

# Effect of Financial Reporting Quality on the Cost of Capital and Investment in China

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## ABSTRACT

The quality of the financial report is a critical issue in accounting supervision and theoretical research and whether and how it affects the resource allocation decision of the capital market for understanding the importance of accounting to investors and management responsibility. In various financial activities of enterprises, investment management activities are the core, based on the specific relationship between the quality of financial reports and the company's investment efficiency, in the process of practice management must grasp the key to the problem, in accordance with the requirements of the process. There is a close relationship between the quality of financial reports and investment efficiency, which is a supervision and management problem and has an essential impact on investment efficiency. It is necessary to start from the current financial management situation, clarify the relationship between the two, and do an excellent evaluation and evaluation. Starting from the mechanism of financial report affecting company's investment decision, this paper summarizes and evaluates the measurement and empirical research of company's investment efficiency in detail. In conclusion, when the quality of financial reporting is the only factor affecting investment, presenting a company's projects to a broader audience through excellent financial reporting does lead to more investment.

**Keywords:** financial reporting quality, financial disclosure, capital and investment

## 1. INTRODUCTION

One of the primary benefits of financial reporting and disclosure is that it helps companies raise capital at a lower cost and fund promising investment opportunities. The task of external accounting is to report on the company's economic situation to external addressees or the users of the annual financial statements [1]. These include people and institutions outside the company, i.e., creditors, banks, the state and the general public. Another topic of the annual financial statements is the information of the company management about the asset, financial and earnings situation of the company. The quality of the accounting determines the extent of the existing information asymmetries between the accounting entity, who heads the accounting unit, and the accounting addressee, who is in a contractual relationship with the latter [2]. This paper aims to examine the importance of these different models for measuring accounting quality, focusing on China.

Before the Luckin Coffee falsification incident, Luckin Coffee's financial reports were not found to be any problem by investors due to its long-term loss-making status. Because when a company is expanding, it is a usual business practice to spend money to expand the market quickly. Even if it operates at a loss for a long time, investors will always view it favourably. The ratio of revenue to cash flow was never questioned until Muddy Waters released the anonymous report. On September 21, which is one month before today, Luckin Coffee made three announcements and planned to return to the Pink Sheets market to NASDAQ. By making their financial statements as complete as possible, Luckin Coffee spent over one year making themselves acceptable to investors again. The GME incident earlier this year also originated from last September when many people analysed that GameStop's stock had been severely undervalued, and there was naked short selling based on the financial report.

## 2. IMPACTS OF FINANCIAL DISCLOSURE

Disclosure lowers the cost of capital for Chinese companies in that it provides the correct account of the revenues that should be taxed. Without disclosure, an organization could evade taxation and retain revenues. In addition, the annual financial statements provide the most critical information for investors to understand the company's business processes. More informative annual financial statements would help improve market efficiency, i.e., reduce information asymmetries between the management of a company and the participants in the capital market. As a result, the quality of financial reporting influences investor opinions about a company's future business.

The quality of financial reporting is detrimental to the cost of capital and investment in China. The International Accounting Standards Board (I.A.S.B.) does not require a uniform application of accounting methods. Information that is received too late by the addressee cannot contribute to the usefulness of the decision because it is of little use and can lose its relevance. On the other hand, information that reaches the addressee too quickly can lead to a breach of reliability, as not all aspects to be mentioned may be known.

The quality of accounting for the significant organization is a critical requirement as it determines the company's sustainability. The extent to which accounting information accurately reflects a company's current operating performance. It is useful for predicting future performance and aid in assessing company value. Auditors are unquestionably in the best position to assess the quality of accounting because of their proprietary information and access to management. This definition covers aspects such as transparency, image fidelity and usefulness in decision-making [3].

Financial reporting standards used in different countries are different. For example, the standards used in the U.S. are different from the standards used in China. As such U.S. company, data may not apply to Chinese companies since the standards are different. The quality of the reporting depends on the relevance and reliability of the financial and non-financial, recognized and disclosed information. The higher the relevance and reliability of the annual financial statements, the better market participants' forecast of future cash flow. The nature of the period results also strongly influences the quality of the accounting. From an accounting-based perspective, re-

ported period results are regarded as qualitative if expenses and income are allocated to the respective fiscal years as appropriately as possible through period delimitations resulting from the difference between annual results and operating cash flow.

## 3. EFFECT OF FINANCIAL REPORTING QUALITY ON THE INVESTMENT

The three main points addressed in this paper are financial reporting quality, investment, and cost of capital. The topic of this part of the discussion is what investment is and how it is measured. For investors, investment is the ability to estimate a certain level of capital and return through reasonable analysis, and to invest funds in the target of expected growth. The measurement of capital can be used, to some extent, to illustrate the impact of the quality of financial reporting on investment.

The two criteria this paper used for the investment measure are Company-specific indicators and first-day stock prices. The focus on Company-specific indicators stems mainly from practical considerations. The investment market is not entirely rational, and celebrity CEOs have shown extraordinary influence on a company's stock price. Likewise, the reduction in the share price of more than \$100 due to CDPR's product offering in December 2020. And the GME event in January 2021 also compels us to consider affiliates as a more prominent influencing factor.

A survey of current stock prices for some companies reveals some companies whose stock prices have been low for an extended time after experiencing earlier high stock prices. However, this is not within the scope of this study, as the low prices come from the epidemic's overall impact on the industry or unfavourable company operations. These reasons have nothing to do with the quality of financial reports.

### 3.1. Sample

This paper first identified a total of 110 S-1 registration statement reports from the SEC's official website for January 2019 through December 2020. Since most of these companies have a record of filing multiple statements, only a valid sample of 47 after screening were obtained. Since this research studied Chinese companies listed in the U.S. and avoid the effect of time factor due to too far ahead, there was no supplementary data with time and companies listed in the U.S. from other countries as supplements. Although the data for 47 companies

may not be generalizable, I believe it is sufficient for the study.

For the sample of 46 companies, descriptive statistics are given in the table below. This paper used these statistics to get a general impression of these companies.

### 3.2. Statistics

**Table 1.** Descriptive Statistics

		Total	1st Quartile	2nd Quartile	3rd Quartile	4th Quartile
Pricing	Mean	4.691	10.342	6.035	1.551	0.325
	Median	3	10	5	1.32	0.1
Assets	Mean	29,350,692.267	107,994,043.583	2,006,656	209,936.182	42,737.727
	Median	324,474	33,654,633.5	1,241,782	198,278	31,408
Internet/Medical	Mean	0.111	0.417	0	0	0
	Median	0	0	0	0	0
Nasdaq/NYSE	Mean	0.644	1	1	0.545	0
	Median	1	1	1	1	0
Risk Factors	Mean	3.222	4.083	3.36	3	2.36
	Median	3	4	3	3	3
S-1	Mean	2.356	4.167	2.546	1.546	1
	Median	2	4	3	2	1
Affiliated	Mean	1.844	4.5	2.455	0.182	0
	Median	1	3	3	0	0

Note: Pricing = Target price in the statement

Assets = Total assets before listing in USD

Internet/Medical = Internet and pharmaceutical-related companies are more bullish due to the impact of the epidemic

Nasdaq/NYSE = One if stock is listed on the Nasdaq or NYSE and zero otherwise

Risk Factors = The level of detail in the company's description of its risks

S-1 = Number of statements made on SEC

Affiliated Companies = The number of companies that can still earn revenue through equity relationships in addition to their own main business.

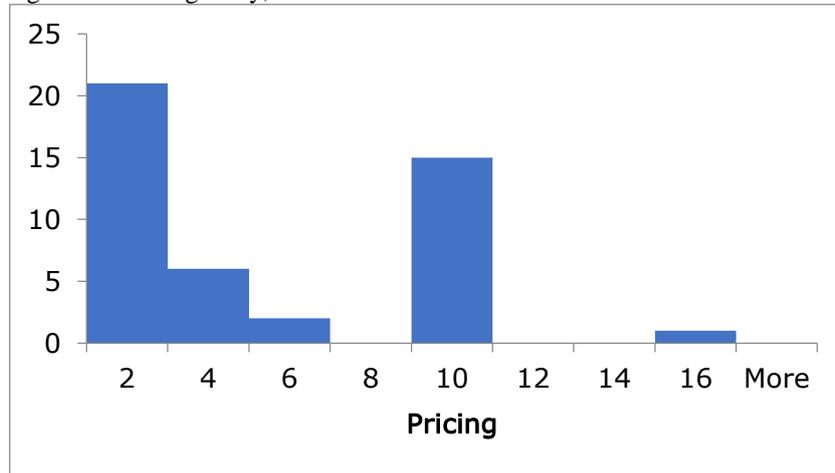
Big 4 = One if a Big 4 audit firm and zero otherwise

As shown in the Table 1, this research selected some specific indicators to be added to the descriptive statistics as quantitative indicators of the company and the capital. The focus on online and healthcare is that these two categories are more bullish for investors in the current envi-

ronment. On the other hand, the focus on exchanges focuses on the choice of these companies for their own markets. Even though it is clear from the table that most of the companies are targeting the top markets, the possibility of ending up trading on the OTCBB cannot be ruled

out, as they have stated in their S-1 release. The risk likewise only indicates how well they explain the risk factors in their statements, and a lower risk rating does not mean that there is less risk involved. The number of S-1s, excluding repeated filings due to ineligibility, also allows

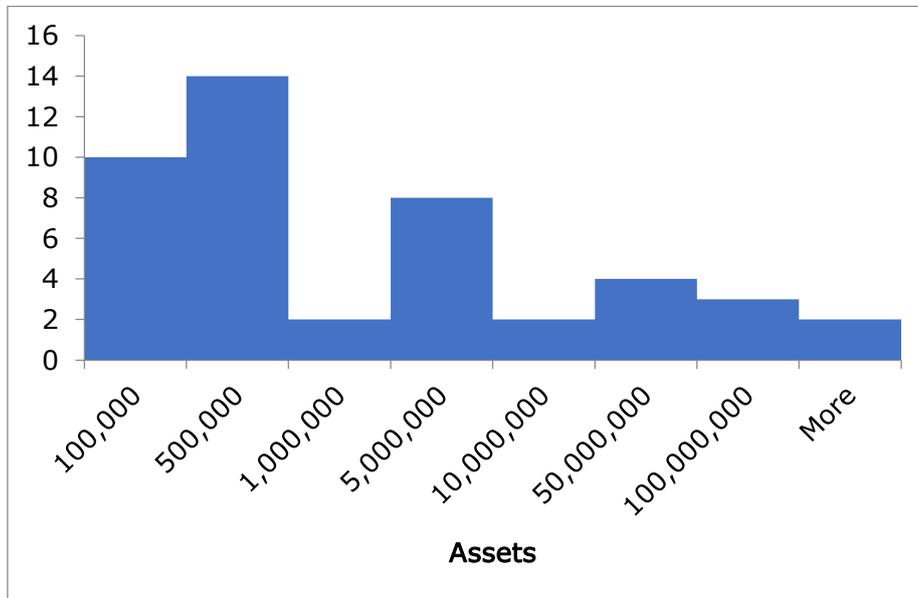
for the possibility of multiple additional stock offerings. In addition to this, since all sample companies did not use Big 4 accounting firms as auditors to add authority, they are not released in the table.



**Figure 1** Histogram of Pricing

As seen in the statistics, many of these companies are overly speculative penny stocks. At the same time, most companies have relatively few assets, and many even directly indicate that they are Special Purpose Acquisition Companies. These factors make it very difficult to find

information about them through means other than financial reports, but it also makes the impact of financial reporting quality on investments very significant. The specificity of these companies allows us to exclude most of the influence of factors other than financial reporting quality (Figure 1 and Figure 2).



**Figure 2** Histogram of Assets

#### 4. CALCULATION

Yield was decided to be used as an investment measure with the following calculation formula:

$$\text{Yield} = \text{net profit} / \text{cost} = \{(\text{sell price} - \text{buy price}) * \text{shares} - \text{fees}\} / (\text{buy price} * \text{shares} + \text{fees})$$

And Table 2 shows the earnings rate of different companies.

**Table 2. Earnings Rate**

Excellerant, Inc.	173.351
Crucial Innovations, Corp.	140.6667
Jufeel International Group (CNJG)	19.76333
Ezagoo Ltd (EZOO)	10.2
CHINA RECYCLING ENERGY CORP (CREG)	6.647059
XT Energy Group, Inc. (XTEG)	3.524
Kenongwo Group US, Inc.	3
JS BEAUTY LAND NETWORK TECHNOLOGY INC	1.15
GreenVision Acquisition Corp. ( GRNV、GRNVR、GRNVU、GRNVW )	1.08
Organic Agricultural Co Ltd (OGAA)	1.05
Newborn Acquisition Corp (NBAC, NBACR, NBACU, NBACW)	0.824
MULIANG VIAGOO TECHNOLOGY, INC. (MULG)	0.63625
Wetouch Technology Inc. (GLFW, WETH, GLFWD)	0.434615
ADDENTAX GROUP CORP. (ATXG)	0.425
TMSR HOLDING Co Ltd (CCNC, TMSR, CCNCW, TMSRW)	0.382022
Bridgetown 2 Holdings Ltd	0.311
Greencity Acquisition Corp (GRCYU)	0.07
CXJ GROUP CO., Ltd (ECXJ)	0.05
CHINA JO-JO DRUGSTORES, INC. (CJJD)	0.015152
Brilliant Acquisition Corp (BRLU)	-0.028
East Stone Acquisition Corp ( ESSC、ESSCR、ESSCU、ESSCW )	-0.0475
Yunhong International (ZGYHR, ZGYHU, ZGYHW)	-0.054
Silver Crest Acquisition Corp	-0.0768
China Yunhong Holdings Ltd (ZGYHR, ZGYHU, ZGYHW)	-0.087
CITIC Capital Acquisition Corp. (CCAC, CCAC-UN, CCAC-WT)	-0.104
MULIANG AGRITECH, INC. (MULG)	-0.26
CXJ GROUP CO., Ltd	-0.28343
IT TECH PACKAGING, INC. (ITP)	-0.28687
WeTrade Group Inc. (WETG)	-0.42667
WU BA SUPERIOR PRODUCTS HOLDING GROUP INC.	-0.59524
Global Seed Corp (GLBD)	-0.73529
Sino Agro Food, Inc. (SIAF)	-0.93667

## 5. COST OF EQUITY CAPITAL

A dividend growth model was used to measure the cost of equity capital, calculated as follows:

$$\begin{aligned} & \text{Cost of equity capital} \\ &= \text{Expected annual dividend} \\ & / \text{market price of common stock} * (1 \\ & - \text{expense ratio}) \\ & + \text{annual dividend growth rate of common stock} \end{aligned}$$

While measuring the cost of capital, it is surprising that, except for one company, Sino Agro Food, Inc. (SIAF), has declared a dividend. The remaining 32 companies all state directly in their dividend policies or risk factors that they will not pay dividends in the foreseeable future. Again, this means that even if use the CAPM model, it would not have any results due to a lack of data.

A Google search of these companies did not give us anything except that we could determine that most of them were blank check companies and penny stocks. It can be found that other companies have issued S-1 statements on the SEC this year and, excluding some of the unfinished statements, several companies also appeared that stated they would not pay dividends. With these statements, it can be concluded that these companies explicitly formed for a specific project or merger are not conventional. An investment in these companies is not something that the average investor would consider.

## 6. FINANCIAL REPORTING STANDARD USED IN CHINA

China generally uses A.S.B.E.s financial reporting standards for their domestic companies. However, international companies operating in China are subject to I.I.F.R.S. standards. Under these standards, four primary principles are explained as qualitative requirements for the financial statements, some of which are substantiated by some secondary principles [4]. These criteria are a prerequisite for the annual financial statements to fulfill their information transfer function.

Chinese companies that use international financial reporting standards include DJI Innovations, Lenovo, Haier, Huawei, electric car-manufacture NIO and Datang Telecom. The concept of the accrual basis and the assumption of the going concern form the basis for decision-useful final information to the addressees. The period definition means that business transactions should be shown in the financial statements when they occur and regardless of their cash flow. Furthermore, according to R.K.R.K. 23, financial statements are to be prepared on

the assumption that the company will continue as a going concern, as long as the company neither has the intention nor is forced to cease its activities or to significantly reduce the scope [5].

This raises an interesting research question as to the extent to which the application of high-quality international accounting standards also de facto lead to a higher quality of financial reporting by capital market-oriented companies [6]. This thesis examines whether and to what extent the quality of financial reporting in China with a focus on capital market-oriented companies in China has improved in the course of the uniformly applied IFRS standards and which determinants are decisive here [1]. On the basis of theoretical knowledge gained, hypotheses are checked through empirical studies.

## 7. CONCLUSION

This paper examined the effects of the mandatory financial accounting of capital market-oriented companies within the Chinese market on the quality of financial reporting and was rated very good. The harmonization of accounting has led to a fundamental change for capital market-oriented companies through the mandatory introduction of IFRS Financial reporting. The application of international accounting standards is intended to limit the scope for discretion in accounting options and, in particular, to give investors a better picture of the company's assets, financial and earnings position that corresponds to the actual circumstances.

At the same time, the large number of unconventional companies also makes the quality of financial reports increasingly important. The sample size is only 30, and their statements on the SEC also have a lot of unclear information, which makes any conclusions this research drawn not generalizable. The external environment over the past two years and the possibility that the Luckin Coffee incident may have caused many companies to abandon their U.S. listings may also have influenced the conclusions.

The current results are based only on the impact that financial report quality brings to an investment, where penny stocks generally exhibit higher yields. This implies that presenting one's projects to a broader audience through excellent financial reports does lead to more investments when financial reports quality is the only factor influencing investments.

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