In October 2001, the world became aware of the biggest accounting scandal in history. Enron Corporation, an American energy company, announced the restatements of its financial statements for years 1997 to 2000 in order to correct accounting violations. The restatement reduced earnings for the four-year period by $613 million (or 23 percent of reported profits during the period), increased liabilities by $628 million and reduced equity by $1.2 billion at the end of 2000 (Healy & Palepu, 2003). The Enron Scandal, as it was labeled, raised significant questions about American capitalism and its ethics, as well as about accounting regulation. An article published on The Economist on 17 January 2002, titled *Enron: The Real Scandal*, called for systemic reforms in three areas, namely auditor regulation, conflicts of interest, and accounting standards. Leading to one of the busiest enforcement periods for US regulators in all these three areas (Masters, 2011).

The Sarbanes-Oxley Act raised the bar for law enforcement significantly by requiring corporate executives to take personal responsibility for the accuracy of company accounts and by increasing auditors’ responsibility in auditing financial statements. Accounting standard setters have moved towards principle-based standards, which have increased disclosure requirements. Despite introducing more discretion in financial reporting, principle-based standards claim to provide a fairer representation of companies’ economic value (Hellström, 2006; Barth, Landsman, & Lang, 2008). Empirical research shows that accounting quality has been improving worldwide (Land & Lang, 2002; Barth et al., 2008), but also that the extent of such an improvement depends on other context characteristics such as law enforcement (Cairns, 1999; Street & Gray, 2001; Ball, Robin, & Wu, 2003; Burgstahler, Hail, & Leuz, 2006), regulatory and litigation environment (Bradshaw & Miller, 2008), and management and auditor incentives (Ball et al., 2003).

However, as Karl Marx noted, ‘history repeats itself, first as tragedy, second as farce’. And in September 2008, Lehman Brothers Holdings Inc., the fourth largest US investment bank, declared bankruptcy formally igniting the Global Financial Crisis (GFC). Accounting practices were again the first to be in the dock. Following the Lehman collapse, the Financial Times published an article titled *Accounting is...*
Dead, which quoted ‘investors are once again questioning the value of the financial statements on which they spend such large sums of money’ [March 15, 2010].

These major scandals have undermined investors’ trust in accounting reports, despite the evident increase in accounting quality. However, accounting reports still represent the primary source of information for investors; what is changed is that investors tend integrate accounting information with other sources such as the Internet (Drake, Roulstone, & Thornock, 2012) and Social Media (Blankespoor, Miller, & White, 2014). In other words, investors tend to consider accounting information as less relevant in their decision-making than they used to.

An accounting number is described as value relevant if it has a significant association with the market value of equity (Barth, Beaver, & Landsman, 2001; Holthausen & Watts, 2001). Empirical research indicates a downward trend in accounting information value relevance (Collins, Maydew, & Weiss, 1997; Francis & Schipper, 1999; Lev & Zarowin, 1999; Core, Guay, & Van Buskirk, 2003; Dontoh, Radhakrishnan, & Ronen, 2004), but such a general trend tends to vary across countries (Hung, 2000).

Holthausen and Watts (2001) classify the extensive ‘value-relevance literature’ into three categories:

1. Relative association studies, which assess the variance explained in regressing stock market values on accounting measures, to determine whether one accounting standard provides more value relevant accounting information than another standard;
2. Incremental association studies, which examine the explanatory power of accounting numbers for returns or values over a long period;
3. Marginal information content studies, which determine whether the release of accounting information is related to a short-term change in equity values.

The studies reported in this volume provide useful insights on all the key aspects of accounting value relevance presented in the existing literature. In order to better prepare the ground for a deeper understanding of these significant contributions, let us consider the following questions: why is accounting information value relevance so important from a capital markets perspective? What are the effects of unreliable accounting information on capital markets participants?

The primary role of capital markets is to raise long-term funds for governments, banks, and corporations while providing a platform for securities trading. As such, capital markets provide benefit for both organizations and investors. Organizations have access to larger funding and can exploit growth opportunities while investors obtain financial growth from their investment; consequently, the development of capital markets contributes to economic growth. Harris (2002) describes trading
as a ‘search problem’. Buyers must find sellers, and sellers must find buyers and they both aim to trade at a fair price, which is based upon available information. A large part of the empirical research in accounting and capital markets has focused on testing market efficiency. Fama (1970, 1991) defines a market as efficient if ‘security prices fully reflect all available information’. Market efficiency is of great interest to all market participants since security prices determine the allocation of wealth among firms and individuals (Kothari, 2001). Accounting information is a key source for assessing security prices since it describes the past, and provides the basis to estimate the future performance of a firm. Therefore, unreliable accounting information and poor information disclosure compromise market efficiency by enhancing the information gap between the sides of the market (i.e. information asymmetry).

Let us discuss the next question: what are the effects of unreliable accounting information on capital markets participants? In answering this question, I will refer to shares and options trading, since these are the most frequent traded instruments (Harris, 2002).

Shares are units of ownership corresponding to an equal proportion of a company’s capital. Shareholders are entitled to an equal claim on the company’s profits and an equal obligation for the company’s debts and losses. Options are derivatives, meaning that their value is derived from the value of an underlying investment. In most of the cases the underlying investment on which an option is based is the equity shares in a publicly listed company, but they can be also based on stock indexes, exchange traded funds (ETFs), government securities, foreign currencies or commodities. Despite some important differences between shares and options, they are traded in a similar manner. Both shares and options are listed and traded on regulated marketplaces, are transacted through brokers with bids to buy and offers to sell, and can be monitored through the marketplace.

Empirical studies in accounting and finance has demonstrated that information asymmetry and uncertainty have a significant impact on market participants. In this discussion, let us focus in this discussion on three key market participants since they are the key players in capital markets, namely investors, brokers, and dealers.

Investors in capital markets are either individual or institutional (e.g. pension funds, mutual funds). They typically trade with the aim of moving wealth from the present to the future and have different levels of sophistication and risk tolerance (Harris, 2002). In case of information asymmetry, investors can be divided into two categories, namely informed and uninformed investors. Institutional investors and insiders tend to fall into first category because of their ability to process and interpret information, or to access private information. Individual investors tend to fall into the second category. When information asymmetry arises, uninformed investors tend not to trade so as to avoid losing against informed investors. As a result,
information asymmetry leads uninformed investors to either give away investment opportunities or incur higher losses.

Brokers are agents who arrange trades for their clients and receive commissions for their services. They also make easier for investors to trade by solving clearing and settling problems, or by providing investment advice. Given that exchanges generally allow only their members to trade, brokers provide the only channel to exchanges that ‘average investors’ cannot access themselves. Information asymmetry increases the principal-agent problem, which typically exists when one party works on behalf of another party. In this case the information advantage rests on the brokers’ side and may result in opportunistic behaviors aimed to increase brokers’ commissions at the expense of clients’ profits. When a broker takes a trading order from a client, it is a broker responsibility to obtain the best execution of that order. Opportunistic brokers typically violate such a norm for their private gain by exploiting one (or more) of the following practices:

1. **Dual Trading**: Occurs when a broker is also a dealer (broker-dealer) and it completes the orders internally instead of obtaining a better price trading against other dealers;
2. **Order Preferencing**: The routing of order flow to a preferred dealer that compensates the broker;
3. **Front Running**: Occurs when a broker improperly allows one order to trade ahead of another so that the first profits from the price impact of the following order;
4. **Fraudulent Trade Assignment**: Occurs when a broker executes orders on the same side of the market for more than one client and assigns the best prices to the favorite client;
5. **Unauthorized Trading**: Occurs when a broker trades for its clients without authorization.

It appears clear that an ‘opaque’ market provides higher incentives for such opportunistic behaviors, which may cause significant losses for investors.

Dealers, also known as specialists or market makers, are passive traders that provide liquidity to the market; they trade when other traders want to trade, and profit when buying from impatient traders at a low price or selling to impatient traders at a high price. Being passive traders, they cannot refuse to trade, therefore they need to carefully consider what to trade, when to trade, and at what price to trade. Dealers quote the prices at which they are willing to buy (bid) and sell (ask), the difference between these two prices is referred to as bid-ask spread. As passive traders, dealers lose when trading against informed investors therefore, when information asymmetry rises, they defend themselves by widening the bid-ask spread; in such
a way they are able to recover from uninformed investors what they may have lost in trading with informed investors. This recovery from losses enables dealers to be more financially sustainable in the long run; in other words, information asymmetry increases the risk of dealer’s activity and trading costs.

To summarize, value relevant accounting information provides a clear view of the economic value of companies and provides a significant contribution to capital markets development, which, in turn enables long-term economic growth.

This volume provides useful insights into the importance of value relevance of accounting information in capital markets. By addressing developed and developing countries, and theoretical and empirical studies, the volume allows the reader to explore the topic from different perspectives.

This volume is not just for academics; it is also for practitioners, accountants and regulators. The recent economic crisis has shown how interconnected the relationship between accounting, capital markets and the overall economy are, and how these relationships extend over national boundaries. In order to avoid other similar devastating crises in the future, it is essential to promote a collaborative and open approach to financial and accounting regulation. Accounting standard setters have been moving towards unified standards and market regulators around the world are working hard to increase market transparency, however further collaboration between standard setters, academics and practitioners is needed to converge upon international shared accounting and ethics standards. By proving a multidimensional view of the topic, I believe this volume is a good step in that direction.

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REFERENCES


