

# INVESTIGATING FINANCIAL REPORTING TRANSPARENCY

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## Abstract

This article includes two sections: in the first section, theoretical basics about disclosure have been dealt with. It is said that disclosure is a relative concept. After finding out that financial information is presented for whom and for what purpose, disclosure should be considered as one of the fundamental goals of restatement of financial statements. The most relevant financial information should be presented in summary and if possible, in financial statements and then in notes attached to foregoing statements. Descriptive information should be mentioned in financial statements precisely and in summary and details should be described by notes attached to mentioned statements. Literature review is stated in the second section. It contains both internal and external related studies to the research subject.

## Introduction

Reporting and information disclosure are the most important tools that are used for communicating with stockholders by companies. When disclosure has been obligatory owing to regulations and rules, it is called mandatory disclosure, and if information disclosure is not affected by certain rules and it is done arbitrarily by companies, it is called voluntary disclosure (Owusu-Ansah, 1998). Market globalization phenomenon pushes companies toward internationalization and leads to many complexities in business environments. Today, capital markets create unexpected investment opportunities. Investors need much information about companies' activities to take these opportunities. In order to respond to individual's information needs, besides information disclosure and information asymmetry according to reporting requirements, company presents information about its activities for recognizing latent factors of company value in capital market. Whenever new information about companies' condition is often published, this information is analyzed by analysts, investors and other users, based on this analysis put and call price is decided on. In case of confidential and heterogeneity publication of information, investors have different reactions because of information asymmetry in capital market, this issue leads to incorrect and illusive analyses of market current situation. In this case small investors are unwilling to investment, this leads to capital cost increase in company, it becomes risky that should be tolerated by less investors (Lambert et al., 2011). Disclosure is a comprehensive word in accounting, it almost comprises all financial reporting processes. One of initial principles of accounting is disclosing all related and important realities about events. Appropriate and information related to decision problem is one of the effective factors in making decision.

When needed information is distributed among individuals asymmetrically, it can lead to different consequences about a sole subject. For decision makers measuring information distribution quality should be more important than information. Measuring transparency is one of the most important challenges in experimental researches related to transparency. The amount of transparency can be measured conceptually by received information accuracy, which is a function of information quality relevance (Lander and Auger, 2008). Financial statements accounting is considered as one of the most important tools that ensures the companies information transparency. Independent auditors remove contaminations via accreditation in financial statements and other investigated information, it makes companies information transparent. In recent effort, to measure transparency criteria including financial crisis or profit smoothing have been utilized (Lander and Auger, 2008). When accounting profits are smoothed artificially, accounting profit will

be faced with challenge in showing accurate company performance. Such reduction in information value of profit leads to reduction of profit transparency (Noorvash and Hesarzadeh, 2010).

### **Transparency and information disclosure**

Publication of important and effective information in market is called disclosure. Transparency can be defined as simplicity and easiness of meaningful analysis of company activities and its economic foundations by individuals outside the company. Transparency is management power index for presenting necessary information accurately, clearly and timely (Hallwood, 2001). Especially audited information that has been published and disclosed as public reports and in mass media or by other methods. In other words, transparency reflects that if investors have a real image of everything happens inside the company? Then, it can be concluded that disclosure and transparency are dependent factors. Transparent systems need accurate and authentic information that is available for all stockholders easily, timely and directly via authentic and well-known agencies including accountants, auditors rating agencies, securities analysts, financial journalists and mass media. Hallwood (2001) published a study that dealt with transparency procedures and Sand P institute, disclosure of top companies from several countries.

Based on procedures and done researches of this international institute and its considered features including 110 features about transparency quality and disclosure of companies in Kazakhstan and Russia in 2009, this study aimed at analyzing transparency quality and disclosure of current companies in Tehran Securities Exchange. This institute researches have been already done in countries such as Germany, Turkey, Russia, China, England, Japan, and several other countries. For instance, average of transparency and disclosure index score of 22 top companies in Kazakhstan has been reported about 44% by this institute, this score somewhat is low compared to global average (Stepanov et al., 2009).

### **Information asymmetry**

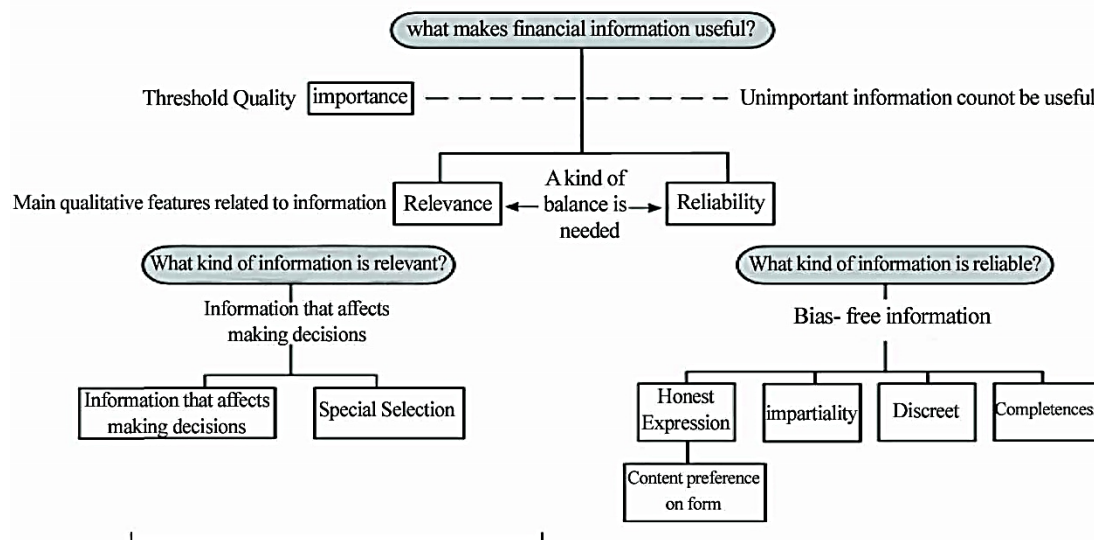
The issue of information asymmetry had been important theoretically. Stiglitz and Weiss (1981) have had an effective role in financial literature. They have expanded the role of information asymmetry so much that it has had a considerable role on economic policies and loan procedures of all economic institutes. Theories show that information inequality may cause the market fail by tendency to more or less investment, this issue cause's inefficiency in macro and micro levels. More understanding of this concept helps to be solved optimal. Inappropriate selection and moral hazard are two effective factors on market inefficiency.

Inappropriate selection is the first factor of information asymmetry, it occurs when one or more numbers of parties have information advantage than other parties in a potential or real business exchange. This issue gives policymakers and lenders efficient motivation for paying attention to and confirming information integration among financial statements users. Moral hazard is the second factor of information asymmetry. Accordingly, each party is able to observe his own actions in fulfilment or violation in a real or potential business exchange, while other parties are not able to observe others' actions (Scott and O'Brien, 1997). Moral hazard pushes policy makers and leaders toward codification imperative laws about debts and legal lawsuits to control contracts and exchanges parties' performance better. According to these factors, measuring and removing information asymmetry would be difficult practically, and collecting experimental evidence in this field and the importance of information inequality would not be simple especially in credit markets. In fact there is information symmetry when managers and market have the same information about the company. Otherwise, because of having confidential information about company, managers have more and better information than market and the information is available for them before market. Profit sharing is of high importance in companies and it is paid attention to by investors, analysts and economists. The findings of experimental studies show that increase in companies' dividends makes share price increase. These studies have stated different reasons for dividend behavior that signaling theory is one of them. In contrast with these studies, Miller and Modigliani study showed that profit sharing in value sharing in effective markets is an irrelevant item (Li and Zhao, 2008).

### **Usefulness of financial information**

In theoretical concepts of financial reporting, the aim of presenting financial information has been reported as follow; "the aim of financial statements is presenting summarized and classified information about financial condition, financial performance and financial flexibility of a business unit that would be useful for a wide spectrum of financial statements users for making economic decisions." In fact, financial statements present information about business unit that is published for all users. Financial information users are varied.

When financial information has qualitative features, they will be useful for all users. Figure 1 shows a summary of qualitative features of financial information. As it can be seen main qualitative features related to financial information are reliability and relevance. Conservatism is one of the most important qualitative features of reliability, it is mentioned as prudence principle (audit organization; theoretical concepts of financial reporting, 2007).



based on findings of this research there is no significant relationship between used disclosure level in preparing financial statements and stock return in investment companies.

Setayesh et al. (2011) has studied 105 Iranian companies to find out the effect of disclosure quality on liquidity and current and future common stock cost, the results showed that there is no significant relationship between disclosure quality and company current and future liquidity, and there is a negative and significant relationship between disclosure quality and company current and future common stock cost.

Etemadi et al., (2011) tried to find out whether compulsory disclosure improves the relationship between return on stock and future profits and provides more information for stockholders, finally they found out that disclosure in companies report contains information content about future profits and investors utilize disclosed information in their decisions. Fakhari and Hedayat-Tabar (2011) have studied the effect of disclosure on earnings management of accepted companies in Tehran stock exchange. For measuring disclosure, they have used a disclosure list based on experts' ideas. They studied disclosure relation with unusual obligatory items as profit management index. The results showed a negative relationship between disclosure quality and profit management. By studying the relationship between fluctuation of return on stock and institutional investors, Fakhari and Taheri (2011) concluded that presence of institutional investors increases monitoring on managers' performance and decreases information asymmetry. Finally by increasing ownership percentage of these stockholders, stock return fluctuation will decrease.

Rahimian and Ebrahimi Meimand (2013) have studied the relationship between disclosure and conservatism in Tehran stock exchange. The results showed that there is a negative and significant relationship between disclosure quality and level of voluntary obligatory items, and there is a positive and significant relation between disclosure quality and conditional conservatism. Khaajavi and Alizedeh Talatapeh (2014) have studied the effects of voluntary disclosure level on information asymmetry of accepted companies in Tehran stock exchange. The results represent that there is no significant relationship between voluntary disclosure level and information asymmetry of accepted companies in Tehran stock exchange.

### ***External Literature***

By studying Saudi Arabia companies, Allseed (2006) found out that there is a positive and significant relationship between company size and the amount of information disclosure, and debt rate, ownership dispersion, years of membership in exchange, profit margin, type of industry and auditor have no significant effect on difference between different levels of disclosure. Kamal et al. (2006) have studied Qatar stock exchange corporates, they found out differences in information disclosure among corporates pertain to company size, business risk and company's growth. Hussain and Reaz (2007) have studied Indian companies, they realized that there is a relationship between some of company factors and information voluntary disclosure. They found out Indian banks disclose considerable amount of information voluntarily, and also there is a significant relationship between size of company and disclosure level, and there is no relationship among variables including age of company in exchange, variety of activities, board of directors' bonus and activity complexity with amount of disclosure.

Francis et al. (2008) studied the relationship among voluntary disclosure, earnings quality and cost of capital. The results showed that there is a positive relationship between voluntary disclosure and profit quality and a negative significant relationship between disclosure and cost of capital. Hassan et al. (2009) have studied the relationship between companies disclosure and company value in capital market. By controlling factors including amount of assets and profitability, the results of study showed that there is a negative significant relationship between compulsory disclosure and company value. Whereas there is a positive relationship between voluntary disclosure and company value but this relation is not significant statistically. Hussainey and Walker (2009) examined the effect of voluntary disclosure on relationship between current stock yield and future profits. Results showed that stock price prediction based on profit is improved by increasing disclosure level in annual reporting. Chi (2009) has studied the effect of disclosure quality on Taiwanese firms' performance. Results of this study showed that there is a direct significant relationship between disclosure quality in a level higher than average and company performance.

Nan-Chen et al. (2013) have studied the effect of disclosure regulation on earnings management through related-party transactions. They used modified Jones model for measuring earnings management. They concluded that after passing disclosure regulation in Taiwan in November, 2000 a decrease has happened in earnings management of Taiwanese companies that had transactions with parties related to Chinese companies. Generally they stated that disclosure regulations decreases earnings management.

## **Effective factors on disclosure quality**

### ***Size of company***

For the following reasons, large enterprises are expected to disclose information with better quality:

1. Large companies have enough resources for collecting, analyzing and presenting a vast amount of data at the least cost. Furthermore, in large companies detailed information is collected for internal reporting to top managers. Thus, disclosing such information is not costly (Singhavi and Desari, 1971).
2. Due to the need for more funding resources, large enterprises disclose information with better quality (Singhavi and Desari, 1971). Theoretical discussions and experimental evidence suggest that there is a negative significant relationship between disclosure quality and cost of capital due to funding (Dastgir and Bazzazzadeh, 2003).
3. Small enterprises know that thorough disclosure of information can jeopardize their competitive position, thus, they disclose less information with lower quality (Singhavi and Desari, 1971).
4. Large enterprises are sensitive to political costs (Watts and Zimmerman, 1986). Large enterprises disclose more information with more quality to reduce public criticism or government interference in their activities (Raffoufner, 1995).
5. Large enterprises tend to use powerful internal control systems and internal auditors. Thus, financial statements are presented by better quality and independent auditors spend less time to perform compliance and substantive tests. Consequently, delay in presenting accounting report would be minimized and companies can notify timely.

### ***Type of industry***

Due to unique features of companies of a specific industry, different disclosure procedures can be adopted than companies of other industries. Adoption of specific disclosure procedures for different industries can be effective on quality and the amount of their disclosure (Wallace et al., 1994). Watts and Zimmerman (1986) suggest that being in an industry affects the kind of political sensitivity of a company. Inchausti (1997) claims that based on signaling theory if a company does not adopt a reporting strategy similar to other companies in a similar industry, this issue is transmitted as “bad news”. Thus, companies of an industry are expected to adopt similar reporting procedures and strategies.

### ***Company Background***

Companies improve their reporting procedures and quality of information disclosure during time (Allseed, 2005). Based on learning curve theory, he argues that reporting delay will be decreased (timeliness will be increased) by increasing the number of annual presented reports by a company. Problems that cause reporting delay will be minimized by increase accountant learning and information providers and presenters during the time. Thus, a company with more background in collecting, processing and presenting information acts more timely and disclosure more transparent information.

### ***Audit institute size***

Generally, it is said that annual reports not only are audited but their contents are affected by auditors. Assuming such an effect and auditors’ belief that their performance is judged by quality of their annual reports, there is a probability that large accounting institutes (that have less dependency on one or several employers) suggest that more qualitative information should be presented in their employers’ annual reports. Besides, it is likely that auditing employers agree with ideas and opinions of large auditing companies more. In contrast, small auditing institutes are not capable of affecting on their employer’s disclosure procedures, they try to meet their employers’ needs to protect them.

### ***Financial leverage***

Funding through loan as a mechanism to reduce agency costs helps to solve agency problem at least via two following ways:

1. By issuing new shares, managers’ ownership percentage will decrease. Thus, in contrast with issuing new shares, funding through loan can prevent ownership percentage reduction. Consequently it will be favorable for managers and owners.
2. Debit increase with cash flow available to management, makes agency cost of free cash flow decrease. The relationship between managers and creditors is different from their relationship with stockholders. The amount and time of debt service have been subscribed by managers. While they have no obligation to distribute a certain amount of profit to stockholders in predetermined time. Loaning with regular and predetermined outflow of cash funds leads to decrease free cash flow. This issue reduces investment such funds in projects by negative net present value. Accordingly by increasing loan, agency costs of free cash flow will decrease. Besides, financial statements transparency and quality of

presented information disclosure has been considered as a practical strategy to reduce agency costs (Karamanou and Vafeas, 2005).

### ***Profitability***

A company with good news (favoring performance) will experience increase in value of stock market and management credit. The opposite of this issue is true for a company with bad news (negative performance). Inchausti (1997) believes that more profitable companies present more and high quality information. He argues that based on agency theory, managers of profitable companies utilize information disclosure to access to personal benefits. Thus, they present detailed and qualitative information to maintain their positions and bonus contracts. To prevent being measured less than their real shares based on signaling theory owners are eager to present good news to capital market. According to political processes companies with more profitability are eager to disclose more information to justify profit level.

### ***Ownership Structure***

Generally, companies can be divided into family business and non-family business. Family firms by long-lasting investment incur more potential costs in contrast with benefits of timely and high-quality disclosure of information, thus they prefer less disclosure. It is argued that family firms have no motivation or response for information costs of public investors, because major stockholders access to needed information. Furthermore, in contrast with other owners, family owners participate more in management of company as executive managers or board of directors. Thus, family owners have better access to information and they are able to control management better. Accordingly agency problems between management and stockholders will reduce. Because of replacement role of direct control and information disclosure by company other stockholders utilize this monitoring freely. Consequently, there will be less demand for public information, thus family firms disclose information in low volume and lower quality (Chen et al., 2007).

### ***Liquidity***

Liquidity shows company ability to meet financial commitments. Probability of bankruptcy and financial crisis are higher in companies with low liquidity ratios. Thus, companies with good financial condition are expected to disclose more and high-quality information than companies that have liquidity shortcoming (less liquidity). This issue is confirmed in economic depression.

### ***Board of directors' composition***

Ajinkya et al. (2005) claim that besides superintending on quality of financial information, non-executive members of directors have important roles in determining and controlling arbitrary disclosure policies. Regarding trustworthy role of 20 non-executive members toward stockholders, these members should ensure that high-quality and more information in favor of stockholders is disclosed. According to special position and supposed independency of non-executive members, they are expected to have more motivation for ensuring the disclosure quality and information transparency. Besides when non-executive directors control disclosure policy and information transparency improvement, disclosure is expected to be more accurate and less optimism.

### ***Disclosure Level***

Disclosure principle is one of the basic principles of accounting that affects all aspects of financial reporting. Disclosure principle implies that all important realities about financial activities and events of a business unit should be reported properly and completely. Based on this principle, basic financial statements should contain all important, related and timely information and this information should be comprehensive and be available for different groups of user thoroughly and properly. Reporting and information disclosure are the most important tools that are utilized by companies to communicate with stockholders. If disclosure has been required by a regulatory resource and legislator it is called compulsory disclosure, and when information disclosure is not under certain rules and it is done arbitrarily by company, it is called arbitrary disclosure (Owusu-Ansah, 1998). Arbitrary disclosure theory states that managers will disclose information that is managed by themselves in case of increasing disclosure benefits on its costs (Heitzman et al., 2010). Useful and related information prepared via arbitrary disclosure improves investors' making-decision process and puts other users of information disclosure in a more suitable position to allocate economic resources.

Relevance of financial information means considered information would be effective to users' economic decisions to evaluate past and present events and also for verifying or correcting their past assessments. Relevance feature of information is based on effectiveness concepts in predicting and selecting special measurement. Participants of capital market look for high-quality information to reduce information asymmetry between managers and themselves. Quality and used disclosure level to provide information are of basic and effective prerequisites for accounting information relevance (Hellström, 2006). Used level of arbitrary disclosure in providing financial statements may affect quality of prepared information and makes

value and relevance of information increase. Companies may disclosure information arbitrary for different reasons including information asymmetry reduction, decrease cost of capital (Botosan, 1997), and decrease cost of debt.

**Measuring financial reporting transparency**

There are two different dimensions in measuring transparency of financial reporting in terms of measurement level. The first dimension deals with financial reporting transparency in market or a country level. Measuring accounting transparency in country level means measuring the amount of transparency that is imposed on market forces and it pertains to related measurement rules and accounting systems. Whereas each company operates based on accounting systems and laws of its own country, these accounting rules and systems show the least level of companies’ financial reporting transparency. The second dimension is related to financial reporting transparency in level of each company. Although, all accounting systems and rules of all companies in a country are same, companies’ financial reporting transparency level is different.

For measuring financial reporting transparency, unidimensional or multidimensional criteria may be used. Since unidimensional criteria are constructs that measure transparency by error (DeBoskey and Gillett, 2013), most of researches like Bushman et al. (2004) has designed thorough criteria for transparency that measure different dimensions of financial reporting transparency. All unidimensional criteria are indirect indexes and probably are independent of financial reporting transparency, accordingly multidimensional criteria increase analytical capacity of tests. In DeBoskey and Gillett (2013) research have been concluded that extracting casual relationships based on unidimensional indexes of transparency has big errors, but considering these indexes as a group can be a more appropriate criterion for company obligation to transparent financial disclosure and general quality of information environment. For extensive evaluation of different dimensions of company transparency in information environment, Bushman et al. (2004) definition of transparency has been accepted in this study, it covers wide range of concepts related to transparency, and accordingly access to transparency would be achieved via three different channels (Table 1).

**Table 1: Bushman et al. Model (2004)**

Company reporting channel	Acquiring private information and communication channel	Information distribution channel
Financial disclosure indexes	The amount of analysts pursuit	Reports of media about company
Corporate governance disclosure		
Accounting principles		
Timeliness		
Reliability		

**Conclusion**

Lack of information symmetry is one of negative phenomena that occur usually in securities market and leads to inappropriate economic decisions by investors. Existence of symmetry information does not create a necessity for posing information economy. Whereas individuals in a special market do not have same information about a considered issue, they encounter information asymmetry, and backtracking on optimum portfolio would be possible easily. Because one of basic prerequisites for ensuring investors and creditors for economic constructive activities is preparing and presenting information that would be effective for financial and economic making-decisions. Financial decision should be made based on risk and returns, thus paying attention to a certain level of risk and returns would be important. Stock liquidity is one of effective factors on risk. Because the amount of stock liquidity is effective on investors’ decisions for preparing a portfolio investment. High liquidity of company stocks is considered one of its most important features. Stock that has good liquidity, it is paid attention by applicants of capital market. For obtaining considered financial resources, companies pay special attention to capital market. Needed funding for utilizing investment opportunities can be economical when company stock makes high demand. Information asymmetry is one of effective factors on stock liquidity. Information asymmetry had always been important theoretically. Theories show that information inequality may cause market failure, this issue causes inefficiency in macro and micro levels via less or more investment than real investment. More understanding of this concept helps its optimal solution inappropriate selection and moral hazard are two effective factors on markets inefficiency.

Inappropriate selection is the first factor of information asymmetry, it happens when one party or more has information advantage on other parties in a potential or real business exchange. This matter motivates policy makers and lenders to pay attention to or verify information integration among financial statements users. Moral hazard is the second factor of information asymmetry, based on it each party of a potential or real business exchange can observe his/her actions in executing or violating terms, while other parties are not able to observe Others' actions (Scott and O'Brien, 1997). Moral hazard pushes policy makers and lenders toward passing imperative laws in scope of debt and legal litigation for controlling performance of contracts' and exchanges' parties. According to these factors, measuring and removing information asymmetry is very difficult. Collecting experimental evidence about importance of information inequality especially in credit markets is not possible easily. In fact, information symmetry exists when managers and market have same information about company. Otherwise because of having confidential information about company, managers have better and more information than market and they access to company information before market.

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