



## Shorter and easier is more useful: A longitudinal analysis of how financial report enforcement affects individual investors

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### ABSTRACT

According to the literature, individual investors rarely use accounting and financial information (AFI), even though they do not give it a particularly low valuation when asked. This behavior increases the risk to lose investments. The main contribution of this paper is to propose a new AFI format: a one-page report that is short and easy to understand, as a complement to the long and complex traditional format in order to increase the usefulness of information for investors and to decrease investment risk. Two experiments provide evidence about the increased usefulness of AFI when using the new proposed format. More importantly, it seems that results in terms of profits also improve considerably in medium (one year) and long-term (four years) investments, in contrast to more modest profits of speculative investments. Furthermore, this difference occurs regardless of the investors' previous experience.

### 1. Introduction

*“Without doubt, the most pressing and crucial problem facing the accountancy profession today is the search for a blend of reportable financial information which is likely to satisfy the requirement of its potential users” (Lee, 1975 in Accounting and Business Research).*

In the last few years, around forty years after Lee's paper, both the associations for the defense of investors and the national financial institutions of many countries have renewed the objective to improve investors' protection and decrease risk judgments (Lipe, 1998). After the great recession of 2008, many governmental agencies tried to focus on ways to protect investors (e.g., the Dodd-Frank Act in the U.S). These efforts were concentrated in essentially three different actions: education, training and legislation. These decisions changed not only the role of public institutions but also the way in which individual investor protections have been studied from an academic point of view. However, these actions are needed but they are not enough to increase investor's protection. One of the main messages sent from different public and private organizations relies on the importance of understanding that investing is not a random game, although it involves risk or uncertainty of results. Still, the same organizations admit that individual investors' decisions are usually based on intuition or feelings,

following "hot" advice from the Internet, co-workers or family members. Financial education tries to deal with these situations urging investors to use authorized brokers after consulting reliable information to avoid these types of risky situations. However, small investors admit to ignoring financial advisers, even though the information is not easily interpretable, and financial advisors have access to a larger amount of information and knowledge to interpret it (see Bouwman et al., 1987; Willman et al., 2002). The knowledge of investors' behavior has led to a debate on what approach should be taken by the institutions concerned with the financial education of citizens. It is clear that professional investors make their investments with methodologies and tools that provide them with technical support that individual investors do not have, thus the behavior of individual investors is more speculative and less reasoned. From this point of view the debate is created: should individual investors be the final recipients of the information published or should the information be targeted to professionals? What information should be available to investors? And maybe more importantly, what is the best format to spread information about markets for individual investors?

In our opinion, in addition to the education, training or legislation, the national institutions should focus their efforts on guaranteeing a better accessibility and facilitating the interpretation of the information provided to individual investors, specifically AFI (e.g., Balance, Income

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Statement, Cash Statement, Audit report), which is one of the most important sources of information in the investment decision-making process (Belkaoui, 1980). Therefore, we need to understand how individual investors interpret and/or use AFI in the stock markets. As we can see in the next sections many different studies focus their attention on investors' behavior and the usefulness of AFI, but the fact remains that the role of accounting information in individual investors' decision-making is negligible at present perhaps because the AFI format in Spain (similar to that in many other countries) is too long (up to more than one hundred pages), too difficult to understand (very complex formats and technical language), and difficult to find (not easy to locate within different website structures for each company embedded among much irrelevant information). The objective of the present paper is to propose a new AFI format of one-page report, shorter and easier to understand, as a complement to the long and complex traditional format in order to increase the usefulness of this type of information for investors.

Some authors have found that individual investors may give importance to different variables based on their demographic characteristics in general (Baker and Haslem, 1974; Warren et al., 1990) and other studies have noted the importance of the place of the investors' origin in particular or of the country they invest in French and Poterba (1991). As we do not have information specific to Spanish investors in the literature, we used the questionnaire as a comparative test to be sure that there are no differences from the existing studies in Anglo-Saxon countries.

On the other hand, recent studies suggest that the investment decision is also affected by internal factors such as one's own knowledge and external factors such as frame (type of investment, investment location, etc.) or the way in which the possible investment is presented (Shefrin, 2000; Shleifer, 2000) that could depend on the experience of the investors. Therefore, we control the effect of the new proposal according to the experience. The experiment was conducted both with real investors and with students completing their last year of a Bachelor of Business Administration to see if their use of AFI depends on previous investing experience and if lower use of AFI is replicated for both participants group.

The main contribution of the present paper is to provide evidence about how the usefulness of AFI significantly increased when using the new format proposed. More importantly, it seems that results in terms of profits also improve considerably in medium (one year) and long-term (four years) investments, in contrast to the more modest profits of speculative investments. Furthermore, this occurs regardless of the previous experience of the investors.

## 2. Theoretical framework and hypotheses

Since the seventies many studies have been conducted within a financial perspective, analyzing the importance of the presentation of accounting information (e.g. Martin, 1971; Kaplan and Roll, 1972; Hendricks, 1976; Savich, 1977) or financial reports (e.g. Cassidy, 1976). More recently, continuing in the same line (e.g. Pirie and Smith, 2008; Jumah, 2014; Shin and Park, 2014) other studies have examined variables such as investors' sentiment (e.g. Ho and Hung, 2009; Palomino et al., 2009) or the different types of published information (e.g. Chen and Chan, 2009). However, most of these studies extrapolate results from markets analysis to individual investors without working directly with individual investors. Only a very few papers have focused on a direct analysis of individual investors. Significant differences have been found between the results of those studies based on markets and those based on the direct analyses of investors (De bondt, 1998); therefore, in our opinion direct analysis is essential.

Collecting their opinions about the decision making of the investments has made a direct analysis of investors' behavior. The results found in this research are based on questionnaires given to individual investors globally, and they have found fairly homogeneous results

regarding the usefulness of financial and accounting information. Three main conclusions can be derived from these studies. Firstly, investors initially make their investment decisions based on future expectations. It is important to allow companies to voluntarily express their expectations of benefits and financial statements because these future expectations are extensively used by investors (Baker and Haslem, 1973; Nagy and Obenberger, 1994). Second, there is information of greater relevance than financial statements, for instance, expectations of benefits (Baker and Haslem, 1973). Nagy and Obenberger (1994) also found that financial reports were the fourth variable used by investors, behind earnings expectations. However, in the same study, a factor analysis ranked AFI as the second most important factor to explain investors' behavior behind the general information. Third, in the nineties a new tendency could be observed in which the most important variable for individual investors was company management instead of expectations (e.g. Rogers and Grant, 1998; Clark-Murphy and Soutar, 2004).

In the late nineties and early in the new millennium, demand for information about markets increased considerably from the investors. The development of the media, specifically the financial press and financial television channels, and particularly the rise of the Internet, have offered investors much more information. The benefit of Internet use by individual investors is unavoidable and yet quite controversial. Internet information is immediately available, but there is such a large amount of information that selection of the most productive and useful sources is difficult for investors. The sheer quantity of information has driven investors to focus on many different selective variables of the markets. Perhaps because of this, in recent years insufficient importance has been directed to the AFI reporting itself, but rather to interpretations made of this information by management. Clark-Murphy and Soutar (2004) used the Adaptive Conjoint Analysis questionnaire (ACA) to study which variables may be crucial for investors. They applied the ACA to the client list of an Australian company of brokers. The results found are truly striking showing that the most important factor for respondents is the management of the company over the financial report or dividend expectations. Previous studies (Rogers and Grant, 1998) had pointed to management as a key variable for analysts but not for individual investors. Moreover, those studies showed that it is not only financial reports that are under valued. As shown by the ACA results, financial information like dividends is less valued than other variables such as recent movements in the shares on the stock market (Clark-Murphy and Soutar, 2004). Baker and Haslem (1973) also found that financial statements are used for investment decision-making, but they only represent 8% of all of the sources used. In the same line, Nagy and Obenberger (1994) found surprisingly that neither recommendations of brokerage firms and individual brokers nor the financial reports themselves are taken into account to a large extent.

Regarding the search and retrieval of information for individual investors, they have a variety of sources at their disposal everyday (Pascual-Ezama, Pavoni and Gil-Gomez de Liaño, 2010). Media and financial press, radio and television, have made available a large quantity of economic and financial data. In addition, investors are exposed to a continuous stream of opinions from experts, family, friends and colleagues. However, no clear effects on investors were found. According to Baker and Haslem (1973) the advice of experts and consultants, the financial press and even the opinions of family and friends may be relevant. Yet, Nagy and Obenberger (1994) found that the vast majority of investors are self-sufficient when it comes to deciding on investment, not giving much importance to the opinions of their family or coworkers.

It is so important for individual investors to obtain and process as much information as possible, which has an obvious cost for them (Coleman, 2015). Investors who have a high information cost should settle for less information while investors who have a low information cost, should obtain much information more easily (Loibl and

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