

Decision Usefulness Paradigm: Investment Decision Making

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Abstract: The article states about how the decision usefulness paradigm was used as an approach in making investment decisions on financial information presented by an entity. The financial information presented in the entity's financial statements must be relevant and reliable to the information users, whether it is from internal or external parties to the entity. IASB (2008) The objective of financial reporting is to provide economic entities with high quality financial reporting information, especially for general finance, which is useful for making economic decisions. Decision usefulness paradigm is an approach in making investment or not investing decisions. By using literature methodology, various literatures, journals and others were used to conclude how the decision usefulness approach affects investment decisions.

Keywords: decision usefulness, investment

Date of Submission: 01-01-2021

Date of Acceptance: 13-01-2021

I. Introduction

Financial information is useful if the information can have an influence on capital market in general and if the information can make investors have decisions to invest or vice versa. The stock market does not always show the ideal conditions under which the conditions of cash flows and interest rates can be known to the public with certainty. Conversely, conditions that show unpredictable cash flow and interest rates are said to be non-ideal market conditions.

Market conditions are not ideal raises the question of whether financial information is useful or not. How can financial statement information remain relevant and reliable in non-ideal market conditions? Does this mean that the financial statements are no longer relevant for making investment decisions? How can people keep accounting information relevant in non-ideal circumstances? And various other questions.

Scott (2009) explains that to understand the paradigm with decision usefulness concept, the usefulness of information is not only seen from the completeness in presenting information about an entity. However, the extent to which information is considered useful if the information can help in making decisions. The paradigm requires better attention to users and the types of decision-making problems they face. The approach is called the decision usefulness approach.

II. Discussion

The Decision-Usefulness Approach

According to Scott (2009), there are important factors that must be considered when using the decision usefulness approach, namely:

1. Who are the users of financial reports? There are many users of financial reports. The Financial Accounting Standards Board (FASB) in its reporting purposes states that information is intended for decisions related to corporate business and investment. Based on the reporting objectives, users of financial reports can be grouped into owners (investors), lenders, suppliers, employees, and management (Hendriksen and Van Breda, 1992).

According to Harianto and Sudomo (1998), users and how to use financial reports are described as follows:

- Owners (investor). An owner has an interest in financial reports for the benefit of management's performance appraisal, as the party given the responsibility for running shareholder funds. In addition, financial reports include earning information. Several previous studies also used earning information to determine share ownership policies, for example: Little (1962); Little and Rayner (1966) in Watts and Zimmerman (1986); and Ball and Brown (1968). If the ability to generate earnings is low, then it can be considered to transfer share ownership to another company.

- **Lenders.** A lender is a group with an interest in financial statements to assess and see the entity's ability to repay loans and interest. The information can be seen through liabilities analysis with assets in financial statements.
- **Suppliers.** The relationship between suppliers and companies can be bridged through financial reports. The supplier will give a special price if they see the company's financial capabilities are good. Such as information in financial reports that shows a high level of liquidity and solvency, it means that it shows the entity's ability to pay its obligations.
- **Employees.** Requests for financial statements by employees are based on several motivations. Employees have an interest so that the company always develops well and generates profits. Financial reports are important information that can be used to view the current and future conditions of a company's profitability and solvency. Financial reports can also be used as the basis for providing incentives based on the achievement of certain profit targets.
- **Management.** Management has an interest in financial reports as a medium of accountability to company owners. In addition, as a tool to show management performance, financial reports can be used as a basis for giving bonuses to management. Many studies use accounting information as a medium to control management, especially bonus giving, including Healy (1985).

2. What problems might users of financial reports face in making investment decisions?

By understanding the problems in making decisions for users of financial statements, accountants will be better able to meet the information needs of these users. Financial reports that have been prepared are then adjusted according to the specific needs of its users. This is expected to lead to better decision making. However, it is not easy to find out the types of problems in making decisions for financial statements users. Accountants must understand their logic of thinking. One way to do this is by using economic and financial theory. Two theories that will be discussed in this article are the theory of individual decision making and the theory of investment.

Single-Person Theory of Decision

Single-person decision usefulness theory is based on the point of view of an individual who must make decisions in conditions of uncertainty. The theory supports this research because it establishes procedures to allow additional information to be obtained from the reporting entity to revise the decision maker's subjective judgment about the probability of what may have happened after the decision was made. According to El-Maud et al. (2015), the philosophy behind single-person theory of decision is to tilt financial reporting to a special class for users with a view to optimally making use of all available information that is capable of making decisions. The use of single-person theory of decision is that this theory applies the view that "if we cannot prepare theoretically correct financial reports, at least we can try to make financial reports more useful" (Dandago and Hassan, 2013).

As for some of the benefits of this theory, among others: First, it helps accountants understand how individuals make rational decisions in uncertain conditions. Second, it makes accountants appreciate the concept of information, a concept that is able to make decision makers sharpen their subjective beliefs about the future payoff, as a result of the decisions they make.

This theory uses the point of view of individuals who have to make investment decisions in uncertain circumstances. The probability used is no longer objective as in ideal circumstances. Thus, a formal procedure is needed for individuals to be able to make the best decisions that is choosing one from a set of alternative decisions. This procedure allows for additional information, which is needed to improve the subjective determination of the probability of events after a decision has been made. The role of accounting is needed here because it is able to provide additional information for the procedure.

Role of Accounting Information

To be said to be useful, information must be able to help predict future investment returns. How do historical cost based financial reports help users? The answer is to help predict that bad news or good news contained in financial statements will remain in the future. According to Scott (2009), there are two types of ways to use financial information to predict the expected return on investment in the future, namely:

1. By using current financial statement information (good news or bad news in net income) → future earning power prediction → prediksi future expected return prediction.
2. Zhang (2002) stated that a good quality earning is an earning which can be a good indicator for predicting future earnings. They term a good quality earning as "sustainable earnings".

The results showed that the earning behavior has a random walk characteristic (Watts dan Zimmerman, 1986). In other words, earning behavior cannot be patterned so that it is difficult to use it as a prediction basis. Meanwhile, Penmann and Zhang (2002) show that if companies consistently apply conservative accounting without changing methods and estimations, it will improve the quality of the company's earnings. If the quality

of earning information is reflected in changes in market reactions (stock prices), Franci et al (2002) showed that if financial statements are presented in detail and there is an explanation (disclosure), it will have a positive effect on the market. However, Easton and Monahan's (2005) study showed that the use of accounting numbers as a proxy for expected return does not show a positive association. In other words, accounting numbers cannot be used as a basis for determining the expected rate of return on investment.

1. By using current cash flow information

Current Financial Statement (good news or bad news in cash flow) → future cash flow prediction-
→ future expected return prediction.

Thus, based on decision theory, it can be concluded that historical cost-based financial reports are still useful for investors even though these reports do not directly report future cash flows based on present value calculations (present-value-based).

The line connecting current financial statement information with future financial statement information is a probabilistic condition. The concept of information systems shows that the greater the probability in the information system (in the main diagonal), the information is considered informative. Why? This is because the large probability indicates that current information has the ability to predict a great deal about future events. The more informative the information, the more useful it is for decision making. Thus, the definition of information in decision theory is: evidence that has the potential to influence individual decisions. This theory is part of an individual decision-making theory that specializes in modeling rational investor decision-making processes. By understanding this theory, it helps accountants understand the characteristic of risk in an investment context. An investment decision is a trade off between return and risk (Jones, 1998). A return is the result obtained from the capital people invest. It is divided into 2 types which are: expected return (expected return in the future) and realized return (actual return that happened in the past). Meanwhile, a risk is the possibility that the actual return will not be the same as the expected return. Return and risk have a positive relationship, the greater the risk that must be borne, the greater the return that must be compensated (Jogiyanto, 1998).

In decision theory, it is assumed that (Scott, 2009):

1. Investors, in making decisions, will choose the investment with the largest expected utility. In this case, it is the largest expected return at a particular risk.
2. A rational investor is an investor who has risk-averse characteristic. Risk-averse investor is an investor who will not accept a certain level of risk unless there is an expectation of proper compensation for taking that risk (Jones, 1998). Knowledge of the risk-averse characteristic of investors is important for accountants because it shows investors' information needs related to risk as well as the expected return value in the future.

The investment decision making processes include (Jones, 1998):

1. Stock Analysis, namely the process of valuing and analyzing individual shares.
2. Portfolio Management, which is the arrangement of a group of assets (i.e. portfolios) into a unit.

There are 2 types of investment risk, including:

1. Economic-widerisks, which is a risk that arise from changes in the company's external environmental factors and are usually macro in characteristic. Examples of such factors are: interest rates, foreign exchange rates, levels of economic activity, etc. This macro-perspective risk becomes meaningful if the return on one stock is high, then it is likely that the return on the other stock is also high. In other words, the returns between the company's shares are well correlated. The risk of these stocks cannot be eliminated by forming a portfolio. In many textbooks, residual income capital charges are recommended as market-risk (Christensen et al, 2002).
2. Firm-specific risks, which is a risk that arise from internal factors of the company and only affect that company. The examples are: changes in production processes, changes in marketing strategies, etc. This risk is independent between companies. High returns in one company are not always the same as in other companies. This risk can be eliminated by forming a portfolio. Disclosure of corporate risk is one of the things requested by the Security and Exchange Commission (SEC) through Financial Reporting Release No. 48 (Jorgensen and Keirschenheiter, 2003)

How a diversified portfolio reduces investment risk?

According to Jogiyanto (1998), the assumption used in diversification is that there are no transaction costs, so the more portfolios the better, the lower the risk. With portfolios, one entity-specific risk will offset the other entity-specific risks. If one company turns out to have a low return, there is always a chance that the other company's shares will have a high return. The more diversification, the more efficient. In contrast to economy-wide risk, there is no complete process of eliminating each other. When a market portfolio is carried out,

economy-wide risk still contributes to portfolio risk and this risk cannot be diversified. This risk that cannot be diversified is called systematic risk. With diversification, investors can minimize risk without reducing returns (Jogiyanto, 1998).

Benefits of the Decision-Usefulness Paradigm in Investment Decision

Most of the accounting professional organizations have adopted the decision-usefulness paradigm. This can be seen in the FASB Conceptual Framework in SFAC Number 1 concerning the purpose of reporting is for rational investment. This is the same as stated by the decision theory which states that individuals who try to maximize the expected utility are called rational individuals.

The second reporting objective of SFAC No. 1 is the provision of information to help determine the amount, timing, and degree of uncertainty of cash received from dividends or interest. This objective recognizes the need for predictive information about the value of future investments. It is the same as predictions in investment theory. How can historical-based financial reports be used for future returns? It may be the main difficulty faced by the FASB. Historical cost has been applied by the company regularly, so it is necessary to draw a line connecting the company's past performance (because financial reports are based on historical costs) with future prospects in accordance with the objectives of SFAC No. 1.

According to SFAC No. 1, although investment and credit decisions represent expectations of a company's future performance, these expectations are usually, at least in part, based on past performance evaluations of the company. The SFAC statement is in line with the information system in the decision-making model. Financial statements are now the basis for determining good or bad news probabilities and the characteristic of future performance (high or low earning power).

In SFAC No. 2, the FASB states the characteristic of accounting information needed to achieve financial reporting objectives. According to Suwardjono (2006), information is considered useful if:

1. Increase decision makers' knowledge about past, present, and future decisions.
2. Increase the users' confidence about the probability that an expectation will be realized under conditions of uncertainty
3. Change the decisions or behavior of users.

This relevant essence is the same as the definition of information in decision theory. In decision theory, information is something that has the potential to change a person's decision. An evidence that does not have the potential to make changes, means that it is not an information. According to SFAC No. 2, another thing that characterizes information is reliability. Reliable information is information whose presentation is fair, verifiable, and neutral from influence. These characteristics are the same as the characteristics of information in decision theory, which are precise and free from bias.

III. Conclusion

Accounting information is closely related to decisions and to the decision-making problems that users face. It is to achieve the objectives of preparing financial statements as compiled in SFAC No. 1. The step taken by accounting is to borrow the "glasses" of economic and financial theory. In preparing financial reporting objectives, the decision to borrow from economic and financial theories cannot be separated from the existing capitalist economic system. Emphasis on capital, the interests of investors, and investors' information needs, making accounting use the basis of assessing the usefulness of the information they provide is from the point of view of capital holders, which is market reaction (reaction of the capital owners). Information is considered to have "value" if it reacts to the stock market price (owners of capital respond to accounting information). One example is Ball's research (1972), which links accounting information (changes in accounting techniques) to stock prices. Gaffikin (2008) stated that the tendency of accounting research to side with the owners of capital was because there is grant assistance from American industrial groups to conduct research oriented towards industrial interests as a funder. In fact, users of accounting information are not only shareholders. There are still employees, suppliers, the community. Their point of view may make the definition of "informative" different.

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Santiadji Mustafa, et. al. "Decision Usefulness Paradigm: Investment Decision Making." *IOSR Journal of Business and Management (IOSR-JBM)*, 23(01), 2021, pp. 30-34.