

CHAPTER II

PART 1: TEHRAN STOCK EXCHANGE

**PART 2: FINANCIAL REPORTING QUALITY AND
INVESTMENT EFFICIENCY: THEORETICAL
PERSPECTIVES**

Contents

2.1	The Tehran Stock Exchange	25
2.1.1	History	25
2.1.2	Industry Affiliations:	27
2.1.3	Structure:.....	27
2.1.4	Trading Platform.....	28
2.1.5	Market segmentation.....	29
2.1.6	Economic Sectors:	30
2.1.7	Membership in International Organizations	33
2.1.8	Capital and Shareholders	33
2.1.9	Roles of the Tehran Stock Exchange	33
2.1.10	Definition used in the Tehran Stock Exchange.....	34
2.1.11	Bodies of the Company in the Tehran Stock Exchange	35
2.1.12	Financial Regulations in the Tehran Stock Exchange	35
2.1.13	Goal of the Tehran Stock Exchange.....	38
2.2	Financial Reporting Quality and Investment Efficiency	40
2.2.1	Definition of Financial Reporting.....	40
2.2.2	Objectives of Financial Statements	42
2.2.3	Standards and Regulations.....	43
2.2.4	Quality of Financial Reporting	44
2.2.5	Methods of Measurement of Financial Reporting Quality	45
2.2.6	Cash Flow Statement:.....	47
2.2.7	Theoretical Perspectives	49

2.1 The Tehran Stock Exchange

The Tehran Stock Exchange (TSE) is Iran's largest stock exchange, which was first opened in 1967. The TSE is based in Tehran. As of May 2012, 339 companies with a combined market capitalization of US\$104.21 billion were listed on TSE. TSE, which is a founding member of the Federation of Euro-Asian Stock Exchanges, has been one of the world's best performing stock exchanges in the years 2002 through 2011. TSE is an emerging or "frontier" market. The most important advantage that Iran's capital market has in comparison with other regional markets is that there are 37 industries directly involved in it. Industries such as the automotive, telecommunications, agriculture, petrochemical, mining, steel iron, copper, banking and insurance, financial mediation and others trade shares at the stock market, which makes it unique in the Middle East. The second advantage is that most of the state-owned firms are being privatized under the general policies of article 44 in the Iranian constitution. Under the circumstances, people are allowed to buy the shares of newly privatized firms. Iran is among the few major economies that has maintained positive economic growth despite the 2008 global financial crisis and international sanctions imposed by the United States, the European Union and the United Nations Security Council.

2.1.1 History

The concept of a stock industrialization dates back to 1936 in Iran with the largest and oldest bank in Iran, Bank Melli together with Belgian experts wrote a report detailing the prospects of having an operational stock exchange in Iran. The outbreak of World War II and other political factors delayed implementation until 1967, when the Government revisited the issue and ratified the "Stock Exchange Act". Consequently a small exchange, the Tehran Stock Exchange (the "TSE") began its operations in 1967. Trading was initially in corporate and government bonds. The economic boom in the

1970s led to a pent-up demand for equity. Meanwhile, certain forces were changing the economic backdrop in Iran. The Government was actively involved in the grant of shares to employees for large state-owned and family-owned enterprises. Market activity was reaching frenzy with many companies and high net worth individuals vying to participate in the new-found wealth associated with the TSE. Everything came to a standstill after the Islamic Revolution leading in a prohibition against interest-based activities and nationalization of major banks and industrial giants. Mobilization of all resources towards the war effort during the 8-year Iran-Iraq war did not help matters. However, the Government fully embraced economic reforms and a privatization initiative in 1989 with a surge of activity in share activity of many state-owned companies through the defined targets in the first "Five-Year Economic Reform" where the Government together with the Parliament defined the economic prospects of the country for the coming five years. Attention to promotion of the private sector and new interest in the TSE brought life back to the market. However, lack of regulation and out-of-date legal framework led to crisis in the market leading to certain "meltdowns" until today. The market has experienced its share of highs and lows in the past years including topping the World Federation of Exchanges' list in terms of performance in 2004 to tumbling down to last place in 2007 due to political uncertainties in the region. This trend with ups and downs has been presented from the view of share price index in Figure 2.1.



Figure 2.1 TEPIX: Tehran Stock Exchange's main index

2.1.2 Industry Affiliations:

Since 1995, TSE has been a full member of the World Federation of Exchanges and is a founding member of Federation of Euro-Asian Stock Exchanges (FEAS). Since July 2010 the TSE is a member of the International Options Market Association.

2.1.3 Structure:

The structure of the TSE comprises of the Securities & Exchange Council and the Securities and Exchange Organization. The objectives of these twin institutions of the TSE have been briefly highlighted below.

The Securities & Exchange Council is the highest authority and is responsible for all related policies, market strategies, and supervision of the market in Iran. The Chairman of the Council is the Minister of Economics and other members are: Minister of Trades, Governor of the Central Bank of

Iran, Managing Director of the Chamber of Commerce, Attorney General, Chairman of the Securities and Exchange Organization, representatives of the active market associations, three financial experts requested by the Economics Minister and approved by the Council of Ministers, and one representative for each commodity exchange.

The Securities and Exchange Organization (SEO) is responsible for administration and supervisory duties, governed by the Board of Directors. The SEO's Board of Directors is elected by the Securities and Exchange Council. SEO also actively promotes innovation in Islamic products and has formed a specific "Sharia Committee" to assess the compatibility of new products with Islamic law. SEO is the sole regulatory entity for the regulation and development of the capital market in Iran.

2.1.4 Trading Platform

The Tehran Stock Exchange (TSE) has started an ambitious modernization program aimed at increasing market transparency and attracting more domestic and foreign investors. Concrete measures that have been taken in the planning and operations of the stock exchange such as the settlement system, geographical expansion, new exchange laws in order to attract local and foreign capital. The TSE has installed the new trading system, which has been purchased from Atos Euronext Market Solutions (AEMS) in 2007. The new system makes it possible to purchase and sell stocks on the same day. The system has also made it possible for 2,000 brokerage stations to work simultaneously, while the number was just about 480 in the past. The rise in electronic dealing, non-stop input and updated data on orders, transactions and indices are among other features of the new system. The new system has made it possible to link the stock market to the international bourses. The bourse can now handle 700 transactions per second and 150,000 transactions per day. The trading system is an order driven system, which matches buying and selling orders

of the investors. Investors can place their orders with TSE accredited brokers, who enter these orders into the trading system. Then, the system automatically matches buy and sell orders of a particular security based on the price and quantity requirements. The mechanism of equity pricing is based on the best price (price priority) and time of order priority.

Under the price priority rule, a selling (buying) order with the lowest (highest) price takes precedence. Under the time-priority rule, an earlier order takes precedence over others at the same price. Thus, when the lowest sell and the highest buy orders match in price, the transaction is executed at the price. In short, the TSE market is a pure order-driven Market. The trading system also generates and displays details of current and historical trading activity, including prices, volumes traded and outstanding buy and sell orders. This ensures that investors have the required information to be able to take informed investment decisions.

The range of price movements is typically restricted to 3% daily either way from last closing. Restriction on Rights is 6%. This can be changed in specific situation by the Board of the TSE in case of unusual price movements resulting in an extremely high or low P/E ratio. Short selling is not permitted. There are no minimum trading lots. According to the Iranian Commercial Law, companies are prohibited from share repurchases. TSE Services Company (TSESC), which is in charge of the site, supplies computer services. TSESC is a member of Association of National Numbering Agencies (ANNA).

2.1.5 Market segmentation

Besides the Main and Secondary Market, there is a corporate participation certificates market (corporate bonds). Secondary Market is an exchange facility where the listed securities of small and mid-size companies can be traded efficiently and competitively. Any company,

domestic or foreign, can list their products on the exchange for as long as they meet the listing criteria and these are presented in Table 1.2. The value of three markets of Securities and Stock Exchange, Over the Counter (OTC) stock exchange and commodity exchange hit \$100 billion in December 2010. In 2010, the Kish Stock Exchange was launched to facilitate foreign investment and monetary activities in Kish Island Free Trade zone.

Table 2.1 Minimum Listing Requirements

Description	Main Board	Secondary Board	Secondary Market
Minimum Capital (billion IRR)	200,000	100,000	30,000
Minimum Shareholders	1000	750	250
Free Float (%)	20	10	15
Minimum Term of Operation (Years)	3	–	–
Profitability (Years)	3	2	1
Equity to Asset Ratio (%)	30	20	15
Market Makers	Selective	Selective	Mandatory

Source: Tehran stock exchange

2.1.6 Economic Sectors:

The major developments in the economic sectors of the TSE have been briefly presented below for the period between 2007 and 2012 with highlights being presented in Figure 1.2.

2007: There were 324 companies listed on the TSE with a total market capitalization (MC) of US\$42,452 million. Close to 60% of the MC relates to listed companies from the following sectors:

- Basic Metals,
- Motor Vehicles and Trailers,
- Chemicals and By-Products,

- Non-Metallic Minerals Products.

A total of 161 companies from these sectors are listed on the TSE, which translates to 49.7% of total companies listed. Largest stocks include:

- Mobarakeh Steel Co. with MC of US\$3,218 million, which translates to 7.6% of MC,
- National Iranian Copper Industries Company at 6.8% of MC,
- SAIPA at 5.3% of MC.

2008: Other companies in the top spots included are:

- Gol Gohar Iron Ore Company (\$2.1 billion MC),
- Chadormalu Mining and Industrial Company (\$2 billion),
- Kharg Petrochemical Company (over \$1 billion),
- Ghadir petrochemical companies (over \$1 billion),
- Khouzestan Steel Company (over \$1 billion),
- Power Plant Projects Management Company (MAPNA) (over \$1 billion),
- Retirement Investment Firm (over \$1 billion),
- Iran Khodro (over \$1 billion),
- Metal and Mine Investment Companies (over \$1 billion).

This indicates that the capital market in Tehran is heavily concentrated on four economic sectors with companies that make up nearly half of the total listed companies on the exchange. While 163 companies listed are spread out amongst 26 sectors, with the "Food and Beverages Sector" alone accounted for 32 companies at a market capitalization of US\$897.5 million. Studies show that in 2008 about 30 firms, involved in 11 industries, hold close to 75% of shares in Tehran Stock Exchange.

2009: A comparison of the top 100 Iranian companies and the Fortune 500 in 2009 indicated that the gross profit margins of the top 100 Iranian companies were almost double those of the Fortune 500. For

Fortune 500 companies, the average gross profit margin was 6.9% and for the Iranian companies, it was 13%. The sector with the highest profit margin among the top 100 Iranian companies in 2009 is mining, with a margin of 58%. The mining companies in the Fortune 500 had a gross profit margin of 11%. After mining, other industries with highest margins are base metals, and telecommunications.

2011: The best performing industries in 2011, in terms of total sales, were the banking and automotive sectors. The worst performers were home appliances and electronics. In terms of gross profit margin, mining, telecommunications, and oil and gas exploration & production were the best performing industries. Sales totals of the top 100 Iranian companies on the list ranged from \$12.8 billion for the top ranking company, Iran Khodro, to \$318 million for the 100th company.

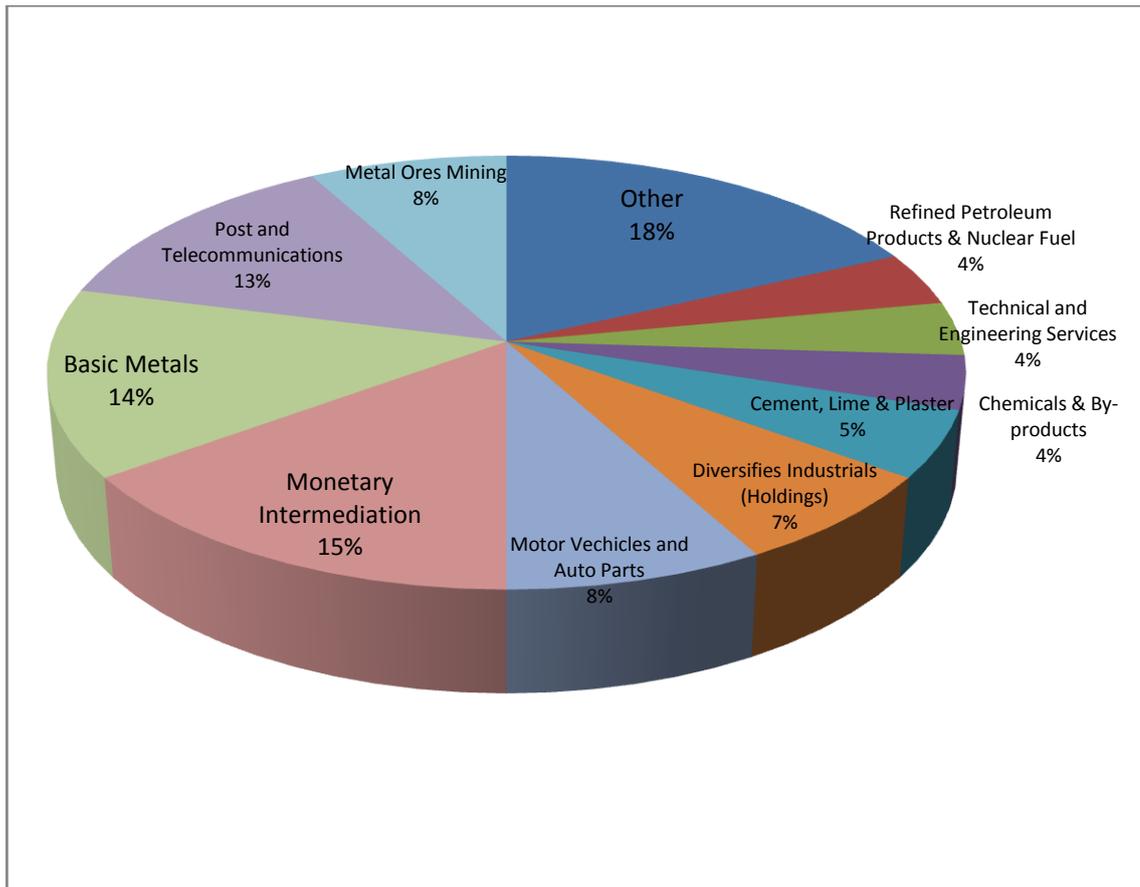


Figure 2.2 Top 10 Sectors by Market Capital, June 2010

As at 2008, about 30 firms, involved in 11 industries, hold close to 75 percent of shares in TSE. In September 2009, Telecommunication Company of Iran was privatized and became the largest company listed on TSE.

2.1.7 Membership in International Organizations

- Joined as full member of the World Federation of Exchanges (WFE) in 1994.
- Federation of Euro – Asian Stock Exchange (FEAS): joined as full member in 1995.

2.1.8 Capital and Shareholders

The capital stock of the stock exchange is equal to the sum of 150 billion Rials, which is divided into 150 million registered common shares of 1000 Rials each. Shareholders are classified as follows:

- ❖ **Class one:** persons who have received the license for brokerage activities in compliance with the stock exchange establishment law (1966) or those who shall receive the license for broker/dealer activities in compliance with the securities Act (2005) and shall be accepted as the members of the **TSE**.
- ❖ **Class two:** Financial institutions other than brokerage firms who shall receive the activity license from the **SEO**.
- ❖ **Class three:** All persons other than class one or two above.

The maximum percentage of shares belonging to each class of shareholders defined above will be determined by the SEO. At the moment the maximum percentages are 40, 40, and 20 percent respectively.

2.1.9 Roles of the Tehran Stock Exchange

Legislation establishing the TSE was formally enacted in 1966 and the TSE began trading on April 6, 1967. Forty years after the establishment

of the TSE, a new securities Act was passed on November 2005. Under this Act, the TSE has been demutualized.

As defined in the article of association, the TSEs primary roles are:

- ❖ Establishing, organizing and managing of the Stock Exchange in order to trade listed securities.
- ❖ Listing of securities.
- ❖ Prescribing membership requirements for member and supervising their performance, and regulating their activities.
- ❖ To oversee the transactions of the Exchange listed securities.
- ❖ Monitoring the performance of issuers of the listed securities.
- ❖ Process and disseminate the information regarding the securities order and transactions of securities.

2.1.10 Definition used in the Tehran Stock Exchange

Article 1) All terms defined in Article One of the securities Market Law of the Islamic Republic of Iran (I.R.I), ratified by the parliament of I.R.I on Nov. 22nd, 2005 shall have the same meaning in these Articles of association. Other terms shall have such meanings as defined below:

- 1) **Law:** securities law of the I.R.I, was ratified by the parliament of I.R.I. on Nov. 22nd, 2005 and the amendments thereto;
- 2) **Commercial code:** commercial code ratified in 1932 and amended in 1968;
- 3) **Regulations:** including the approvals of the Board of Ministers, Supreme Council of Securities and Exchange (Council), SEO and any such approvals by other institutions concerning the securities market and market participants, which are notified to be implemented, to the extent of the power delegated to which under any particular title (by-laws, regulations, procedures and circulars);
- 4) **Member:** A person who is registered by the company under this title, in compliance with the law and Regulations and qualified with respect to

general, professional and financial standards and duties prescribed in the Law and Regulations;

- 5) **Investor:** A person who is the owner of the listed securities or has taken required measures in this regard;
- 6) **Listed Securities:** Securities listed in the company in compliance with the Law and Regulations and facilities for transaction of which are provided by the company.
- 7) **Associate Person:** Associate person as defined in national accounting standards.
- 8) **Relevant Person:** Natural or legal entities who shall have, accounting to an agreement or any other legal relationship, any such mutual rights and commitments to the company.

2.1.11 Bodies of the Company in the Tehran Stock Exchange

Article 18) – Bodies of the Company shall include:

- 1) General Meeting.
- 2) Board of Directors.
- 3) Managing Director.
- 4) Inspector / Auditor.

2.1.12 Financial Regulations in the Tehran Stock Exchange

Article 53) –The fiscal year of the company shall be equal to one solar year (Iranian Calendar) and shall commence from the beginning of the Farvardin to the end of Esfand of the same year, except for the first year of business. The first year of business of the Company shall commence from the day of establishment to the end of Esfand of the establishment year.

Article 54) –The Board of Directors of the company shall provide the inspector / auditor with the annual financial statements of the company

together with a report on performance and general situation of the company to be examined, not later than thirty days before the general meeting which shall be convened to examine such materials.

Note: The board of directors shall prepare the interim financial statements for the first half of each fiscal year and submit it to the inspector / auditor for further comments not later than 45 days after the first half of the same year. The inspector / auditor shall submit his comments to the company and submit a copy to the SEO.

Article 55 –Any such income resources of the company, including commissions, listing fees, membership fees, members access fees, and any other incomes, together with a timetable for receipts, a list of players, payment guarantees and any such other related materials shall be approved by the SEO.

Note:These shall be within the powers of the Board of Directors to determine the price of services and commissions received by the company, observing the ceilings prescribed by the SEO.

Article 56–Precautionary reserve of the company shall be determined by the SEO in addition to the legal reserve stated in Article 140 of the commercial code. The general meeting shall prescribe the amount of one fifth of the company’s net profit as the precautionary reserve until it is equal to the amount prescribed by the SEO. The precautionary reserve shall not be divided among the shareholders without permission of the SEO.

Note: These shall be within the powers of the ordinary general meeting to prescribe an amount for precautionary reserve above what is determined by the SEO.

Article 57–The Company shall deposit collateral determined by the SEO to compensate damages which may be incurred by directors and employees to the others due to violation of any such provisions of the law

and regulations. The type and amount of the collateral may be changed as the SEO thinks fit.

Article 58 –The Company shall not undertake, without permission of the SEO, any such liabilities above 80% of its own capital.

Article 59 –The Company shall not invest in the stocks of the listed companies, members and such other companies which are dealing in securities trade or grant any loan to such companies, or purchase any such securities issued by the aforesaid companies.

Article 60 –The Company may accomplish any such required measures and investment to perform the objects of the company and acquire any such required assets in this regard. The Company shall acquire the permission of the SEO to accomplish or invest in any such activities not related to the objects of the company and acquire any such unnecessary assets for performing the objects of the company.

Article 61 –The authorized signatories and the extent of the powers and responsibilities of whom, shall be determined by the board of directors. The decision of the board shall be submitted, within a periods of one month to the office the registrar of companies to be published in the official gazette after registration.

Article 62 –Distributable profit of the company be the net profit of the company earned during the given fiscal year less the transfer to the legal reserve, precautionary reserve and any other reserves, and losses incurred during preceding years plus distributable profit of the preceding years not previously distributed. The general meeting of the company, after approval by the inspector / auditor that there exists any such distributable profit and having approved the financial statements of the given year by the ordinary general meeting shall decide on distribution of the distributable profit.

Article 63 –The Company shall issue any such securities upon the approval of the SEO.

2.1.13 Goal of the Tehran Stock Exchange

The main goal of TSE is to increase market based financing in the country and to create more value for all direct and indirect shareholders. The other goals are:

- 1) To improve the market integrity and efficiency;
- 2) To attract the confidence of the investors, public, government and other shareholders;
- 3) To reduce risk;
- 4) To promote quality and quantity of the capital market.

2.1.13.1 The following are required to attain the first goal:

- i. To make more timely disclosure of information;
- ii. To increase the role of financial institutions and institutional investors;
- iii. To promote the knowledge of general and specialized investors;
- iv. To promote the trading system and market rules.

2.1.13.2 To attain the second goal, the following are emphasized upon:

- i. To provide transparent methods for market trading;
- ii. To inform public on a timely basis;
- iii. To prevent price and trades manipulation and to reduce the inside information;
- iv. To investigate and detect violations related to issuance of incomplete and misstated information;
- v. To facilitate the process of investment in the TSE.

The stock exchange, as a financial intermediary firm, decreases market risk and cost of capital through increase of transparency, supervision

of, governance of and communications with listed companies. The decrease of expenses is in fact a value added by the securities exchange.

2.1.13.3 The following are required to obtain the third goal:

- i. To improve the quality of listing;
- ii. To improve management systems of listed companies;
- iii. To apply effective surveillance on trades;
- iv. To increase market liquidity;
- v. To design new products like mutual funds and exchange traded funds (ETF).

2.1.13.4 To attain the fourth goal, the following are required:

- i. To increase the return of market portfolio through attracting new large profitable companies, increase of profitability of the existing companies, improvement of dividend policies, improvement of business environment and deregulation;
- ii. To participate more activity in the execution process of general policies of Article 44 of the constitution;
- iii. To develop relations with the relevant international bodies as well as other exchanges

TSE Corporation is going to attain the goals mentioned above through the support by the regulator (High Council of the Securities and Exchange Organization) and capital market participants and attempts of the management and employees of TSE. Enforcement of laws and transferring of operations of the securities and exchange brokers organization to TSE was carried out gradually through effective cooperation with the relevant officials during the year 2006 – 2007. However, some material issues like deciding on the properties mentioned in the Article 57 of the market law and installment of the new trading software will be performed in the current year (2007 – 2008).

2.2 Financial Reporting Quality and Investment Efficiency

2.2.1 Definition of Financial Reporting

If “accounting is the language of finance” (Lasher, 2008, p. 9) then financial reporting is the “communication of financial information useful for making investment, credit, and other business decisions” (Chiappetta, B., Shaw, K., Wild, J., 2009, p. 681) Such communications include general purpose financial statements such as income statements, balance sheets, equity reports, cash flow reports, and notes to these statements. Additionally, items such as SEC filings, press releases, meeting minutes, and auditor’s reports are also included in financial reporting (Chiappetta, B., Shaw, K., Wild, J., 2009, p. 681). Many financial reports, or the accounts and data they represent, are subject to various regulations and standards from organizations such as the Securities Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the International Accounting Standards Board (IASB) (Chiappetta, B., Shaw, K., Wild, J., 2009, p. 9). Much like any language, financial statements could have their own “dialect” so to speak. For example, knowing about the use of cash-based accounting versus accrual based accounting could impact some very serious business or investment decisions (Chiappetta, B., Shaw, K., Wild, J., 2009). The various regulations, standards, and Generally Accepted Accounting Principles (GAAP) helps to make sure that all are on the same page.

In the broad sense of the term, everyone uses financial reports! All people receive bills when they make purchase from stores and receive receipt for payment. In a sense, these are both financial reports that communicate the status of accounts or individual transactions. When focus on business, however, can more easily focus on managers, investors, creditors, and even the government. Managers use financial reports to make business decisions. For example, if a manager of a manufacturing firm observes from internal financial and inventory reports that sales returns were

high, then he might push for increased quality control. Investors and potential investors like to use general-purpose financial reports so frequently that companies often release them together in a bundle called “investor reports,” “annual reports,” or “shareholder reports.” Investors would use this information to make a decision about whether they will buy, sell, or hold onto a particular company’s stock. Another large group of people who use financial reports, are creditors. Creditors would use financial reports to determine their risk in loaning money to a particular company.

Financial reporting is the process of preparing and distributing financial information to users of such information in various forms. The most common format of formal financial reporting is financial statements. Financial statements are prepared in accordance with rigorously applied standards defined by professional accounting bodies developed according to the legal and professional framework of a specific locale. A financial statement (or financial report) is a formal record of the financial activities of a business, person, or any other entity.

For a business enterprise, all the relevant financial information, presented in a structured manner and in a form easy to understand, are called the financial statements. They typically include four basic financial statements, accompanied by a management discussion and analysis.

Balance sheet: Referred is a statement of financial position or condition, reports on a company's assets, liabilities, and Ownership equity at a given point in time.

Income statement: Referred as Profit and Loss statement, reports on a company's income, expenses, and profits over a period of time. Profit & Loss accounts provide information on the operation of the enterprise. These include sale and the various expenses incurred during the processing state.

Statement of Changes in Equity: explains the changes of the company's equity throughout the reporting period.

Statement of cash flows reports on a company's cash flow activities; particularly it's operating, investing and financing activities.

For large corporations, these statements are often complex and may include an extensive set of notes to the financial statements and management discussion and analysis. The notes typically describe each item on the balance sheet, income statement and cash flow statement in further detail. Notes to financial statements are considered an integral part of the financial statements.

2.2.2 Objectives of Financial Statements

The objectives of financial statements are to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements should be understandable, relevant, reliable and comparable. Reported assets, liabilities, equity, income and expenses are directly related to an organization's financial position.

Financial statements are intended to be understandable by users who have "a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently. Financial statements may be used by users for different purposes:

- ❖ Owners and managers require financial statements to make important business decisions that affect its continued operations. Financial analysis is then performed on these statements to provide management with a more detailed understanding of the figures. These statements are also used as part of management's annual report to the stockholders.

- ❖ Employees need these reports in making collective bargaining agreements (CBA) with the management, in the case of labor unions or for individuals in discussing their compensation, promotion and rankings.
- ❖ Prospective investors make use of financial statements to assess the viability of investing in a business. Financial analyses are often used by investors and are prepared by professionals (financial analysts), thus providing them with the basis for making investment decisions.
- ❖ Financial institutions (banks and other lending companies) use them to decide whether to grant a company with fresh working capital or extend debt securities (such as a long-term bank loan or debentures) to finance expansion and other significant expenditures.
- ❖ Government entities (tax authorities) need financial statements to ascertain the propriety and accuracy of taxes and other duties declared and paid by a company.
- ❖ Vendors who extend credit to a business require financial statements to assess the creditworthiness of the business.
- ❖ Media and the general public are also interested in financial statements for a variety of reasons.

2.2.3 Standards and Regulations

Different countries have developed their own accounting principles over time, making international comparisons of companies difficult. To ensure uniformity and compatibility between financial statements prepared by different companies, a set of guidelines and rules are used. Commonly referred to as Generally Accepted Accounting Principles (GAAP), these set of guidelines provide the basis in the preparation of financial statements.

Recently there has been a push towards standardizing accounting rules made by the International Accounting Standards Board ("IASB"). The IASB develops International Financial Reporting Standards that have been adopted by Australia, Canada and the European Union (for publicly quoted companies only) and is under consideration in South Africa and other

countries. The United States Financial Accounting Standards Board has made a commitment to converge the U.S. GAAP and IFRS over time.

2.2.4 Quality of Financial Reporting

The primary objective of financial reporting is to provide high-quality financial reporting information concerning economic entities, primarily financial in nature, useful for economic decision making (FASB, 1999; IASB, 2008). Providing high quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit, and similar resource allocation decisions enhancing overall market efficiency (IASB, 2006; IASB, 2008).

Although both the FASB and IASB stress the importance of high-quality financial reports, one of the key problems found in prior literature is how to operationalize and measure this quality. In 2002, the IASB and the FASB showed their commitment towards developing a common set of high-quality accounting standards, which could be used worldwide.

As a consequence of the joint project to converge the more principles-based IFRS and the more rules-based US GAAP, both boards agreed to develop new joint conceptual framework, which includes the objectives of financial reporting and the underlying qualitative characteristics on which accounting standards, ought to be based. In May 2008, the FASB and the IASB published an exposure draft of 'An improved Conceptual Framework for Financial Reporting' exposure draft [ED] (IASB, 2008; FASB, 2008). This Conceptual Framework represents the foundations of the accounting standards.

The application of objectives and qualitative characteristics should lead to high-quality accounting standards, which in turn should lead to high-quality financial reporting information that is useful for decision making (FASB, 1999; IASB, 2008). Furthermore, the conceptual framework ought to

contribute to decision making of constituents, when transactions or events occur for which no accounting standards are available.

According to the exposure draft (ED), providing decision-useful information is the primary objective of financial reporting. Decision-useful information is defined as “information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers” (IASB, 2008: 12).

This study conceptually defines financial reporting quality as the precision with which financial reporting conveys information about the firm’s operations, in particular its expected cash flows, in order to inform equity investors. As described in the FASB Statement of Financial Accounting Concepts No. 1, financial reporting should provide information that is useful to present and potential investors in making rational investment decisions and also provide information to help present and potential investors in assessing the amount, timing, and uncertainty of prospective cash receipts.

2.2.5 Methods of Measurement of Financial Reporting Quality

To assess the quality of financial reporting, various measurement methods have been used such as: **accrual models, value relevance models, research focusing on specific elements in the annual report, and methods operationalizing the qualitative characteristics.** Accrual and value relevance models focus on earnings quality measurement.

2.2.5.1 Accrual Models

Accrual models are used to measure the extent of earnings management under current rules and legislation. These models assume that managers use discretionary accruals, i.e. accruals over which the manager can exert some control, to manage earnings (Dechow, P.M., Sloan, R.G. and Sweeney, A.P, 1995), (Healy, P., Hutton, A., Palepu, K, 1999).

Management of earnings is assumed to negatively influence the quality of financial reporting by reducing its decision usefulness. The main advantages of using discretionary accruals to measure management of earnings are that it can be calculated based on the information in the annual report. In addition, when using regression models it is possible to examine the effect of company characteristics on the extent of earnings management (Healy, P. & Wahlen, J, 1999); (Dechow, P.M., Sloan, R.G. and Sweeney, A.P, 1995). Other advantage of this method that it is relatively easy to collect data in order to measure management of earnings.

2.2.5.2 Value Relevance Models

Value relevance models measure the quality of financial reporting information by focusing on the associations between accounting figures and stock-market reactions (Choi, B., D.W. Collins & W.B. Johnson, 1997); (Barth, M., Beaver, W. & Landsman, W, 2001); (Nichols, D. & Wahlen, J, 2004). The stock price is assumed to represent the market value of the firm, while accounting figures represent firm's value based on accounting procedures. When both concepts are (strongly) correlated, i.e. changes in accounting information correspond to changes in market value of the firm, it is assumed that earnings information provides relevant and reliable information (Nichols, D. & Wahlen, J, 2004). Focus on earnings quality, and indirect measure of financial reporting quality are the major disadvantages of this method.

Accrual models and value relevance literature focus on information disclosed in financial statements to assess the financial reporting quality (Dechow, et al., 1995); (Choi, B., D.W. Collins & W.B. Johnson, 1997); (Healy, P. & Wahlen, J, 1999); (Barth, M., Beaver, W. & Landsman, W, 2001); (Leuz, 2003); (Nichols, D. & Wahlen, J, 2004).

2.2.5.3 *Focusing On Specific Elements In The Annual Report*

This method evaluates the influence of presenting specific information in the annual report on the decisions made by the users (Hirst, D., Hopkins, P. & Wahlen, J, 2004). For instance, Hirst et al. (2004) put emphasis on the use of fair value accounting and financial reporting quality. Disadvantages of this method are: focus only on selected elements and this is also difficult to measure.

2.2.5.4 *Methods Operationalizing the Qualitative Characteristics*

Methods that operationalize the qualitative characteristics aim to assess the quality of different dimensions of information simultaneously to determine the decision usefulness of financial reporting information (Schipper, K. & Vincent, L, 2003). In general it is difficult to operationalize, which is resulting in causing measurement difficulties.

2.2.6 Cash Flow Statement:

In financial accounting, a cash flow statement, also known as statement of cash flows is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities. Essentially, the cash flow statement is concerned with the flow of cash in and out of the business. The statement captures both the current operating results and the accompanying changes in the balance sheet. As an analytical tool, the statement of cash flow is useful in determining the short-term viability of a company, particularly its ability to pay bills. International Accounting Standard 7 (IAS 7) deals with cash flow statements.

People and groups interested in cash flow statements include:

- ❖ Accounting personnel, who need to know whether the organization will be able to cover payroll and other immediate expenses,

- ❖ Potential lenders or creditors, who want a clear picture of a company's ability to repay,
- ❖ Potential investors, who need to judge whether the company is financially sound,
- ❖ Potential employees or contractors, who need to know whether the company will be able to afford compensation, and
- ❖ Shareholders of the business.

2.2.6.1 Purpose of Cash Flow Statement:

The cash flow statement was previously known as the flow of Cash statement. It reflects a firm's liquidity.

The balance sheet is a snapshot of a firm's financial resources and obligations at a single point in time, and the income statement summarizes a firm's financial transactions over an interval of time. These two financial statements reflect the accrual basis accounting used by firms to match revenues with the expenses associated with generating those revenues. The cash flow statement includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not directly affect cash receipts and payments. These non-cash transactions include depreciation or write-offs on bad debts or credit losses to name a few. The cash flow statement is a cash basis report on three types of financial activities:

- a) Operating activities,
- b) Investing activities, and
- c) Financing activities.

Non-cash activities are usually reported in footnotes.

The cash flow statement is intended to:

- ❖ Provide information on a firm's liquidity and solvency and its ability to change cash flows in future circumstances,

- ❖ Provide additional information for evaluating changes in assets, liabilities and equity,
- ❖ Improve the comparability of different firms' operating performance by eliminating the effects of different accounting methods, and
- ❖ Indicate the amount, timing and probability of future cash flows.

The cash flow statement has been adopted as a standard financial statement because it eliminates allocations, which might be derived from different accounting methods, such as various timeframes for depreciating fixed assets.

2.2.7 Theoretical Perspectives

The association between financial reporting quality and investment efficiency relates to a reduction of information asymmetry between firms and external suppliers of capital. For example, higher financial reporting quality could allow constrained firms (firms facing financing constraints) to attract capital by making their positive net present value (NPV) projects more visible to investors and by reducing adverse selection in the issuance of securities. Alternatively, higher financial reporting quality could curb managerial incentives to engage in value destroying activities such as empire building in firms with ample capital.

In other studies (Daniel A. Cohen, 2003) found evidence of a positive association between investors' demands for firm-specific information and financial reporting quality. For the economic consequences, the evidence suggests that firms with high quality financial reporting policies have reduced information asymmetries.

Recent researches (Bushman and Smith, 2001; Lambert, Leuz, and Verrecchia, 2005) suggested that enhanced financial reporting can have important economic implications like increased investment efficiency. Another recent study (Verdi, 2006) hypothesized that higher financial

reporting quality can improve investment efficiency by reducing information asymmetry in two ways:

- ❖ First, it reduces the information asymmetry between the firm and investors.
- ❖ Second, it reduces information asymmetry between investors and the manager.

This could be achieved, for example, if higher financial reporting facilitates writing better contracts that prevent inefficient investment and/or increases investors' ability to monitor managerial investment decisions.

A firm has investing efficiency if it undertakes all and only projects with positive NPV under the scenario of no market frictions like adverse selection or agency costs. Therefore, inefficient under-investment includes passing up investment opportunities that would have positive NPV in the absence of adverse selection. Likewise, inefficient over-investment includes undertaking projects with negative NPV (Verdi, 2006).

Biddle and Hilary (2006) found that firms with higher-quality financial reporting exhibit higher investment efficiency proxied by lower investment-cash flow sensitivity. However, investment-cash flow sensitivity can reflect either financing constraints or an excess of cash (Kaplan and Zingales, 1997, 2000; Fazzari et al., 2000).

These findings raise the further question of whether higher-quality financial reporting is associated with a reduction of over-investment or with a reduction of under-investment. Wang (2003) predicted and found a positive relation between capital allocation efficiency and three earning attributes (value-relevance, persistence, and precision) without making the distinction between under and over-investment.

Agency theory is frequently used by researchers to explain accounting practices in country-specific studies. It explains accounting practices in corporate settings that have a strong agency orientation as it is based on the notion of separation among ownership, debt, and

management (Asheq Rahman, Jira Yammeesri, Hector Perera, 2010). For example, studies focused on the United States usually support the agency argument that certain firm and board features, and good quality accounting and auditing are the bases for better firm performance. For example, Gabrielsen and et al. (2002) found that managerial ownership (an agency variable) has different effects on the information content of earnings and discretionary accruals in Denmark and in the United States. Further, in a review of audit independence, discretionary accruals, and earnings-informative studies, Rainsbury (2007) finds that in many non-U.S. settings agency monitoring mechanisms such as board of directors, accounting arrangements, and audit quality do not relate to discretionary accruals and earnings informativeness in the same manner as they do in the US setting.

Agency theory is originated in the environment of growth of large modern corporations in Anglo-American countries. It mainly focuses on exogenous factors that relate to financing (Asheq Rahman, Jira Yammeesri, Hector Perera, 2010).

Agency theory was developed by Berle and Means (1932) for a corporate setting with a clear separation between ownership and control. Its central issue is how to resolve the conflict between owners, managers, and debt holders over the control of corporate resources through the use of contracts (Simerly & Li, 2000). An unambiguous separation of ownership and control of firms is not common in many countries. Agency theory doesn't take into consideration corporate environments that have no discernible separation between ownership and control, nor does it consider that managers might have to make choices from a perspective other than maximizing wealth for stockholders (Asheq Rahman, Jira Yammeesri, Hector Perera, 2010). According to Simerly and Li (2000), organizations match the demands of their environment with management and organizational systems in order to survive and succeed. They argue that management and organizational systems most appropriate for any given firm

will be a product of the specific set of environmental contingencies being faced by the firm. Similarly, the choice of capital structure is less a matter of predefined alternatives and more a search for alternatives in a complex and uncertain environment in which the firm exists. The choice of managerial and organizational systems and the capital structure, in turn, affects accounting practices of firms within a particular corporate environment (Asheq Rahman, Jira Yammesri, Hector Perera, 2010). Prior studies have shown that various forms of organizational and capital structures exist outside the Anglo-American countries (Fan & Wong, 2002; Nagano, 2003; Booth, Aivazian, Demircug-Kunt, & Maksimovic, 2001; Antoniou, Guney, & Paudyal, 2008). This suggests that there is a need for a more generic theoretical model to explain accounting behavior across countries.

Theoretical arguments and empirical evidence suggest a positive relation between reporting quality and growth (Feng Li and Nemit O. Shroff, 2009). Specifically, findings show that a good financial reporting system lowers the cost of capital and improves capital allocation efficiency (Bushman and Smith, 2001). These findings suggest that a high-quality financial reporting system is likely to facilitate economic growth, one of the ultimate goals of economic policy.

One of the objectives of financial reporting information is to facilitate the efficient allocation of capital in the economy. An important aspect of this role is to improve firms' investment decisions (Feng Chen., Ole-Kristian Hope., Qingyuan Li., Xin Wang, 2010). Specifically, theory suggests that improved financial transparency has the potential to alleviate both under and over investment problems and recent studies support this prediction (e.g., Biddle and Hilary, 2006; Hope and Thomas, 2008; McNichols and Stubben, 2008; biddle et al. 2009).