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CHAPTER I
INTRODUCTION

THE PROLOGUE

There is a positive relationship between the growth of an economy and the growth of capital market. This relationship has become a reality through the free-flow of transparent and reliable information both at the international and national levels. Such a free flow of information is achieved by the corporate world, which has become the chief institutional framework for conducting economic activities, through the mechanism of corporate annual report prepared by the corporate managers and authenticated by the professional auditors. In fact, the corporate annual reports have become the main vehicle through which information is disseminated. However, the information flow through corporate annual reports should be qualitative and relevant for the users. Normally, financial reporting and audit are characterized by deficiencies having the impact on the capital market. In this regard, Painter and Rourke [1991:270] observe: "Deficiencies in accounting and auditing procedures can affect both the demand for and the supply of securities. On the demand side, inappropriate accounting and auditing standards discourage savers from investing in securities because they cannot obtain accurate information about the financial position of companies. On the supply side, companies may be reluctant to go public for fear that financial disclosure will result in higher taxes to the company." The impact of these deficiencies has been cogently presented by Reilly [1986] and Asian Development Bank [1985]: Uniform and professional accounting and auditing procedures are central to the efficiency and effectiveness of resources mobilization and allocation through the securities market. If accounting, auditing, and financial reporting practices are inadequate, it is not possible to ascertain the true financial position and profitability of companies. As a result, resources can be misallocated and investors misinformed. Moreover, in the absence of uniform reporting requirements and generally accepted accounting principles, investors cannot draw reliable comparisons among different firms. Yet, in many developing countries, financial statements are not governed by legally binding generally accepted accounting principles (GAAP) and audits
are not conducted in accordance with legally binding generally accepted auditing standards (GAAS).

Problems ensuing from or associated with the absence of such standards are numerous: auditors who are not independent of the companies they audit; business that maintain two sets of books; one for the owners and the other for tax authorities; absence of a professional body of accountants and auditors to develop uniform principles and standards and to license and regulate the membership, lack of private or government authority with the power to enforce duties and standards, and a lack of criminal penalties for false certification by auditors. What are needed from accounting are not the sins committed for long time by the prepares of it, but it is strengthening of corporate annual reports based on quality of information with relevance and reliability to enhance the investor confidence, which is the sheet anchor on which economic growth is sustained.

EVOLUTION OF ACCOUNTING

Accounting has a long path in its present role as a source of providing information for decision making by individual and institutional investors. Historically, accounting was very much concerned with recording process only and this status of accounting continued for centuries. The official recognition of this role was recognized by AICPA [1953: Para. 9], which defined accounting in these words: “Accounting is the art of recording, classifying, and summarizing, in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.”

However, the American Accounting Association (AAA) [1966:] initiated a paradigm shift in the role of accounting by defining it as “…the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of information.”

Recognizing the relevance of this approach of AAA, the AICPA [1970: Para. 40] redefined accounting on these lines: “Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making decisions, in making seasonal choice among courses of action.” With all
these transformations in the role of accounting, accounting practice seems to be guided more by the 1958's definition of AICPA in 1970's than by the 1966's definition of AAA or by the 1970's re-definition of AICPA. However, Freear [1985] posits that accounting is much more than bookkeeping and it involves the communication of accounting data to those who would use them.

IMPORTANCE OF ANNUAL REPORT

In today's financial environment, annual report has become a significant medium of information dissemination by corporate bodies, amidst a plethora of media comprising of prospectus, financial press release, interim report and investor meet or conferences. The importance of financial reporting lies in the fact that all these media fundamentally make use of financial reporting figures as benchmarks to make a positive impact on investment viability about the company in question. Hence Hay [1955] evidenced that 99.00 percent of company managements communicate to investors through annual report. It is in this background that Arthur Anderson and Company [1976:7] remarked that financial reporting is a benchmark for measuring performance, a periodic summary of progress and an auditing checkpoint.

Lee and Tweedie [1975] evidenced that annual report was the most important source of information for security analysts as well as for private shareholders. Similarly, Rusch [1962:23] observed that annual report was considered to be the most important source of information among all the printed documents supplied in USA by the companies. Generally, annual report has a universal usage as observed by Horngren [1957:599]: "There is a widespread agreement among security analysts that company annual report serves as the springboard for their review. Although the annual report is not always the most important source of information, in terms of universal usage, it belongs in first place among the other sources." In addition to investor uses as the main source of information, the annual report serves the other purposes also. In this regard, Bevis [1965:4] opined that it was the annual report as a whole that one must look for the discharge of management's responsibility to report to its shareholders. Beveridge [1963:137] stressed the importance of an annual report as a "major obligation of financial public relations." Lastly, Mendelson and Robbins [1976:186] recognize that no other
communication has the same potentialities but the annual report is an instrument of social integration." To have right perspective of the importance of annual report, one should imagine the absence of it, which leads to chaos in investment environment instead of crystallization and clarity and direction to one’s environment. In order to overcome the ills of absence of reports, the Corporate Report [1975:15] cogently states that annual financial reports should seek to satisfy as far as possible the informational needs of users, and they should be useful.

UNIVERSALITY OF USEFULNESS

The present structure of financial reporting system and its usefulness is universal in the sense that it meets the requirements of users independent of culture, which is defined by Hofstede [1991:155] as “collective mental programming.” The pioneering effort in testing the hypothesis that the financial reporting needs were the same irrespective of religious or cultural groups was positively tested by Baydoun and Willet [2000], who suggested that the current value balance sheet and the value added statement would meet the Islam’s objective of socio-economic justice and accountability. Baydoun and Willet’s model of Islamic corporate financial reports was initially tested through a questionnaire survey by Sulaiman [1998], who found that there were no differences in the perceptions of usefulness between Muslim and non-Muslim respondents. Another study by Sulaiman [2001] revealed that Muslims and non-Muslims were no different as far as accounting matters were concerned.

Further, the Accounting Principles Board’s Statement No. 4 [1970:32] also endorsed the decision-usefulness view of the financial statements: “The basic purpose of financial accounting and financial statements is to provide quantitative financial information about a business enterprise that is useful to statement users, particularly owners and creditors, in making economic decisions.” Sterling [1972:198] observes: “Almost all the literature on accounting states that accounting reports must be ‘useful’ or that accounting is ‘utilitarian art.’ “The Trueblood Report [AICPA, 1973:30] also supported the decision usefulness approach in these words: “Accounting is not an end in itself. As an information system, the justification of accounting can be found only in how well accounting information serves those who use it. Thus, the
study group agrees with the conclusion drawn by many others that the basic objective of financial statements is to provide information useful for making economic decisions." Lastly, the annual report is always tuned to user requirements. Hence the APB [1970:18] considered that because financial information was used by a variety of groups and for diverse purposes, "[T]he needs and expectations of users determine the type of information required."

All these studies tend to focus on the conclusion that the present mode of financial reporting is universal from the viewpoint of preparing to a greater degree and of usefulness to a substantial level irrespective of region and religion and the annual report is the only medium through which significant amount of information is disseminated.

OBJECTIVES OF FINANCIAL REPORTING

The objectives of financial reporting have evolved over time. The issue of purpose of information to be disclosed in annual reports was initially recognized by Chambers [1996:162]. For a long time in accounting history, the objective of financial reporting was to provide a mechanism for exercise of investors' control over management coupled with another purpose of information provisioning for investment decision making focusing on managerial needs as perceived by AAA [1955:402]. Later, the objective was on 'measuring past performance' with an emphasis on profit measurement, which had the management as the target user group. The Study by Rice et.al., [1973:14-17] revealed that 75.00 percent of the companies considered their overall purpose to be accountability for performance or stewardship. However, in recent years, the objectives of financial reporting have undergone a paradigm shift from exercise of control, past performance analysis and information for investment decision making for management to provisioning of information for decision making by a large body of user groups. As a result, the AICPA [1970:62-66] extended objectives for financial reporting by emphasizing relevant economic information intended to be useful for enlarged user groups.

At present, the Statement No. 4 of APB still dominates financial reporting. However, Sterling [1972] long back indicated that the ultimate objective of financial reporting was to provide useful information. Similarly,
Zairi and Letza [1994] conclude that the purpose of the annual report is to convey information that is useful to those who have an active interest in the reporting organization.

To conclude, the literature on accounting provides the extensive discussion but does not provide tacit conclusion on the objectives of financial reporting. Long ago, Stone [1967] observed: “A search of the existing literature for a statement of objectives for published financial reports will inevitably lead to frustration. References to reporting objectives, when found, are either so vague as to give no direction to the development of theory or are specific but lacking a rationale for such objectives.” The whole controversy focuses on whether financial reporting aims at ‘stewardship accounting’ or ‘decision-making usefulness’. The result of this debate has been the gradual transformation of the objective of financial reporting to the decision-making usefulness.

**USERS OF ANNUAL REPORTS**

An important issue in financial reporting is the identification of users, whose composition and requirements influence the contents and formats of financial reporting. It is important to note that more the diversion in user groups, more is the diversity in financial reporting requirements. The diversity in users has also complicated the problem of understanding the decision making process. In this regard, Stamp [1980:48] observes: “One of the most different problems in developing accounting standards arises from our ignorance about the nature of users and decision making process and about the rational (and often irrational) mental process that users go through in reaching their decisions.” The inducement on this problem has led to (i) whether the managements should prepare the general-purpose financial statements should meet information requirement of several through one set of financial statement or prepare the specific-purpose financial statements to meet the specific requirements of each group; (ii) whether the capabilities of users in understanding the accounting figures in financial statements should be assumed as similar for all users resulting in a single mode of financial statements or as dissimilar for different users resulting in different modes of presenting financial statements; and (iii) whether financial statements should
be prepared on the basis of accessibility and affordability of magnitude of information in financial statements.

Keeping in view the impossibility of information requirements, Accounting Principles Board [1970:47] advocates the dissemination of information through general-purpose financial statements. However, there are different views on target users. Mantz and Sharef suggest that financial reports should be mainly for professional financial analysts. Cown suggests for the average investors having limited skills and Chetkovick advocates for standard readers as some one in between the skilled and unskilled users. At present, this suggestion by the Trueblood Committee [1973] on target users is held to be popular in financial reporting: “An objective financial statement is to serve primarily those users who have limited authority, ability or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise’s economic activities.” Lastly, the concept of user group is enlarging and hence Stamp [1980] included the following fifteen types of users: (1) shareholders (present and potential), (2) long-term creditors (present and potential), (3) short-term creditors (present and potential), (4) analysts and advisers serving the above (present), (5) employees (past, present, and potential), (6) non-executive directors (present and potential), (7) customers (past, present, and potential), (8) suppliers (present and potential), (9) industry groups (present), (10) labor unions (present), (11) governmental departments and ministers (present), (12) the public (present), (13) regulatory agencies (present), (14) other companies, both domestic and foreign (present), and (15) standard setters and academic researchers (present). The users of information should be better informed to make right decisions. In this regard, Lawrence and Joehnk [1984:66] observes that the informed investor earns better and safer returns than the uniformed investors, regardless of whether the uninformed investors make decisions solely on the basis of intuition or merely avoids risky investments.

**NEED FOR THE STUDY**

It is true that the corporate investment is characterized by the increasing dominance of institutional investors as evidenced in the studies of Dobbins [1974] and Lawrisky [1978]. However, the role of individual investors
in equity investments is no less important, because of the very nature of public offer of equity investments signifying that the general public for equity investment is to be given priority. This is clearly evidenced in the listing requirements by SEBI and summarized by Sahoo [2004] in these words: “A company seeking listing satisfies the exchange that at least 10% of the securities, subject to a minimum of 20 lakh securities, were offered to public for subscription, and the size of the net offer to the public (i.e., the offer price multiplied by the number of securities offered to the public, excluding reservations, firm allotment and promoters’ contribution) is not less than Rs.100 crore, and the issue is made only through book building method with allocation of 60% of the issue size to the qualified institutional buyers. In the alternative, it is required to offer at least 25% of the securities to public.”

Further, Sahoo [2004] brings out the size and structure of Indian individual investors in these words: “...an estimated 12.8 million, or 7.60 percent of all Indian households representing 19 million individuals had directly invested in equity shares and or debentures as at the end of financial year 1998-99. The investor households increased at a compound growth rate of 22 per cent between 1985-86 and 1998-99. About 35 per cent of investor households became investors in equity shares prior to 1991, while 47 per cent of the investors entered the market between 1991 and 1995 and 17 per cent after 1995. More than 156 million or 92 per cent of all Indian households were non-investor households who did not have any investments in equity/debentures.” In the background of this scenario of individual investors occupying the pivotal role in India’s corporate world, the perceptions of individual investors on the usefulness of financial reporting becomes highly relevant. The review of literature* reveals that the research on usefulness of financial reporting in investor decision making has been mainly done in western countries having different socio cultural and economic environment. The studies in India mainly focus on disclosure practices and company characteristics on one hand and timeliness and relevance of financial reporting on the other only. It is evidenced that (i) the attitudinal behaviour of individual investors regarding the uses of corporate financial reporting has not been evidenced in depth; and (ii) the perceptions of individual investors based on formal knowledge of accounting, initiation into equity investment,
investment motives, eagerness to read financial statements, timing of the reading of financial statements and depth of reading have not been enquired in the empirical research conducted so far.* Hence the present study has been taken up by focusing on the equity investors located in Bangalore city.

OBJECTIVES OF THE STUDY

The following were identified for the study:

(i) To analyze the dynamics of financial reporting;
(ii) To understand the relative role of quantitative and qualitative information provided in annual reports;
(iii) To analyze the relative role of external and internal source of information provided in annual reports;
(iv) To analyze the relative importance of accounting information items;
(v) To measure the relationship between share price movements and accounting information items;
(vi) To analyze decision usefulness of audit reports;
(vii) To understand the relationship between decision usefulness and accounting knowledge, eagerness level, time of entry into equity investment, depth of reading and reading incident; and
(viii) To understand the relationship between disclosure level and management motive.

HYPOTHESES FOR THE STUDY

The following were the hypotheses for the study:

(i) Financial reporting is influenced more by legal formalities than by decision usefulness;
(ii) Qualitative information is more important than quantitative information to enhance decision usefulness of annual reports;
(iii) The level of disclosure is a function of management motives;

*Review of literature is presented in Chapter III,
(iv) External sources of information play a greater role than internal sources of information in investor decision-making process;

(v) The hybrid figures drawn from income study and balance sheet are more useful in decision-making process;

(vi) There is a positive relationship between share price movements and accounting information items;

(vii) Users prefer enlarged audit reports to be useful, and

(viii) The usefulness of annual reports is positively related to accounting knowledge, eagerness level, time of entry into equity investment, depth of reading and reading incident.

RESEARCH METHODOLOGY

The study envisages an analysis of the perceptions of individual investors in making use of quantitative and qualitative information from the corporate annual reports for equity investment decisions. The study relies upon both primary and secondary sources. The secondary sources of information relate to empirical evidences on the problem and they are used to present the review of literature. The primary source of information is used to empirically test the perceptions of individual investors towards the usefulness of corporate financial reporting. One of the serious problems faced in the process of selections of sample respondents was non-availability of list of individual investors in Bangalore city. Hence the problem was tackled by contacting the brokers and sub-brokers of Bangalore Stock Exchange (BSE) through whom the individual investors did their transactions.

The selection criterion of respondents was that the individual investors were defined as those individuals, who subscribed to initial offering of listed companies in India between 2000 and 2004. Using this criterion, frequent visits to brokers and sub-brokers of Bangalore Stock Exchange were made by listing 500 sample respondents on contact basis. In the background of the objectives and hypotheses for the study, a pilot questionnaire was prepared on Likert’s five-point scale and served to elicit the opinions from 50 individual investors from the list. The opinions on questionnaire were collected from 43 respondents. Based on the opinions on a pilot survey, the final questionnaire
was prepared and served personally to elicit the responses. Totally, 388 questionnaires were received from the sample respondents. The verification of filled-in questionnaires revealed that there 28 incomplete questionnaires and these were removed and 360 questionnaires were complete with responses. Thus the response rate was 72.00 percent. In order to analyze the perceptual differences of users of accounting information, the data from the questionnaires were collated on the basis of twelve independent variables, which comprised of age, income, designation, initiation, investment motive, eagerness, reading incident, periodicity of investment, readership and belief system, sources of income and investment avenues. The data was collated on SPSS package to arrive at meaningful analyses and conclusions. The statistical tools used in the study were weighted mean value and standard deviation.

LOCALE AND PERIOD OF THE STUDY

The study covers the individual equity investors and traders residing in Bangalore city. The sample respondents were selected from this city to enquire into the perceptions of respondents towards the usefulness of corporate reporting in their investment decisions in view of the city having heterogeneous, economic, social and cultural environment, which represents the country adequately.

OPERATIONAL DEFINITIONS

In carrying out the present study the following operational definitions for independent variables consisting of age, income, designation, initiation, investment motive, eagerness, reading incident, periodicity of investment, readership and belief system, sources of income and investment avenues.

(i) Age: Based on age, the respondents were classified into youth and adult. Youth were defined as those who were aged below thirty-five years and adults were defined as those who were aged above thirty-five years.

(ii) Income: Based on income, the respondents were classified into low-income group and high-income group, who defined as those having
less than Rs. 2.00 lakh as annual income and more than Rs. 2.00 lakh per annum respectively.

(iii) Designation: From the viewpoint of designation, respondents were classified into accountants (As) and non-accountants (NAs). Accountants were defined as those who had studied accounting as a discipline in the graduate programme or post-graduate programme and who were accounting professionals on one hand and the non-accountants were defined as those having no such formal education in accounting and those who merely equity investors.

(iv) Initiation: Based on initiation, the respondents were classified into early entrants (EEs) and new entrants (NEs). The early entrants were defined as those who became equity investors before 2000 and the new entrants were defined as those who became equity investors after 2000.

(v) Investment Motive: From the viewpoint of investment motive, the respondents were classified as satiated respondents (SRs) and ambitious respondents (ARs). The satisfiers were identified on the basis of their stated objective of earning decent returns and the ambitious respondents were defined as those who stated their investment objective to be earning maximum profit.

(vi) Eagerness: From the viewpoint of eagerness, the respondents were classified into exciters (Es) and non-exciters (NEs) based on the anxiety level to receive the annual report. The respondents, whose weightage was marked 4 and above 4 were identified as exciters, and the respondents who has assigned less than 4 weightage points were classified as non-exciters.

(vii) Reading Incident: From the viewpoint of reading incident, the respondents were classified into early readers (ERs) and late readers (LRs). The early readers were identified as those who assigned the weighted point of 4 and above 4 and the late readers were defined as those who assigned the weighted points of less than 4.

(viii) Periodicity of Investment: Based on the periodicity of investment, the respondents were classified into regular investors (RIs) and periodic
investors (PIs) as pursued by respondents to the statement in the questionnaire.

(ix) Readership: From the viewpoint of readership habits, the respondents were classified into shallow readers (SHRs) and serious readers (SERs). The shallow readers were identified as those who devoted below 15 minutes to read an annual report and the serious readers were identified as those who devoted above 15 minutes to read an annual report.

(x) Belief System: Based on belief system, the respondents were grouped into believers (Bs) and skeptics (Ss). Believers were defined as those who stated that the profit reflected in the financial statement was a true figure or an appropriate figure. The skeptics were defined as those who stated that the profit reflected in the financial statement was a deficient figure or wrong figure.

(xi) Sources of Income: Based on sources of income, the respondents were grouped into professional, employee and businessman. The professional respondents included practicing chartered accountants, financial analysts and stockbrokers. Those respondents with paid salary and having invested in equities were defined as employee group. The respondents doing business and having invested in equities were classified as business group.

(xii) Investment Avenues: From the viewpoint of investment avenues, the respondents were classified into primary investors, secondary investors and mixed investors. Primary investors were defined as those who invested their money through initial public offerings. Secondary investors were defined as those who invested their money through secondary market. The mixed investors were identified, as those who were both primary investors and secondary investors.

LIMITATIONS OF THE STUDY

The following were the limitations of the study:

(i) The study was based on the perceptions of selected equity investors of Bangalore city only and hence broader conclusions could not be established;
(ii) The selections of sample respondents was based on contact basis through the stock brokers of Bangalore Stock Exchange only and this approach was adopted due to non-availability of list of investors in any established institutions;

(iii) The study focused on the individual equity investors-user group only thereby excluding institutional investors, bankers and other private financial participants; and

(iv) After having processed the responses for the structured questionnaire under different tables from the viewpoint of perceptual differences that existed, if any, amongst different individual investor user groups identifying on the basis of twelve independent variables stated earlier, it was observed that substantial differences existed mainly in designation status, initiation status, eagerness status, reading incident and readership status and hence the study included only these variables.

CHAPTERIZATION

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