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Assess the Usefulness of Financial Reporting: How to Reconcile the Inconsistence between Financial Reporting and Capital Market Participants

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Abstract: On the one hand, a company's financial reporting provides investors and shareholders with useful information to assess and predict the future prospects of a company, however, market uncertainty and reporting lags led to financial repoting providing limited useful information to investors. The purpose of this essay is therefore to examine how investors can use the limited inforation provided in financial reporting to analyse and invest rationally, thereby reducing their investment risk.

1. Introduction

Assessing the usefulness of accounting reports is always a difficult issue for investors to reconcile. On the one hand, the earnings announcement in the financial reporting reflects the utility of the company's accounting activities (Beaver, McNichols and Wang, 2018). At the same time, its incremental information (e.g. financial statement) also provides investors and shareholders with useful information to analyze and predict the company's development prospects thereby achieving the purpose of helping them make reasonable decisions. On the other hand, due to factors such as market uncertainty and information lag, financial reporting provides little validity to users. In addition, with the development of information technology, more alternative variables have replaced the role of traditional financial statements, which can provide investors with more timely and useful information. Therefore, the purpose of this essay is to evaluate the usefulness of financial reporting to investors and propose measures to reconcile the inconsistence.

On the one hand, it affirms the view that financial reporting provides useful new information for investors. For market participants, whether it is for research, decision-making or supervision, earning announcements are very useful for them (Lev, 1989). This means that there is no substitute for the informative and useful nature of financial reporting. Specifically reflected in (i)The relevance and reliability of financial reports. In fact, the release of financial reporting passed the audit of an annual audit report. According to the research of Schroeder(2013), a completer and more high-quality audit before the release of earnings announcement not merely improves the quality of the financial reporting system, but also enhances the confidence of managers. This shows that the quality of financial reporting through external audits has improved, and thus the reliability has been improved. Besides, the improvement of the quality will also increase the willingness of management to provide more detailed information in the financial reporting, which has proven to be informative and valued to capital market participants (Schroeder, 2013). The theory embodies a virtuous circle, which affirms the characteristics of the relevance of financial reporting. It can be seen that, compared with other information without accurate sources, the accuracy and credibility of financial reporting are higher,and investors are more worthy of reliance on.(ii) Function of the earnings announcement is to add more timely information to supplement the proof that its source of information is veracious (Ball and Shivakumar, 2008). The purpose of issuing financial reporting is not for the timeliness, but to provide investors with more useful information to predict the future development prospects of the company. To be specific, refine and summarize the development status of the company based on historical data with the aid of quantitative analysis by analysts, and then have a priori probability of future company performance. It is an effective way for averse-risky investors to avoid risks. In addition, the incremental information of financial reporting provides investors with effective means to understand the capital market. Through the useful information to revise their probabilities upward/downward. That is why investors are keen on financial reporting. iii)The usefulness of financial reports is reflected in the changes in stock prices in the market. Basu Sudipta believes that the value of information sources lies in whether they can benefit users. When an information source disseminates price-related information at a high frequency, its value and usefulness may be greater (Basu et al., 2013). This is reflected in the stock price rising when the financial reporting is higher than expected, on the contrary, when the financial reporting is lower than expected, the stock price falls. The response of the capital market to different situations will also change accordingly. Under the premise of the market efficiency hypothesis, investors will make rational decisions about holding, buying or selling based on changes in stock prices. If the security price did adjust quickly when new information appeared, the conclusion drawn would indicate that the information reflected by the earnings announcement in the financial report is useful (Ball and Brown, 1968). It can be inferred that the earnings response coefficients (ERC) reflected in the financial accounting information to predict the company's risk and financial report quality. Specifically, the higher the ERC, the higher the quality of the company's financial report, in the meanwhile, the lower the risk of the corresponding investor in investing in the company. In this way, it will be conducive to helping capital market participants more accurately assess the information value of returns and make rational investment decisions. All in all, financial reporting can provide useful information for the capital market to a certain extent and conduces investors to reasonably estimate risks and make rational decisions.

On the other hand, the uncertainty of the market and the market participants' reasons have led to the limitations of financial reporting. To be specific, (i) There are many uncertain factors in the capital market itself. Hamidian, Arabsalehi and Amiri (2018) believe under uncertain conditions (information uncertainty and market uncertainty) there is ambiguity in the future state of enterprises and capital markets. In this case, the information provided by the earning announcement is not accepted by the investors or the capital market, and the correlation between stocks, earnings and profit are weak. When there is a high degree of uncertainty in the earnings announcement, investors' reaction to the earnings announcement is low (Hamidian, Arabsalehi and Amiri, 2018), which in turn affects the investors' predictive ability. Due to the above-mentioned uncertainties, the capital market's response to the financial reporting is further lagging. Because of the lagging effect of market prices, it is difficult for investors to immediately form unbiased expectations of future returns. They need to rely on the forecasts of third-party analysts and analysis agencies to make correct decisions (Bernard and Thomas, 1989). However, for some countries, financial analysts and financial media are still in their infancy in capital markets and do not effectively act as an information medium between listed companies and investors (Daqing Qi and Woody Wu, 2002). These are the reasons why people believe that the information brought by earnings announcements to the market is moderate rather than overwhelming. In this case, the direct usefulness provided by financial reporting is forced to be dispersed, which prevents them from becoming a source of new information in the capital market. (ii)The usefulness of financial reporting is also affected by its own limitations. Firstly, there is the problem of information delay in financial reporting, which is specifically reflected in the value-related events, such as mergers, bankruptcies, etc., that affect the revision of earnings announcements(Begley and Fischer, 1998).This means that the release of financial reporting is forced to be delayed ,however, with the development of information technology and technology media, corporate financial reporting(85%-90%) and even interim reports are easily grasped by the media and even predicted(Ball and Brown, 1968).It can be inferred that, in the current information age, media propaganda enables market participants to understand the operating conditions of enterprises before the release of financial reporting, to make reasonable predictions in advance. There are various signs that financial reporting has lost its traditional market dominant position to some extent, and they are just one piece of useful information. iii) Financial reporting gives the problem of information asymmetry. The financial reporting is prepared by the internal staff of the company, so there is a large degree of subjectivity. Lev indicates in some cases, due to the manipulation of data reports by internal management personnel, the information content of the financial reporting is low (Lev, 1989). It will lead to the result that low useful information will affect the predictions of users of financial reporting on the company's future profitability development. In addition, large companies have a greater response to earnings announcements. Most of the reported profits are not lost. Apart from that, small companies further seize the market by disclosing profit-related information (Beaver, McNichols and Wang, 2018). This phenomenon will not merely mislead capital market participants, but also lead to vicious market competition. It can be seen that, information asymmetry and loss of supervision have limited the possibility of financial reporting becoming a new source of information in the capital market. iv)Investors' subjective factors also limit the usefulness of financial reporting. Investors are sometimes biased towards financial reporting and are highly subjective. It is specifically reflected in the limited attention and inclination of investors. The subjective propensity of investors sometimes underestimates the risk shown in the financial reporting or overestimates the budget. Besides, the conservatism and over-confidence of financial reporting users not merely tend to retain excess prior beliefs but also reflected in insufficient or overreaction to new information, leading to irrational investment results. For price perception, investors are not fully aware of the impact of current returns on prices on future returns, which will affect their investment decisions (Mahmoudi and Salari, 2016). For example, the abnormal rate of return generated by the good news or bad news provided by the financial reporting floats, which leads to the abnormal drift of the earnings announcement. In view of this, it is difficult for investors to rely on financial reporting as the only useful information to make decisions. For accruals anomaly, low reliability in accruals may be ignored by investors, apart from that, investors may ignore the possibility of lower future returns for growth companies. Therefore, it is hard for them to make a rational decision. Finally for the short-term window evidence that FAI causes share prices to change (Ball and Brown, 1968), therefore, it is unrealistic for investors to determine the usefulness of financial reporting and make rational decisions based on the data. In conclusion, after the release of the financial reporting, a series of objective and subjective factors have led to the limitation in financial reporting. At the same time, it is difficult for investors to make rational investment choices based on a single factor.

How to adjust the problems existing between financial reporting and capital market participants so that investors can make reasonable decisions? First, the reliability and relevance of financial reporting determine its usefulness in the capital market. Fierce information competition between companies proves that earnings announcement is a superior source of information because it can convey more extensive and true information than other independent sources of information (Basu et al., 2013). In view of this capital market affirmed that financial reporting brings useful information to investors. However, with the development of informatization and the improvement of corporate governance capabilities of the internal management system, much other information and reported income (dividend announcements, other financial reports, etc.) are presented to the capital market along with financial reporting. In addition, net income has become an important indicator for investors to evaluate companies as well (Basu et al., 2013). This phenomenon makes financial reporting only one piece of useful information in the capital market. Under this circumstance, investors should pay attention to changes in market stock prices promptly. Do not rely solely on financial reporting as a data source but ask and follow the opinions of financial analysts and related professionals, choose reliable data from multiple sources, analyze carefully and make rational decisions. Second, companies need to pay attention to the quality of accounting information. When facing deadlines, companies pay more attention to timeliness rather than accuracy. In addition, the decentralized organizational system within the company leads to inconsistent information. Therefore, the company must pay attention to the integrity of information while preventing excessive information (xu et al., 2003). It is suggested that enterprises can rationally use the accounting information system model, and under the FASB model, ensure that its relevance and reliability are unified to provide more comprehensive accurate financial information to the capital market (Jonas and Blanchet, 2000). Third, improve the market supervision system. Although IFRS has been widely adopted globally (and basically consistent with US GAAP), there is still competition in financial reporting supervision. There are uncertain factors in how to implement, additional disclosure requirements, enforcement and penalties, and the supervision of the third-party intermediary structures (Leuz and Wysocki, 2016). Therefore, the capital market must clarify regulatory regulations, formulate clear regulatory penalties, and form a healthy competitive capital market to provide market participants with a safe and reliable investment environment.

2. Conclusions

Through analysis and comparison, the paper concludes that financial reporting provides useful information for capital market participants under the traditional model due to their relevance, reliability, and completeness. However, it is difficult for traditional financial reporting to accurately and sensitively capture the impact of more valuable economic changes (Healy and Palepu, 2000). That means traditional financial reporting has the problem of information lag. In addition, the variability of market and capital market participants' reasons, which have led to the limited useful information provided. In summary, it is recommended that investors, internal enterprises and the capital market should work together to reconcile the inconsistence between capital market participants and financial reporting so that investors can effectively use the useful information provided by financial reporting, reasonably analyze the development prospects of the company, estimate risks, and invest rationally. The limitation of this article is that the analysis and conclusions are all based on the previously published research literature, and there is no actual data analysis.

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