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Reactions of capital market to financial reporting

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Abstract
This study aims to understand the role of capital market research in assessing the information content of accounting disclosures, the assumptions of market efficiency adopted in capital market research, the difference between capital market research that looks at the information content of accounting disclosures, and capital market research that uses stock price data as a benchmark for evaluating accounting disclosures, be able to explain why unexpected accounting earnings and abnormal stock price returns are expected to be related and to describe the main results of capital market research in financial accounting and disclosure. Conclusions about market reactions to certain released information or events are based on general evidence from a large number of companies, with data spanning several years. This type of research is often used to examine equity market reactions to corporate information announcements, and to assess the relevance of accounting choices and alternative disclosures for investors. If the price of a security changes around the time of the release of certain information, and assuming that information and not some other event causes the price change, then it is considered that the information is relevant and useful for investment decision making.

Keywords: Capital Market, Financial Reporting, Market Reactions

1. Introduction

The developments in auditing and accounting standards, as well as rapid growth in global business have created a need for quality assessment of corporate governance mechanisms, top management performance and corporate performance. Research on the quality of financial reporting includes business ethics, behavior-based research, political processes, and the effect of changes in accounting regulations or standards. Basically, capital market research requires analysis of the determinants of investment efficiency, cost of debt, cost of equity, investor protection, investor behavior, analyst forecasts, company profitability, and many others.

Research in this area is considered valuable in setting accounting standards, decisions in capital market investments, in decisions relating to corporate financial disclosures, and external auditors. Financial reporting involves offering financial information about the reporting entity, which is valuable to potential and existing lenders, investors and other creditors in making decisions regarding the offering of resources to the reporting entity.

In particular, we look at compelling research on the impact of accounting alternatives and disclosure choices on the investment decisions of financial statement users such as sharemarket investors, financial analysts, bank loan officers, and auditors.

Reported earnings depend on many financial accounting decisions, managers have a lot of scope in choosing between alternative accounting methods and accounting assumptions. For example, they will choose between charging or capitalizing certain expenses; they will choose between alternative accounting methods such as straight line or reduced balance depreciation; use the full life of the asset to be depreciated; and so on, decisions must be made with respect to how much information to disclose, the medium for disclosure, and, in some circumstances, whether to recognize certain items in the financial statements, or only disclose them in the notes to the financial statements.

Basically, the capital market research examines the role of financial information such as accounting in the equality markets. In this form of research, statistical relations between financial information and returns or share price are examined while the investors' reactions are demonstrated by their transactions in the capital market. In case the security price change during the time when particular financial information is being released and this information resulted in price change, then the information would be considered useful and valuable for making investment decisions. The capital market research examines the financial reporting aggregate effect, especially the accounting earning reporting on investor through decisions about the analysis share price decisions. In accounting, equity markets are considered in the capital market research as semi-strong from efficient. That is to say, all disclosures that are publicly available are fully and rapidly impounded into share price impartially while being released.

The market cannot ignore the relevant information. Since there are only a few studies about what makes financial reporting from multinational companies valuable to the users, the study will try to bridge this knowledge gap. Because of the global financing by multinational companies and diversification of transnational portfolio by investors is still increasing, the study will demonstrate why the financial reporting by multinational companies are of significant importance. The ultimate objective is learning more with regard to why capital markets react to accounting information supplied by multinational companies.

2. Literature Review

Zakari (2014) [7] article will be used to explain how the International Financial Reporting Standards (IFRS) played an important role in fixing the international accounting standard; hence, creating an enhanced financial understanding of every company. Many countries in Europe have stopped using the U.S. GAAP to converge their financial reporting standard to IFRS. As pointed out by Zakari (2014) [7], the IFRS is a globalization manifestation since the financial reports that are prepared under this standard present an image that is in line with that of developed nations and multinational corporations. IFRS has been accepted by more than 115 countries across the globe, such as EU, U.S. China, Russia, Australia, and many others.

Cox and Weirich's (2002) [1] article will be used in this study to show how fraudulent financial reporting by companies has become a matter of serious economic and social concern. The authors point out that since the Treadway Commission report was published; Fraudulent financial reporting is increasingly becoming an important issue for accountants and the public at large. Between 1990 and 1999, many financial statement frauds have been reported and were fueled by increased significance by the entity for exceeding or meeting analysts' expectations. Given that financial markets require real-time financial information and the systems available for financial reporting only offer quarterly and annual reports, analysts filled the gap for immediate financial information. Because these expectations must be met, the company's management is very pressured to meet these demands. Driver and Weirich (2002) [1] argue that the pressure to meet analyst expectations has led many entities to use activities related to financial reporting. CEOs often engage in fraudulent attempts to inflate profits and consequently lead to a drop in stock prices. This negative impact affects both management and company shareholders who disclose fraudulent financial statements. As a result, negative reactions emerged in the capital market.

Meek's (1991) [4] study will be used to show why the responses in the capital market to earnings announcements are different. This study will also be used to show how accounting information or company characteristics are related to reactions to earnings announcements. According to Meek (1991) [4], company characteristics include exchange listing, size and analyst following.

A study conducted by Mureşan (2012) [5], will be used to demonstrate the ways in which the provision of financial market information sees improvement if capital market performance is regulated. The author observes that for the assessment and comparability of financial reporting, information must have the attributes of comparability, reliability, and availability. With the new information, increased liquidity increases the efficiency of the capital market. In 2008, The US Securities and Exchange Commission (SEC) adopted the XBRL (eXtensible Business Reporting Language) system to replace the Electronic Data Collection, Analysis and Retrieval system. Implementation should be carried out in 3 phases, between 2009 and 2011. Mureşan (2012) [5] observed that the trading volume recorded by firms that adopted XBRL was smaller than the sample of firms that did not adopt the system. According to the SEC, this new approach will increase market efficiency as well as remove information barriers.

In Dooley and Skalak (2011) [2] study, they observed that major capital markets in the world are fuelled and informed by timely, complete and accurate financial information of different types. This study will be used to demonstrate why other forms of information (scientific, commercial, demographic, and political data) are important to the activity of the capital market activity. To comprehensively examine fraud, Dooley and Skalak (2011) [2] observed that capital market definition that is relatively broad must be included in every forum whereby capital consumers contract with capital suppliers to satisfy their needs. The authors point out that capital markets focus on the flow of money between different parties and enable the fraudsters to redirect the funds' flow, normally by misleading the parties in the transaction with false financial information. In the present financial reporting and accounting environment, there are great temptations to commit irregularities in financial reporting.

Grüning's (2011) [3] article will be very important because it will help to show why so far neither the consequences of corporate disclosure nor the capital market implications have been fully explored. The author argues that the purpose of corporate disclosure is to offer information about activities related to the company's operations, and the company's business and financial situation to interested parties. Therefore, corporate disclosure is not limited to financial information because it also focuses on a large diversity of non-financial information. Grüning (2011) [3] observes that corporate disclosure increases the amount of information accessible to recipients. Actually, the disclosure of company information is purely driven by economic considerations. Previous studies as cited by Grüning (2011) [3] showed a sustained and strong effect on trading activity for various disclosure instruments. The effect of earnings announcements on stock turnover has been widely documented showing that disclosure has a positive effect on stock turnover. Saccon and Dima (2015) [6] will also be valuable because they show why IFRS is designed to offer high-quality and relevant financial information to diverse users, which can consequently lead to a reduction in capital market information asymmetry. Therefore, this study will help demonstrate how changes to financial reporting for joint ventures can reduce problems associated with information asymmetry.

3. Methods

Content analysis will be used as a research methodology to collect possible data to answer research questions. Content analysis will involve a number of steps, which include formulating research questions to be answered, selecting text, defining applicable categories, highlighting the coding process and executing the coding process, determining reliability, and checking the results of the coding process. The contents of the selected articles will be analyzed to bring out the main points related to the research topic. The articles that

will be used for content analysis will be sourced from international databases. Without a doubt, content analysis will facilitate the classification of the factors that determine the reaction of the capital market to accounting information and financial reporting. The research methods that will be used are quantitative and qualitative. Content analysis will essentially be a coding operation as the raw data will be converted to standard form. Content analysis will involve techniques to reduce the texts in the article into a unit per variable matrix and the matrix will be examined quantitatively to find answers to research questions.

4.1. Result

This study will show why financial statements are an important element of capital markets as well as corporate governance. This finding will show why an effective corporate governance system requires an effective financial reporting system and why a financial reporting system requires a well-organized financial accounting system. Capital market success is rooted in full disclosure; Therefore, financial reporting standards show that it plays an important role in how capital markets disclose their information. These standards play an important role in the development of capital market developments. Market performance can be improved if capital allocation is reliable and efficient. The study findings will show why financial statements are an important part of the financial reporting system necessary for the effective functioning of the capital markets. In addition, audits of financial statements provide value to the capital market. While it would have been desirable to have a unique and comparable model for financial reporting, it has not been realized due to cultural influences, national characteristics, and compliance with varying standards. Undoubtedly, transparent and qualitative financial reporting in the capital market can be achieved if there is a high level of disclosure.

Historical Cost-based income used by investors

Ball and Brown (1968), in the first major capital market research publication in accounting, investigated the usefulness of accounting earnings under the historical cost model. Prior to their research, there was a widespread view that historical cost accounting methods yielded "meaningful" information that was not useful to investors and other users of financial statements. Ball and Brown see the need for empirical evidence about whether accounting earnings, calculated using historical cost accounting principles, provide useful information for investors.

If, as the evidence shows, the actual stock price adjusts rapidly to new information available, then changes in the stock price will reflect the flow of information to the market. The observed revision of stock prices associated with the release of earnings reports will therefore provide evidence that the information reflected in the earnings proxies is useful.

Using data on 261 US firms, they tested whether firms with unexpected increases in accounting earnings had positive abnormal returns, and firms with unexpected decreases in accounting earnings had negative abnormal returns (mean). Unexpected income is calculated (simplifyingly enough) as the difference between current profit and previous year's profit. That is, they assume that this year's profit is expected to be the same as last year's profit. Monthly stock price data is used, with market models used to calculate abnormal returns for each company. Cumulative abnormal returns (CAR) are then calculated for each of (a) the full sample of firms, (b) firms with unexpected earnings increases (favorable announcements), and (c) firms with unexpected earnings declines (unfavorable announcements), with summing up the average abnormal return for each group over time.

They found evidence showing that the information contained in the annual report is used in making investment decisions despite the limitations of the historical cost accounting system. This result is evidenced by the CAR during the month of the earnings announcement (month 0). As can be seen from Figure 10.1, companies with unexpected earnings increases (profitable announcements), represented by the top row in the table, have positive abnormal returns, while companies with unexpected earnings decreases (unfavorable announcements), represented by bottom lines in the graph, have negative abnormal returns during the announcement month (on average). Since Ball and Brown's early studies, this research has been replicated many times using more sophisticated data and research methods. The results appear to confirm the usefulness of historical cost-based earnings to investors. This is not to say that historical cost accounting systems are “the most useful”, as present value or current value accounting systems may be more useful, but it does lend some credence to the continued use of historical cost.

Prior to the release of earnings, investors get much of the information they need from other sources

In addition to confirming the benefits of the historical cost accounting model, Ball and Brown found that most of the information contained in earnings announcements (85-90%) was anticipated by investors. The gradual slope in the line (which is the cumulative abnormal return) before the earnings announcement (made at time 0) in Figure 10.1 provides evidence of this. Anticipation of changes in earnings by investors indicates that investors obtain a lot of information useful for making investment decisions from sources other than annual earnings announcements (perhaps from press releases, analysts' releases, information about production and sales trends in the industry, and so on). This is not surprising given that alternative sources of information, such as analyst conferences, and press releases, are generally more timely than annual reports, which tend to come out several weeks after the balance sheet date and less frequently than many alternative sources of information. Therefore, we can never expect to produce accounting reports that will tell investors everything they might want to know. That is, the provision of all relevant information from investors is not a good basis for regulation or practice. When making financial reporting decisions, it is important to remember that, while accounting appears to be an important source of information for the stock market, it is not the only source of information.

The information content of earnings announcements depends on the extent to which alternative sources of information.

Research shows that the information content of earnings varies between countries and between companies within a country. For example, Brown (1970) finds that when compared to the US market, the Australian market has a slower adjustment throughout the year, with larger adjustments on earnings announcement dates. These results suggest that annual reports are a more important source of information for Australian capital markets than for US capital

markets because there are few alternative sources of information for Australian companies. The difference in the level of alternative sources of information is partly due to Australian regulations requiring only semi-annual rather than quarterly reports, and is also a function of the difference in average firm size between the two countries. Small companies tend to have fewer alternative sources of information than large companies, and securities analysts tend to follow. Differences in the level of alternative sources of information between small and large companies lead to differences in the usefulness of announcements, with these being more useful for small companies than for large Australian companies. Therefore, to what extent are alternatives sources of information should be considered when making financial reporting decisions.

The capital market impact of unexpected earnings changes depends on whether these changes are expected to be permanent or temporary

Following Ball and Brown's finding that the direction of unexpected earnings changes is positively related to the direction of abnormal returns, further research was conducted on the relationship between the magnitude of the unexpected change in earnings, or earnings per share, and the magnitude of normal returns. This relationship is often referred to as the earnings response coefficient. The results show that this is not a one-to-one relationship. Indeed, several studies have shown that average abnormal returns are associated with a 1% unexpected change in earnings of only 0.1–0.15% (Beaver, Lamberd and Morse, 1980). This relationship varies, depending on whether the change in earnings is expected to be permanent or temporary. A permanent increase is expected to result in an increase in dividends, and future cash flows, and this means a change in the value of the firm. On the other hand, temporary increases are discounted or ignored, because they are not expected to have the same impact on expected future dividends (Easton and Zmijewski, 1989). While some earnings changes such as those due to restructuring costs are clearly transient, it is more difficult to determine whether other earnings changes are likely to persist.

Profit Estimates Have Information Content

Announcement of earnings forecasts by management and securities analysts related to stock returns. That is, not only does the announcement of actual earnings appear to cause a change in stock prices, but the announcement of expected earnings also appears to cause a change in price. Similar to earnings announcements, earnings forecasts are related to market returns in both direction and magnitude (Penman, 1980; Imhoff and Lobo, 1984). This result is not surprising because earnings forecasts are expected to contain new information that can be used in predicting future earnings. Forecasting future earnings is expected to appear to be an effective way of communicating information to the stock market. Also, bad news forecasts about lower than anticipated future earnings may be useful; to avoid potential shareholder lawsuits (Skinner, 1997). Revenue forecasting has also been explored in terms of the information transfer phenomenon discussed above. Baginski (1987) produces results showing that stock prices of companies in the same industry do not provide earnings forecasts that are positively correlated with changes in earnings expectations indicated by earnings forecasts issued by managers of other companies in the same industry.

4.2 Discussion

Stock prices and returns (changes in price plus dividends) are considered by some researchers to provide useful benchmarks for determining whether accounting information is relevant for investors' decision making. The stock price is considered to represent a benchmark measure of the company's value (per share), while the stock returns represent a benchmark measure of company performance (per share). These benchmarks are in turn used to compare the usefulness of alternative accounting and disclosure methods. For example, this methodology is used to answer questions such as: is cash flow from operations a better measure of company performance than profit calculated using the accrual system? Each of these accounting measures of performance is compared with a benchmark market measure of performance (return) to determine which accounting measure best reflects the market's assessment of the firm's performance. This type of capital market research also assumes that markets are efficient, and recognizes that financial statements are not the only source of available information for the market, so security prices reflect information generally available from many sources. In particular, he considers that investors and financial analysts actively seek relevant information when making investment decisions or recommendations, rather than waiting for the release of the annual report. Furthermore, this section of the study allows researchers to consider questions about statements of measures of financial position. For example, are disclosures about the current values of assets value-relevant? That is, are they related to, or related to, the company's current market value? Again, there is an assumption that market values reflect all publicly available information, including but not limited to information contained in financial statements.

This perspective says that market value is related to book value, if it relates to accounting earnings per share, divided by the price at the beginning of the accounting period. This analysis provides reasons why we should expect returns in relation to earnings over time. However, it is interesting to note that the total earnings per share versus earnings per share is not unexpected by this theory to be accounted for. This is in contrast to studies that assess earnings 'information' by analyzing the relationship between unexpected earnings per share and abnormal returns in studies that report reported earnings on the basis of how closely reported price movements or EPS are related to stock changes.

Using the market value of a firm's securities as a benchmark, a number of studies have also attempted to define an asset valuation approach by providing accounting figures that best reflect the valuation that the firm's market place on. The perspective taken is that book value which is more closely related to market value (determined through a stock price review) provides more relevant information than other accounting valuation approaches. Barth, Beaver and Landsman (1996) conducted a study that investigated whether estimates of the fair value of bank financial instruments (as required in the US by PSAK No. 107) seem to provide a better explanation of stock prices bank relative to values determined on the basis of historical cost accounting. Their findings indicate that PSAK No. 107 in the disclosure provides significant explanatory power for banking share prices, beyond that provided by book values (p. 535), thereby providing evidence that these values are investor-relevant values.

Consistent with the view that market prices seem to already

reflect the current values of overall assets, as indicated in the research discussed above, it is interesting to note that asset revaluations do not appear to provide investors with information over and above historical cost accounting information. That is, several studies have shown that the provision of current cost data in financial statements does not contain information (Brown and Finn, 1980). These results indicate that investors can estimate the value when the price information is disclosed in the financial statements. Therefore, while the provision of current value information does not provide new information to investors, it appears to reflect the information used by investors in making their investment decisions.

5. Conclusion

In concluding our discussion on capital market research we can see that this research has investigated a number of issues. The core of this research is the assumption about the efficiency of the capital market. In the "information content" study considered in the earlier part of this chapter we saw that researchers investigate stock market reactions to information releases, often specifically the provision of accounting information. The view taken is that accounting disclosures often reveal new information and in markets that are perceived to be of little help efficiently with regard to actions taken on the basis of new information, stock prices react to this information.

In the final section of this chapter we consider studies that investigate whether accounting disclosures reflected, or perhaps confirmed, information that had seized stock prices. The perspective taken is that in an informationally efficient capital market, stock market prices will reflect information from many sources. If the accounting information does not reflect the information that has confiscated stock prices, then some researchers argue that accounting data that are not related to price sharing, and changes in them, are somewhat lacking. The idea is that market prices reflect information from multiple sources and if the accumulated data give a certain signal, accounting disclosures should also give the same signal. As we know, this approach implies that the market has it "right" when it comes to pricing a stock, and therefore returns. In practice, the market cannot be expected to always get it "right".

Since much of the knowledge of an entity will be obtained from sources other than accounting, it may be reasonable to expect that accounting information should relate to the expectations held by capital market participants, such as those contained in stock prices. However, because arguably there will always be some unexpected information when accounting results are public, we might expect that not all accounting data will be confirmed. Some of the information in accounting will be new releases, and in markets that use information efficiently, some price revisions are expected.

Many stock price studies have investigated market reactions to certain disclosures. Often, if no reaction is found, it is assumed that the information is useless and therefore the company should not go to great lengths to incur costs in making such disclosures. This form of argument has been used to criticize accounting regulators for requiring certain disclosure requirements. What must be acknowledged, however, is that capital market research investigates the aggregate reactions of one stakeholder group, the investors. While the stock market is an important user of accounting information, providing information to the stock market is not the only function of the accounting system. Accounting information is also used for monitoring purposes (Jensen and Meckling, 1976; Watts and Zimmerman, 1990), and therefore, financial statements play an important role in relation to the contracting process. Financial reports provide a relatively low cost way of measuring manager performance and monitoring compliance with contract terms, thereby helping to reduce agency costs. Furthermore, financial statement information can be used to fulfill the people's right to know, that is, to fulfill the duty of accountability. Therefore, while investors are important users of financial statements, it would be foolish to only focus on financial statements as information for investors, leaving aside considerations about the role of monitoring/accountability.

The market performance can be improved if the capital allocation is reliable and efficient. The study findings will demonstrate why financial statements are a crucial part of the financial reporting system needed for effective functioning of the capital markets. Besides that, the auditing of the financial statements provides value to the capital market. Although it has become desirable to have a unique and comparable model for financial reporting, it is yet to be realized because of the cultural influences, national characteristics, as well as submission to diverse standards. Without a doubt, transparent and qualitative financial reporting on the capital markets can be achieved if there is a high level of disclosure.

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