between safeguarding stakeholders' interests and being alert to managers' speculative behavior. Adequate disclosure and more transparent financial reports help investors monitor managers' behavior more closely. Dechow and Dichev (2002) indicate that the magnitude of accrual in earnings is negatively related to the surplus quality, which helps investors to use financial reports to identify managerial manipulations. Accountants can also observe market attitudes towards earnings via the earnings response coefficient, which can improve the decision relevance of financial reports (Scott, 2015).

Finally, from the perspective of accounting's stewardship function, the role of financial reports is to contract efficiently. Contracts rely on accounting variables as performance and solvency measures. Efficient contracting theory asserts that accounting information forms efficient contracts and strengthens corporate governance by alleviating information asymmetries between the contracting parties (Scott, 2015). Contracts are divided into compensation and debt contracts depending on the contracting parties (shareholders or creditors). The former motivates employees to work hard with high remuneration. For example, staff stock options combine employee interests with company value. The latter is a control imposed on the borrower to ensure that firms will be capable of repayment in the future (Dichev and Skinner, 2002). Watts (2003) argues that moral hazard can be mitigated through using conservatism in financial reports. Conservatism means that profits are not predicted in advance, but all losses are predicted (Bliss, 1924). Basu (1997) also suggests that accountants need a higher degree of validation to identify good news in financial reports, thus earnings respond to bad news more

quickly. The asymmetric verifiability in accounting reports limits the opportunistic behavior of managers, which enhances corporate governance.

Some flaws of the information provided by financial reports make critics believe that they are not as efficient as theory claims.

Firstly, financial statements based on historical perspective cannot be used to predict firms' future performance (Scott, 2015). Although the strength of historical cost lies in the reliability and verifiability, its relevance to the firms' future value is weak. Consequently, instead of providing decision-useful information to investors, financial reporting may create distractions for information users. Agus Indra (2007) argues that critics' dissatisfaction is due to the shift in the function of financial reports from responsibility allocation to decision-making support. Scott (2015) suggests that financial statements based on current value can improve the value relevance of financial information and enhance the explanatory power of reports for firms' future value. While current value accounting reduces the lag in information recognition, the reliability of information is weaker. Therefore, the choice of measurement basis is a trade-off between reliability and relevance. Meanwhile, Ohlson's clean surplus theory also emphasizes that financial information is the basis for recognizing corporate value, while providing the theoretical foundation for the inclusion of current value in financial reports. Full disclosure of off-balance sheet information can have a positive effect. For example, Sloan (1996) provides evidence that the different components of earnings have different persistence. Adequate disclosure of the components of earnings helps investors to assess firms' value more effectively. Secondly, information can be provided by more timely sources (e.g. analysts, media and conferences), which competes with financial reports (Cascino et al., 2014). Critics argue that it is unnecessary to use earnings as agent to convey internal information for the business valuation, which inevitably increases bias (Beaver, 1968). It is not exaggerated to say that approximately 85% of information is captured by more timely sources (e.g. interim reports, dividend announcements, etc.), but companies have to consider the cost of other information channels (Ball and Brown, 1968). Therefore, financial reports are not useless, and its advantage is to provide verifiable, standardized and objective information (Cascino et al., 2014). The studies of Ball and Brown (1968) and Beaver (1968) support each other. The former confirms that other sources can be used to correct valuations using financial reports information, and the latter suggests that more timely media would not cause distress to users. Overall, financial reports and other information sources complement each other, creating an effective financial information system.

Thirdly, the choice of accounting policies varies across firms leading to a lack of comparability across firms and affecting investors' decisions. There is limited evidence indicating that changes of accounting policies (e.g. depreciation methods) lead to significant fluctuations of share prices (Beaver, 1973). However, an important implication of Beaver's (1973) study is that the choice of accounting policies does not have a significant impact on firms' value if accountants disclose the changes timely and investors can switch between different policies. Consequently, full disclosure of the adoption and changes in accounting policies can enhance the usefulness of financial reports.

Fourthly, from the perspective of efficient securities markets, prices already reflect all information so financial reports seem to be redundant. As mentioned earlier, the market is relatively efficient for the information that is available to the public (Scott, 2015). Financial reports convert internal information into external information to ensure the validity of the market as much as possible.

Overall, the five advantages of financial reports mentioned in this paper can all be attributed to the function of information transmission. Mitigating information asymmetry, improving market efficiency and helping investors update prior probabilities are consistent with the

purpose of providing decision-useful information. Reducing poor earnings management and helping companies contract efficiently are aligned with the managerial objectives of accounting. Certainly, some critics argue that financial reports are still flawed in terms of historical perspective, competition with other sources, variety of accounting policies and contradiction with the assumption of efficient securities markets. It is obvious that financial reports leave scope for improvement.

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