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The Effect of Accounting Information Quality on the Relation between Financial Constraints with Stock Returns and New Investment[1]

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Research Paper

INTRODUCTION

In companies with higher accounting quality, financial transparency is greater and their sensitivity decreases to financial market failures (Bharath et al., 2008). On the contrary, companies with lower accounting quality, have less access to external financing, and these companies are more sensitive to changes in net income and net worth. On the other hand, a higher interest rate increases the interest cost and decreases the net income, subsequently, in this situation, their expected cash flows are discounted at a higher rate, and the borrowers' net wealth decreases. In this situation, the decrease the value of the assets causes a decrease in the value of the company's mortgage assigned to the lenders, including banks, and then it causes a decrease in the access of potential applicants to loans, because due to the existence of restrictions in the loan market, cash flows, and financial status of companies limit companies' access to loans (Armstrong et al., 2019). On the other hand, the asymmetry of information between borrowers and lenders aggravates the problems of

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adverse selection and moral hazard. Subsequently, the payable interest and the value of their collateral will decrease (Balakrishnan et al., 2020). This increase in the scope of agency conflict between borrowers and lenders has led to a gap between the cost of internal and external capital, which makes it difficult for companies to access external capital. Most of the time, companies cannot provide all their necessary financial resources from internal sources, therefore, despite the problem of accessing external financial resources, they are forced to ignore profitable investment opportunities and thus cause a decrease in the wealth of shareholders (Bernanke and Gertler, 1995). The performance, financial status, and financial health of companies can affect their production and growth of the company. On the other hand, companies' information environments and their accounting quality in particular can play a role in reducing information asymmetry between companies and capital providers (Armstrong et al., 2010). Therefore, for companies that have the problem of financial limitations and the risk of failing to pay debts, this limitation prevents the necessary financing for investment, which will hurt the stock returns of those companies (Akhgar and Karani, 2018). Therefore, the research question is whether the quality of accounting information can moderate the relationship between financial constraints with stock returns and new investment.

Theoretical review and development of hypotheses

Increasing the quality of financial reports leads to the reduction of information asymmetry between managers, lenders, and investors, it reduces the possibility of moral hazard, incorrect selection, and management monitoring costs and ultimately reduces investment risk and the cost of financing is reduced in the company (Balakrishnan et al., 2020). Therefore, the accounting quality of companies plays a key role in reducing information asymmetry for actual and potential investors. There is also evidence that there is a direct and significant relation between the level of disclosure quality above the average and the performance of companies (Cho and Kang, 2019; Lambert et al., 2007).

One of the main reasons for the difference between the cost of internal and external financing is information asymmetry and agency problems. The increase in the uncertainty of the information provided prevents the flow of capital from investors and creditors into the company or investors demand a higher rate of return, both of which lead to limitations in the company's investment opportunities. (Bharath et al., 2008; Cho and Kang, 2019; Tirole, 2015). In such a situation, the quality of financial information can play an important role. Financial information can lead to companies reaching appropriate investment opportunities and improving the supervisory role of managers through the reduction of information asymmetry (Ahmad et al., 2021). In this regard, Balakrishnan and Ertan (2018) argue that companies with better financial information quality have fewer restrictions in financing, they argue that due to the asymmetry of information from companies with higher quality, less guarantees, and collateral is taken for financing and therefore they are less limited in financing. Inadequacies in financial markets can affect development and growth (Kaplan and Zingales, 1997).

Armstrong et al. (2019) have stated that the quality of financial information helps to reduce defects in the market in several ways: First, the high quality of financial information helps managers to identify desirable projects or investment opportunities, which leads to efficiency in investment (Balakrishnan et al., 2014; Cho and Kang, 2019), secondly, the quality of financial information helps the control mechanisms of the company to prevent the deprivation of power and wealth from shareholders and creditors by managers (Balakrishnan et al., 2020; Mishkin, 2016), third, the quality of financial information can affect economic performance by reducing liquidity risk, the risk of incorrect selection, and information risk (Balakrishnan et al., 2020).

RESEARCH HYPOTHESES

Based on the above arguments, the following hypotheses can be proposed:

1) Improving the quality of accounting information weakens the negative relation between financial constraints and stock returns.
2) Improving the quality of accounting information weakens the negative relation between financial constraints and new investment.

RESEARCH METHOD

This research is based on archival data of the past type. Also, it is a descriptive-correlation type of study. In terms of purpose, it is functional.

Studies and articles published in databases have been used to compile theoretical foundations. To collect data, the Rahavardnovin database and the information of the companies listed in the Tehran Stock Exchange were used. The statistical population of the companies admitted to the Tehran Stock Exchange during the years 2013 to 2019 and 148 companies were selected by the screening method.

RESEARCH VARIABLES

Stock return (R): It is a set of benefits that are given to a share during a period, including increased cash profit, benefits due to pre-emptive rights, bonus shares, a capital increase from claims, and cash receipts. In this research, the share return is directly from the database.

New investment (NewInv): To measure new investment, the following relation was used, which is adjusted with the book value of assets at the beginning of the period.

new investment = purchase of fixed assets + Research and development costs - Accumulated depreciation - Sale of tangible fixed assets

Quality of accounting information: In this research, the quality of accounting information was used to measure the quality of accruals according to Dechow and Dichev (2002) and the adjusted method of Francis et al. (2008).

Financial Constraints: The value of the Z score in Altman's model is a scale for estimating the probability of bankruptcy (financial limitation) of a business company. Modified Altman’s (2000) model, a value less than 1.8 indicates a potential probability of the company's bankruptcy in the next two years with a probability of 95%, while the Z value is greater than 3, and the probability of the company's bankruptcy is low. If the Z value is less than 1, then the company has financial constraints, and if they do not have financial constraints, it is assigned a zero value (Batcheler, 2018).

CONTROL VARIABLES:

Growth rate: It is equal to the changes in the company's sales compared to the previous year.

Size: It is equal to the natural logarithm of the company's total assets at the end of the financial year

Return on Assets: It is equal to net income divided by total assets.

Book Value to Stock Market Value: Book value (BV) is obtained from the sum of the equity section recorded in the balance sheet divided by the market value of the company's shares.

Financial Leverage: total liabilities at the end of the financial year divided by the total assets of the company at the end of the financial year.

Market Concentration Index: the sales of a company's products are a percentage of the total sales of the products of companies in that industry. This variable takes a value between zero and one, the larger this ratio is the more concentrated the company is in the industry, and vice versa.

Age: equal to the natural logarithm of the difference between the company's entry year and the current year.

FINDINGS

The findings show that the quality of the accounting information of the sample companies had a negative bias during the studied period, that is, it has decreased. The increase in the quality of accounting information has been accompanied by an increase in stock returns and an increase in new investments. The increase in financial constraints has been associated with a significant decrease in stock returns, but financial restrictions have not had a significant relation with new investments. Accounting information quality weakens the negative relation between financial constraints and stock returns. The quality of accounting information intensifies the positive relationship between financial constraints and new investment.

RESULTS

Improving the quality of accounting information leads to the reduction of information asymmetry and subsequently increases stock returns, therefore, the capital market reacts positively to the improvement of the quality of accounting information. Also, improving the quality of accounting information is associated with increasing new investments. An increase in financial

restrictions will result in a decrease in stock returns. In this regard, the quality of accounting information reduces the negative impact of financial restrictions on stock returns. Financial constraints have no relation with new investment, but with the increase in the quality of accounting information, the positive relationship between financial constraints and new investment is strengthened.

Keywords: Accounting Information Quality, Financial Constraints, Stock Returns, New Investment.
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