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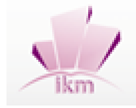

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THE IMPORTANCE OF FINANCIAL REPORTING FOR INVESTMENT DECISION MAKING

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Abstract: The process of decision making requires information, financial and non-financial information as well. The most important financial information needed in the process of business and investment decisions comes from accounting, i.e. financial reporting in a company. Therefore, it can be said that accounting is a service function to the management in a company. It basically processes or gathers and studies "raw data" and converts them into suitable information, necessary for the process of decision making. The basic characteristics of the accounting are: gathering, processing and presenting accounting (financial) information; information considering company's business and those directed towards different interested users. Accounting process contains several phases and basically, it is a process in which input data are converted into output information. All organizations, both public and private, need to disclose financial information relating to their operations in order to assist investors in making investment decisions. They do so as a matter to satisfy the legal requirement, retain existing investors and to attract potential ones through the publication of their financial statements where the capital stock of an organization is widely held and its affairs are of interest to general public relations.

Financial statement methods in terms of information disclosure pattern, transparency, auditing, reporting standards, regulatory control and flexibility, corporate governance and financial scandals have influence on investment decision making in any organization. The perceived relevance of the financial statements are to provide information about the financial position, performance and changes in financial position of a company, that is useful to a wide range of users in making management and investment decisions. These users include managers, directors, employees, prospective investors, financial institutions, government regulatory agencies, media, vendors and general public.

Accurate and transparent business and corporate reporting are in the spotlight today, more than ever before. National and also international market conditions and frequent company failures both highlights needs for transparency and efficiency in the process of generation and dispatching of information. Transparency is necessary in order to meet regulators and authorities requirements, while efficiency is important for enabling company executives to quickly respond to changing market conditions and meet investors and analysts needs.

The benefits of standardized and high quality financial reporting are: lower preparation costs, simplified and international access to information, standardized information recognized and understood by all recipients, high degree of required transparency by regulators, enhanced analytical capabilities and most important of all: enhancement of informed and efficient investment decisions.

Keywords: financial, reporting, information, investment, decision making.

1. INTRODUCTION

Business is moving at an increasingly faster pace - a fact not lost upon the financial markets, which are loudly demanding efficient financial, i.e. business reporting, in order to keep up. Companies are facing regular challenges in the dissemination of financial information, both internally within their group and externally to the analysts, investors, local authorities and stock exchanges. It is clear that the speed of gathering qualitative information is of essence and big importance, that's why loss of accuracy is an increasingly apparent risk.

One of the aims of financial reporting is to facilitate the capital allocation in economy which stems from investment decisions improvement. In fact, increasing of financial transparency is a potential factor for reducing the investment inefficiency. More financial reporting quality and using of valid convention and standards in financial reports and

auditing preparation, increase confidence in financial information by users and decreases information risk, therefore, increases stock`s value. The importance of financial information quality multiples when some financial and nonfinancial events occur. Participants in these events need transparent information with high quality of firm's performance and position, to mitigate information asymmetry. However, the importance of present study is to discover the relationship between financial reporting and investment efficiency and also influential factors on this relationship, in order to help users of financial statements in optimal decision-making.

2. THE BENEFITS FROM HIGH QUALITY FINANCIAL REPORTING

Theoretical arguments and empirical evidence suggest a positive relation between financial reporting quality and economic growth. Specifically, findings show that a good financial reporting system lowers the cost of capital and improves capital allocation efficiency. These findings suggest that a high-quality financial reporting system is likely to facilitate economic growth, one of the ultimate goals of economic policy of each country.

A better way to examine the implications of financial reporting quality for growth is by focusing on specific channels through which the effects of financial reporting may manifest. In particular, theoretical arguments suggest that high-quality financial reporting helps companies lower the cost of capital and improve project identification and project selection by reducing information uncertainty and asymmetry. In conditions of absence of information uncertainty and information asymmetry, managers can perfectly identify value maximizing projects and investors can contractually obligate managers to pick the value maximizing projects, making accounting information (financial reporting) less useful. Therefore, we argue that the marginal benefit from financial reporting quality is higher in industries with more information asymmetry and uncertainty.

Overall, the results in many papers imply that financial reporting quality may not be a critical growth factor for countries that heavily invest in low information uncertainty industries (e.g., mature industries or industries with more tangible assets than intangible assets). However, as a country moves upward along the chain of industrial evolution and focuses more on industries with greater information uncertainty, such as high–growth or high–tech industries, a high-quality financial reporting system can play a pivotal role in fostering faster economic growth

The primary objective of financial reporting is to provide high-quality financial reporting information concerning economic entities, primarily financial in nature, useful for economic decision making. Providing high quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit, and similar resource allocation decisions, enhancing overall market efficiency[176].

Although both the FASB and IASB stress the importance of high-quality financial reports, one of the key problems found in prior literature is how to operationalize and measure this quality. Because of its context-specificity, an empirical assessment of financial reporting quality inevitably includes preferences among a myriad of constituents. Since different user groups will have dissimilar preferences, perceived quality will deviate among constituents. In addition, the users within a user group may also perceive the usefulness of similar information differently given its context. As a result of this context and user-specificity, measuring quality directly seems problematic. Consequently, many researchers measure the quality of financial reporting indirectly, by focusing on attributes that are believed to influence quality of financial reports, such as earnings management, financial restatements and timeliness.

In 2002, the IASB and the FASB showed their commitment towards developing a common set of high-quality accounting standards, which could be used worldwide. As a consequence of the joint project to converge the more principles-based IFRS and the more rules-based US GAAP, both boards agreed to develop new joint Conceptual Framework, which includes the objectives of financial reporting and the underlying qualitative characteristics on which accounting standards ought to be based. In May 2008, the FASB and the IASB therefore published an exposure draft of 'An improved Conceptual Framework for Financial Reporting'. This Conceptual Framework represents the foundations of the accounting standards. "The application of objectives and qualitative characteristics should lead to high-quality accounting standards, which in turn should lead to high-quality financial reporting information that is useful for decision making". Furthermore, the conceptual framework ought to contribute to decision making of constituents, when transactions or events occur for which no accounting standards are available (yet). According to the ED, providing decision-useful information is the primary objective of financial reporting.

[176] Aharony, J., R. Barniv, and H. Falk (2010). The impact of mandatory IFRS adoption on equity valuation of accounting numbers for security investors in the EU. *European Accounting Review* 19 (3): 535 - 578.

Decision-useful information is defined as "information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers".

3. HOW DOES FINANCIAL REPORTING AFFECT INVESTMENT EFFICIENCY

Financial reporting quality can improve investment efficiency mainly by reducing information asymmetry, in two ways:

(1) it reduces the information asymmetry between the companies and investors and thus lowers the firm's cost of raising capital; and

(2) it reduces information asymmetry between investors and the managers and thus lowers the shareholders' cost of monitoring managers and improves project selection.

The two key constructs in our short analysis are investment efficiency and financial reporting quality. We assume that a company is investing efficiently if it undertakes all and only projects with positive net present value (NPV) under the scenario of no market frictions, such as adverse selection or agency costs. Thus, inefficient investment include spassing up investment opportunities that would have positive NPV in the absence of adverse selection (underinvestment). Likewise, inefficient investment includes undertaking projects with negative NPV (overinvestment). Investment efficiency is measured as deviations from expected investment using a parsimonious investment model, (that is not part of our analysis) which predicts expected investment as a function of growth opportunities. Thus, both underinvestment (negative deviations from expected investment) and overinvestment (positive deviations from expected investment) are considered inefficient investment[177].

On the other hand, financial reporting quality can be defined as the precision with which financial reporting conveys information about the companies' operations, in particular its expected cash flows, in order to adequately inform equity investors. As described in the FASB Statement of Financial Accounting Concepts No. 1, financial reporting should "…provide information that is useful to present and potential investors in making rational investment decisions…" and "…provide information to help present and potential investors in assessing the amounts, timing, and uncertainty of prospective cash receipts...". Further, expected cash flows is a key input to companies' capital budgeting, which is particularly important in the context of analysis of relationship between the financial reporting and the process of investment decision making.

In general, there are three channels of companies' financial reporting affecting companies' investment efficiency. Namely, accounting information:

(1) reduces capital market imperfections,
(2) facilitates internal and external investment decision making (project identification), and
(3) enables external capital suppliers to monitor companies'decisions.

First, without financial market imperfections theoretically all investment opportunities with positive net present values are funded and implemented by companies. In reality, financial market imperfections are severe and companies' resources allocation could be inefficient. For example, companies could suffer from financing constraints that limit their ability to fund potential projects, suggesting that underinvestment may take place. Even if financing is available, managers' allocation of resources could be inefficient, due to overinvestment (e.g. empire building) resulting in a reduction of profitability and company value. A general purpose of financial-accounting reporting is to reduce adverse selection or moral hazard costs associated with information asymmetry, in order to foster the efficiency of capital markets.

Second, financial reporting affects the economic performance of companies by providing information that helps managers to identify investment opportunities. As investment decisions depend on expectations about future growth and product demand, financial reporting information aids stating more precise expectations, and thus helps to distinguish resources from "bad" to "good" projects. Hence, higher quality financial reporting should improve companies' investment decisions.

Third, financial reporting information acts as a control mechanism for external capital suppliers. Monitoring the companies through their financial disclosure (financial reports), capital suppliers could evaluate their future cash flows, assess how risky their capital is invested, and if necessary intervene.

[177]Biddle, G. C., G. Hilary, and R. S. Verdi. 2009. How does financial reporting quality relate to investment efficiency?" *Journal of Accounting & Economics*. 48 (2/3): 112-131.

Neoclassical model of investment predicts that a company will invest up to a level where the marginal cost of investing is equal to the marginal profitability of capital. Thus, investment should only increase with underlying investment opportunities. However, the misalignment of managerial and shareholders incentives and asymmetric information between corporate insiders and the capital market, could cause investment to vary with internal cash flows. Under the agency view, managers over-invest to reap private benefits such as “perks”, large empire, and entrenchment. Because external capital market disciplines managers from pursuing self-interested investment, an influx of cash flows enables managers to invest more. Under asymmetric information, managers in the interest of existing shareholders restrict themselves from external capital market due to costly external capital, and thus investment is expected to increase with internal cash flows. A substantial body of studies provide empirical evidence that corporate investment increases with internal cash flows. Furthermore, most of literature interprets a lower sensitivity of investment to cash flow as evidence of lower agency or information friction, thus lower investment distortions.

Traditional theories of corporate investments share the common assumption that capital market is efficient with respect to either disciplining misbehaved managers or incorporating all available information. However, a growing body of studies in accounting and behavioral finance suggests that the market efficiency premise should be viewed with some skepticism.

4. THE ROLE OF IFRS IN PROCESS OF INVESTMENT DECISION MAKING

Financial statements are the principal means through which a company communicates its financial information to all users outside it (stakeholders). Financial statements provide a company’s history quantified in money terms. The most frequently provided financial statements are:

(1) the statement of financial position,
(2) the income statement or statement of comprehensive income,
(3) the statement of cash flows, and
(4) the statemen tof changes in equity.

Notes and disclosures are an integral part of each financial statement.

Some financial information is better provided, or can be provided only, by means of financial reporting other than formal financial statements. Examples include the president’s letter or supplementary schedules in the corporate annual report, prospect uses, reports filed with government agencies, news releases, management’s forecasts and social or environmental impact statements. Companies may need to provide such information because of authoritative pronouncements, regulatory rule, or custom. Or they may supply it because management wishes to disclose it voluntarily.

Resources are limited. As a result, people try to conserve them and ensure that they are used most effectively. Efficient use of resources often determines whether a business thrives. This fact places a substantial burden on the accounting profession. Accountants must measure performance accurately and fairly on a timely basis, so that the right managers and companies are able to attract investment capital. For example, relevant financial information that faithfully represents financial results allows investors and creditors to compare the income and assets employed by such companies as Nokia (FIN), McDonald’s (USA), Air China Ltd. (CHN) and Toyota Motor (JPN). Because these users can assess the relative return and risks associated with investment opportunities, they channel resources more effectively. Illustration 1 shows how this process of capital allocation works.

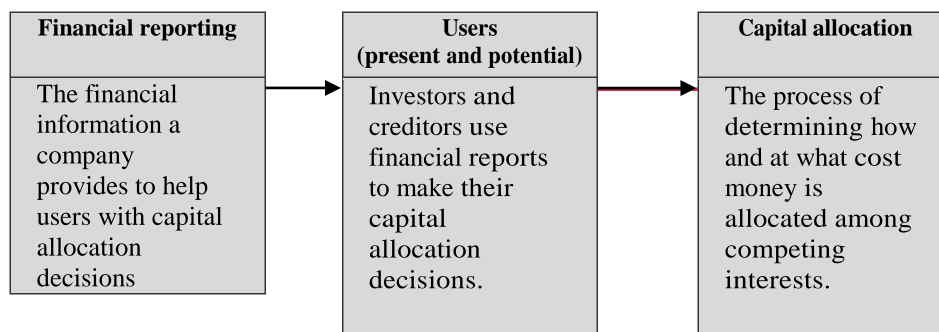

Illustration 1: Capital allocation process

An effective process of capital allocation is critical to a healthy economy. It promotes productivity, encourages innovation and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit. Unreliable and irrelevant information leads to poor capital allocation, which adversely affects the securities markets.

To facilitate efficient capital allocation, investors need relevant information and a faithful representation of that information to enable them to make comparisons across borders. For example, assume that you were interested in investing in the telecommunications industry. The five largest telecommunication companies in the world in descending order of revenue size are AT&T (USA), Verizon Communications(USA), Nippon Telegraph and Telephone (JPN), Deutsche Telekom (DEU), and Telefonica (ESP and PRT). How do you decide which, if any, of these telecommunications companies you should invest in? How do you compare, for example, a U.S. company like AT&T with a Japanese company like Nippon Telegraph and Telephone?[178]

A single, widely accepted set of high-quality accounting standards is a necessity to ensure adequate comparability. Investors are able to make better investment decisions if they receive financial information from AT&T that is comparable with Nippon Telegraph and Telephone. Globalization demands a single set of high-quality international accounting standards. But how is this to be achieved? Here are some elements:

1. Single set of high-quality accounting standards established by a single standard setting body.
2. Consistency in application and interpretation.
3. Common disclosures.
4. Common high-quality auditing standards and practices.
5. Common approach to regulatory review and enforcement.
6. Education and training of market participants.
7. Common delivery systems.
8. Common approach to corporate governance and legal frameworks around the world.

Fortunately, significant changes in the financial reporting environment are taking place, which hopefully will lead to a single, widely accepted set of high-quality accounting standards is developed.

Recent empirical research in economics and finance investigates the relation between financial accounting information and economic performance. A general purpose of financial accounting information is to reduce costs of adverse selection or moral hazard associated with information asymmetries to foster the efficiency of capital markets. Hence, capital market frictions (e.g., restrictions in raising external capital) should be mitigated by high quality information allowing external capital suppliers to better assess information about the company's investment opportunities and monitor managerial actions. Thus, higher-quality financial reporting should improve companies' investment decisions. In line with this prediction, several empirical studies provide evidence that higher-quality financial reporting is associated with more efficient companies investment.

In this part we examine the impact of adopting IFRS on companies' investment efficiency. IFRS are adopted by companies in more than 100 countries around the world seeking to harmonize companies' financial accounting, and thus to facilitate their comparability in different countries. Besides the comparability effects, various other benefits are expected to come with an adoption of IFRS. Recently, there has been much research on the consequences of IFRS adoption. Several studies find that adopting IFRS leads to a higher accounting quality, more market liquidity and a lower cost of capital.

Financial economics theories argue that companies' suboptimal capital investment processes are largely driven by the information asymmetry between companies and outside capital providers. Some finance theories demonstrate how the *ex ante* information asymmetry between managers and outside capital suppliers influences how a company allocates its capital to investment opportunities. Other theories highlight how the *ex post* information asymmetry between shareholders and bondholders renders companies' investment policy suboptimal.

If information asymmetries between managers and outside capital suppliers contribute to suboptimal investment policies, then a reduction in this asymmetry could ameliorate the problem. The adoption of better accounting policies and a subsequent increase in reporting quality could reduce this asymmetry; Biddle and Hilary (2006) find that reporting quality is negatively associated with the sensitivity of companies' investment to cash flow.

[178] Ding, Y., O. K. Hope, T. Jeanjean, and H. Stolowy. 2007. Differences between domestic accounting standards and IAS: Measurement, determinants and implications. *Journal of Accounting &Public Policy* Vol. 26 (1): 1–38.

The adoption of a single set of global standards could reduce information asymmetry by improving the level of comparability of financial statements, therefore improving investors' ability to identify good (and bad) investment opportunities. Comparability across companies and across countries could improve after the adoption of IFRS if investors, financial analysts, auditors, regulators and other stakeholders no longer need to understand financial statements that are prepared using different accounting standards from many jurisdictions, reducing information processing costs. Many researches find that the value relevance of goodwill, research and development expenditures, and property, plant and equipment revaluations is positively associated with the level of deviation between local accounting standards and IFRS, suggesting that the informativeness of these accounting items to investors increases after the mandatory adoption of IFRS.

In addition, the adoption of accounting standards that require a higher degree of disclosure can enable outside capital providers to more effectively compare value-creating investment projects with value-destroying investment projects. For instance, Li (2010) shows that the mandatory introduction of IFRS in the EU increases disclosure levels, resulting in lower cost of equity capital by an average of 47 basis points. If the disclosure level increases from compliance with the reporting requirements of IFRS, managers' investment policies could become more visible to investors, increasing the transparency of companies' investment policies and reducing information asymmetry.

As the level of disclosure and the comparability of financial information increases, agency problems stemming from information asymmetry with outside capital providers should decrease. Increased financial reporting quality, for example, facilitates the identification of positive NPV projects by outside capital providers, therefore it should be associated with reduced adverse selection problems (e.g., capital rationing by shareholders) that companies might encounter when issuing securities to finance positive NPV projects. Additionally, increased accounting transparency enhances external monitoring to reduce insiders' dysfunctional behavior such as moral hazard, empire building, free cash flow problems and escalation of commitment, among others.

The conclusion is that the mandatory adoption of IFRS is associated with enhanced company-level investment efficiency. After the mandatory adoption of IFRS, companies' investment policy is associated with a shift towards a risk adjusted optimal level while their investment-cash flow sensitivity decreases. Further, this association is more pronounced in countries with weak law enforcement institutions and higher ownership concentration. Considering these results it can be concluded that the adoption of IFRS benefits outside capital providers through the increased financial disclosure and comparability of accounting information, and thus, enhanced investment efficiency. This suggests that the use of IFRS is associated with enhanced investment efficiency at the company level, a matter of great importance to firm managers and regulators worldwide.

5. CONCLUSION

Financial reporting quality has economic consequences such as increased liquidity, lower costs of capital, and higher company growth. This short paper show that financial reporting information can reduce information asymmetries that impede efficient corporate investment policies.

IFRS requires a higher level of disclosure in financial reporting relative to most national accounting standards; an increased level of disclosure is linked to increased accounting quality and decreased information asymmetry between controlling shareholders and outside capital supplier. The improved financial reporting environment could increase the effectiveness of oversight and discipline that international financial intermediaries provide to markets, reducing the opportunity for controlling shareholders to expropriate returns from outside capital suppliers by undertaking value-destroying investment projects. Therefore, minority investors should be able to use the enhanced disclosures required under IFRS to identify dysfunctional investment processes of controlling shareholders.

Under IFRS, companies are required to disclose more comprehensive information relative to local accounting standards; this higher degree of disclosure requirements is expected to reduce information asymmetry between controlling shareholders and outside capital suppliers. Reduced information asymmetry after the adoption of IFRS should allow current and potential outside capital suppliers to more easily identify controlling shareholders' dysfunctional investment processes (e.g., under- and over-investment). Thus after the adoption of IFRS, outside capital suppliers monitor and discipline controlling shareholders' self-serving investment policies. If the disclosure of more comprehensive financial information facilitates more effective monitoring mechanisms, controlling shareholders should not be able to expropriate wealth from outside capital suppliers as easily by undertaking value-destroying investment projects. A reduction in expropriation risk can decrease shareholder concentration by improving outside capital suppliers' ability to identify companies that are attractive investment targets. If this is the case, companies with valuable growth opportunities that report their financial statements in compliance with IFRS

should be able to attract sufficient external capital to finance profitable growth opportunities, increasing the efficiency of firms' investment policies.

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