# Financial accounting theory – ball and brown study

Business, Accounting

## Conclusion of Research Paper

Through the paper and the information provided by the textbook, it is clear that two brief conclusions we can get and explanations will be attached.

1. Thefinancial statementdo impact the share price

2. The influence caused by the financial statement is limited.

The main reason, that financial statement impact the share price, is the efficient capital market. Namely, the efficient security market will go hand in hand with full disclosure. Once the relevant information provided by the management on the timely basis, the rational investors could make decision based on the new information.

Moreover, there are some differences between the narrow window and the long window, the previous one show the strong relationship between the financial report and the changes in share price. In long window, the price leads the earnings because the share price includes not only the accounting information but also other available information in efficient market. Thus, investors will read the financial statement and realize that whether they need to modify their investment portfolio.

Because of the rational and risk-averse investors, the information provided by the financial statement may do not have so huge influence on the share price. Before the statement is issued, the investors will try their best to get information about the company and they will gather the information about the company every time when they release information (not necessarily financial data). So investors could understand more and they can foresee the performance of the company before the issue date.

In general, annual financial report could issue some inside information that may hardly forecast by investors. The information asymmetry existed between inner and outer could be narrow when the financial statement released. According to the information approach, the accountants for the financial statement will provide more useful information in order to allow the investors to make their decision related to future performance. Even though only 85% to 90% information in the report will be reflected in the share price, we cannot regard the financial reports as ignorant stuff.

## Further investigation

We hold a viewpoint that because the market shows a weak responds for annual financial in a more efficacy stock market and higher media social. The market could require more timely interim and quarter reports, and the corporation will evaluate cost between the preparing of timely quarter report and annual report. Also as the information approach is the default assumption in this analysis, current financial news provides that investors show less confidence and trust less on the financial report. It could not be a positive phenomenon in capital market.

To improve the useful for investor decision making, accounting information should be developing three levels of enterprise reporting system.

The first level is the same regulation of whole global. If financial reporting is to be credible, there must be public confidence that the standard-setting system is credible. General Accepted Accounting Principle (GAAP) is the very basic requirements when preparing the financial report. GAAP is the bottom line to let accounting information be comparable across different companies and over different time periods. As a rule based principle, there is one limitation that they could just the figures to the standard. A good company will not limit them within basic requirements.

For a healthy and well-developed company, if the company can provide more authorized reports with better information, the better future they can have because they can have more funds from investors which can create more value in the market. This is a beneficial cycle for company, investors and markets. For the atmosphere, the regulation need improvements and the company also need to establish the proper strategy. All the companies should contribute to creating fair and transparent market. This is because the GAAP is the basic requirements and guidelines for the company but both the

optimal one, thus the company needs to dig out the best way to present information.

The second level is more precise criteria based on different industrial characteristics should be applied in the accounting information system for the business performance and risk. The role of financial reports, which is to releasing more reference value, is critical for users. The more precise the information is, the more reliance they can ensure.

For different industries, the differentiation should be figured out and make it accessible and understandable for investors. For example, the manufacturing companies and retailing companies have the differences that should presented and give clear clues to analyze for naïve investors. In general, the financial report should show the industrial characters apparently with reliance.

The third level is that some particular accounting issues related to specific company could be designed in order to make sure that the information is more accessible for investors. It is mainly based on the fundamental value of the company and the strategy within the industry. For instance, the company with unique value chain (e. g. Wal-Mart) creating more value to the customers, the financial report could show the unique point in their report in order to offer better information to the investors. The accounting information with the special information only in the company could improve the reliability gradually, with less information asymmetry suffered by investors.

In addition, from the report and the data showed, the impact caused by the time lag is declining. But the reliance is now the questionable in the market. Investors may not find the most useful information or puzzled by numerous knowledge at the very beginning of researching the company (especially in the modern period that various information in Internet). So the media should issue the most accurate accounting information to the investors timely and trustworthy. Maybe the media should be fixed and credible in the information explosive era.

## The Ball and Brown Study

Information approach to decision usefulness supports that investors want to make their own predictions of future security returns instead of having accountants do it for them and the security markets will response to the new information quickly if the security market is efficient.

However, investors make their forecast about the future earnings based on the information they have, the actual earnings are sometimes different from the expected, and the difference of the actual return and expected return is the abnormal gain/loss or unexpected return. From Bell & Brown's study, since all the information available about an individual firm, one-half or more is captured in the income numbers, the annual report is considerable.

Report objectives

To use empirical approach rather than analytical approach, to evaluate the usefulness of the income numbers from content and timing component, is the objects of this report. In this report Ball & Brown construct two selection model of market expectation return to inspect how the market reflects and when market expectation is not accurate. Empirical Test

Previous analytical approach before Bell & Brown to evaluate information usefulness lacks of further empirical testing, empirical evaluation meets the agreement to the real world outcomes. Both the content and the timing of the existing annual net income are taking into consideration to evaluate the usefulness.

## Classes of Data

There are three classes of data concerned:

a. The contents of income reports

b. The date of the report announcement

c. The movement of security prices around the announcement dates

Inclusion criteria including the earnings data available on the Compustat tapes each of the years 1946-1966, fiscal year ending December 31, price data available on the CRSP tapes for at least 100 months and Wall Street Journal announcement dates available.

The table one indicated that there was about 25% of change in firm’s income associating with the changes in the market index for the firm in the medium. In the aspect of date of the report announcement, forecasts of the year's income, preliminary reports, complete annual report were three kinds of annual report announcement which were published in the Wall Street Journal. The preliminary report was selected because it contains same net income and EPS as final report and it is regarded as preview of annual report. Moreover, forecasts are imprecise. Table 3 indicates that the time lag between the fiscal year and announcement date was declining yearly. This phenomenon reflects that many firms began attaching importance to the timeliness of accounting data.

## Conclusion

The initial objective was to assess the usefulness of existing accounting income numbers by examining their information content and timeliness. Even though there are many shortcomings and restrictions on the research, it is the first to provide convincing scientifically evidence that firms’ share returns respond to the information content of financial statement. And a republication of study on different sample showed a consistent result with the result of the paper.

## Result ; Special result

From the result of the research, the two models got the similar result ensure that information contained in the annual income number is useful if actual income differs from expected one. The effect caused by the differences could be last for two months beyond the month of the announcement of the annual report.

The research also investigated the relative importance of information contained in net income timeliness of the income report. Through the model they made, they found that:

1. only 25 % of information will persists.

2. half of the 25 % persisted can be related to the information in reported income.

3 Maximum 15% information in report is unexpected.

4. Averagely 20 % of the value of all information coming to the market in that month

## Limitation

There are three limitations on the B; B research. Firstly, the selection criteria may reduce the generality of the results. The subpopulation does not include young firms, those which have failed, those which do not report on December 31, and those which are not represented on Compustat, the CRSP tapes, and the Wall Street Journal. As a result, it may not be representative of all firms. Moreover, the accounting data was limited to nine fiscal years from 1957 to 1965. Secondly, it is not consideration the security price reaction the accounting information distinction between the long-term and the short-term. Thirdly, B; B only classified into GN or BN, a fairly coarse measure.