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Importance of Corporate Financial Reporting and Disclosure in Making Economic Decisions

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Abstract

Financial reporting and disclosure are used to communicate useful information to various users and help them to make appropriate economic decisions. This paper has purpose to clarify the importance of reporting and disclosing accounting information for companies and stakeholders in different aspects, including real investment, debt and equity instruments investment and executive compensation.

Keywords

Accounting Infromation; Economic Decisions; Stakeholders; Communicating and Processing Information Obstacles.

1. Introduction

Information asymmetry exists between companies and their stakeholders, leading to inefficient decision making. The objective and purpose of financial reporting is to reduce such information asymmetry and to provide stakeholders, such as investors and lenders, with useful accounting information about the reporting entity in making decisions, involving decisions on providing or settling loans and buying, selling or holding debt and equity instruments [1]. This paper aims to clarify the importance of financial reporting and disclosures in helping stakeholders to make reasonable economic decisions. Firstly, the paper will discuss the reasons why companies should report accounting information to stakeholders, including creditors, capital market investors, managers, etc., and how these stakeholders use accounting information to make decisions. Secondly, the channels through which accounting information is transmittted will be explained. Finally, obstacles that exist when companies communicate information to users and when users process information will be discussed.

2. Importance of Providing Accounting Information to Stakeholders

This part will explain the reasons for corporations to report and disclose information for stakeholders, and how stakeholders use this information to make economic decisions in the aspects of different activities, including real investment activities, financing activities and executive compensation.

2.1. Real Investment Activities

Firstly, financial reporting could assist to mitigate moral hazard and to improve real investment efficiency by increasing transparency, facilitating the monitoring of managers' investment decisions and incentivising managers through contracts based on accounting information [2]. Secondly, firms tend to use rules that are consitent with external financial reporting to measure performance for internal decision making [2]. Thus, financial accounting rules are the basis of managerial accounting systems and managerial information, which are the primary source of information for managers' decisions such as capital budgeting [2]. For instance, when deciding which projects to invest in, the NPV rule and the IRR rule are widely used, which requires a forecast of the future cash flows of projects. A firm's current business performance showed by

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accounting information is the basis for future cash flow projections. Therefore, managers and the board of directors need information about a firm's operations to make reasonable real investment decisions. Finally, a company's real investment decision is influenced by the disclosures of its competitors. If competitors' financial reports and disclosures inform managers of other companies regarding economic conditions, the reproting and disclosures may help managers make more informed investment decisions [2]. Furthermore, estimates of future earnings, sales, and capital expenditures voluntarily reported and disclosed by peer firms can help managers develop more precise estimates of aggregate demand and supply conditions. Therefore, reporting and disclosures by peer companies can help managers identify new investment opportunities and improve their investment decisions [2].

2.2. Financing Activities

2.2.1. Debt Market

In order to raise money in the debt market, it is important for companies to report accounting information for creditors, and lenders need this information for pricing and trading debt security and designing debt contracts. Otherwise, creditors will not be willing to lend them money. First, the value of a debt security is its cash flows specified beforehand, discounted by the discount rate based on the company's credit rating. Credit rating agencies assess the creditworthiness of firms on the basis of their capital structure, liquidity and cash flow, as reported in their financial reports and other information [3]. Investors can then rely on the credit ratings to evaluate the credit risk of different issuers and debt securities, and make investment decisions and manage portfolios [3]. For borrowers, they can use credit ratings to demonstrate the creditworthiness of their debt securities in order to raise money and to anticipate the interest rates of their new debt issues [3].

In addition, financial reporting and disclosure can be used to design debt contracts. Creditors may be concerned about claim dilution, dividend payments, asset substitution and underinvestment, which may increase the likelihood of loan default; thus, lenders will be required to add covenants in the debt contract to restrict additional borrowings, dividend payments and investment activities to protect lenders [4]. There may be accounting-based covenants such as interest coverage ratio and capital expenditure restrictions, where income statement and balance sheet numbers are used in covenants. When determining which covenants should be added in debt contracts, borrowers should provide lenders with accounting information to help them understand borrowers' current financial conditions and performance. Although covenants can protect creditors, borrowers also benefit from the covenants, as they could pay lower interest rates. Thus, companies are encouraged to provide information to lenders.

2.2.2. Equity Market

Same as lenders, equity market investors also require accounting information to obtain an understanding of firm value and to make trading decisions; thus, it is important for companies to report to them in order to raise capital in the equity market. Accounting information is a description of past economic activities, while value depends on future cash flows; however, past performance may reflect to some extent the intrinsic characteristic of companies. In practice, accounting information is widely used in both absolute and relative valuation of a frim. In absolute valuation, investors or analysts tend to use the free cash flow model, the dividend discounted model and the residual income valuation model to project firms' future business and conduct business valuation, with accounting information as the basis for forecasting [5, 6]. For example, when conducting residual income valuation, accounting information such as book value of equity and current earnings and total payout which are used to forecast future residual income are required. In relative valuation, investors and analysts focus on specific accounting

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measures such as PE, PB and PS of comparable companies and the earnings, book value and sales of the target companies [5].

Furthermore, Zhang develops an accounting-based model of equity value/real option based model (ROM) that incorporates real options, i.e. a company's flexibility to expand or abandon business activities [6]. According to ROM, return on equity (ROE) (comes from the income statement and the balance sheet) and equity book value (comes from the balance sheet) are the most essential accounting variables for valuation, which represent the profitability and scale of a company's investment respectively [6]. Furthermore, when applying ROM to multiple-segment firms, it is found that segment reporting will have an incremental effect on valuation if profitability and/or growth opportunity of the segments are different [6].

Providing accounting information in equity market not only helps investors to select stocks and make investments, but also help companies to raise capitals. Firms with favourable information are more willing to disclose information than those with unfavourable information [7]; therefore, disclosures are seen as a positive signal for investors, and they prefer to invest in companies with adequate disclosures. Additionally, companies can also use business valuation to make financing decisions, select capital investment projects, evaluate their corporate events such as M&A and assess business strategies. For example, if stocks are overvalued, managers are more likely to raise money through equity financing, as they can receive more money for each share sold. Convesely, managers may choose to repurchase shares if they believe stocks are undervalued.

In addition to stock price, stock return is also important for investors and managers. In finance theory, stock returns are associated with firm risks, especially systematic risks; however, some empirical results show that equity returns are driven more by financial reporting information than by risks [6]. Zhang develops a model of stock returns from ROM, which shows that stock returns are connected with following five factors: earnings, the change in profitability, capital investment, the change in growth opportunity, and the discount rate change [6]. The estimation result shows that about half of what the equity return model can explain is each explained by earnings and the profitability change, followed by the change of growth opportunity, capital investment, and the discount rate change [6]. Among these factors, current performance (earnings) and the changes in operational characteristics (investment scale, book value of equity and efficiency, ROE) are from financial reporting.

2.3. Executive Compensation

Accounting information is also important when determining executive compensation, as performance-based pay could contribute to more efficient outcomes and is more widely applied by companies. An executive's compensation package typically consists of salary, bonus, restricted stock/option grants and long-term incentive plan payouts. When setting salaries, salaries may be adjusted annually on the basis of accounting measures. Bonuses are more associated with accounting performance such as earnings per share, net income and profitability (ROE). Both performance-vesting and time-vesting equity-based compensation are dependent on accounting information. To be more specific, accounting performance plays a direct role and an indirect role in performance-vesting equity-based compensation through initial award of shares and the actual benefit received which is dependent on stock price. Accounting measures also play an indirect role in time-vesting equity-based compensation through its impacts on stock price. When it comes to adopting multi-year accounting performance (MAP) in executive compensation, Li and Wang find that MAP is related to firm and investor characteristics, including stock price quality compared with accounting performance measures [8]. Thus, the board of directors can use accounting information to understand their companies' characteristics, and to make decision on whether they should adopt a MAP plan. In general, board of directors relies on financial reporting to determine

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compensation for executives, and to incentive directors to make economic decisions which will increase accounting performance. However, this may cause incentives to manipulation, which will be discussed later.

3. Information Transmitting Channels

From this section, we will discuss two main channels through which firms communicate information, including mandatory and voluntary disclosures. Firms tend to disclose information mandatorily through making earnings announcements and regulatory documents such as financial statements, deficiencies on internal control and non-financial information. In terms of voluntary disclosures, companies usually disclose through management discussion and analysis (MD&A) in the annual report, management earnings forecasts, social networking platforms such as Facebook, Twitter and Sina Weibo, etc. According to [9], real-time social media provide instant information to stakeholders, and strengthen companies' social bonds with its stakeholders. Furthermore, many investors believe that information on social media is informative and credible, which can be used for decision making [9]. Currently, social media have been used by an increasing number of corporations to convey their information. For example, Tesla's CEO, Elon Musk wrote a tweet to discuss about taking Tesla private, leading to a 6% rise in Tesla's share price in August 2018 [9].

4. Difficulties in Communicating and Processing Information

Although financial reporting and disclosure are important for companies and their stakeholders, difficulties exist for firms to communicate information and users to process information, which influence usefulness of accounting information and decision-making.

4.1. Manipulation

Accounting performance may affect interests of insiders such as managers and controlling shareholders; thus, they may have incentives to manipulate financial reports through various tools such as accrual manipulation, real activity management and commitment of financial fraud. Accounting information will be biased and misleading if a reporting manipulation exists, which will lead to unwise economic decisions made by stakeholders, including inefficient contractual arrangement, misallocation of resource and unfair wealth transfer.

Firstly, financial manipulation may be induced by debt contracts, as violation of debt covenant is costly, including increased interest rates, renegotiation and waiver fees, adding additional covenants, and shift of control rights. Therefore, firms have incentive to manipulate financial information to avoid accounting-based covenant violations.

Secondly, in order to avoid decreasing of share price, management may manipulate accounting information to meet analyst forecasts on EPS. Managers also have a tendency to release bad news more slowly or more held back than good news [10]. For multiple-segment firms, they can even manipulate firm valuation through applying ROM. Zhang discovers that when growth opportunities of entities are the same and consolidated earnings and assets remain unchanged, as profitability of different segments move apart, total firm value will become greater [6]. Furthermore, if growth opportunities are different and the entity that is more profitable has more growth opportunity, the divergence of segment profitability (DOP) will contribute to higher total firm value [6]. Otherwise, when the more profitable entity has less growth opportunity, DOP will result in lower total firm value [6]. Thus, given overall firm profitability, managers can manipulate accounting data to increase the firm's valuation by shifting earnings of one entity to another entity through applying methods such as setting transfer price for intra-company transactions and cost allocation.

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Finally, since there is a direct and indirect link between executives' compensation and accounting performance through salaries, bonus and equity-based compensation, executives have strong incentives to manipulate reported performance. Furthermore, if a director is dismissed by a company, he or she will face restrictions in seeking other employment opportunities due to non-compete provisions; therefore, the director may try best to secure the job through earning management.

4.2. Cost of Disclosures

In practice, disclosures of information are not costless. The first cost of disclosures is the cost of hiring people to certify information; the second cost is that firms may lose competitive advantages if other companies know their secrets through full disclosures [11]. Companies only disclose information if benefits exceed costs; therefore, many corporations only make a partial disclosure instead of a full disclosure.

4.3. Processing Difficulties

According to [11], investors may make mistakes when processing information, leading to market anomalies, that is underreaction and overreaction. The psychological theories of the "representative heuristic" and "conservatism" can be used to explain the overreactionn and underreaction. Firstly, the representative heuristic states that individuals have tendency to see patterns in random sequences [11]. Investors may be too quick to observe patterns in the feigned features of information [11]. For example, when people notice that there is a continuous increase in a firm's earnings for several years, they believe that they have discovered a trend and it will sustain in the future; however, long-run changes in company earnings have a random pattern in reality [11]. Such overly optimism leads to overreaction.

Secondly, there are biases such conservatism when human processing information. Conservatism states that it takes time for investors to change previous impression when facing new evidence, once impression has been formed [11]. Investors will be suspicious of new information and can only change their views gradually, resulting in underreactions. Post earnings announcement drift (PEDA) is an example of investor underreaction, that is stock prices adjust gradually and slowly to earnings news. Empirical results show that the release of news on all five factors will cause price drift, and earnings news has the largest drift magnitude, followed by news on profitability, capital investment, growth, and finally discount rate [13]. However, some research shows that the responsiveness of institutional investors and analysts can help to reduce the PEAD [14, 15].

5. Conclusion

In conclusion, it is important for companies to report and disclose accounting information to stakeholders, because this can help firms to make real investments, raise capitals from debt and equity market, and set executive compensation. Accounting information can also help stakeholders to make economic decisions such as making investment in debt or equity securities, designing debt contract and designing executive compensation. In order to transmit accounting information, companies often use two main channels, that is mandatory and voluntary disclosures. However, obstacles exist when firms communicating information to users and when users processing information due to potential manipulation, costs of disclosures and over/under reactions of users.

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