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*Review*

# The Importance of financial reporting to capital market development in Ghana

**Williams Abayaawien Atuilik* and Hussein Salia**

Department of Accounting, School of Business, Heritage Christian University College, Amasaman – Accra, Ghana.

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**The finance literature suggest that investment decisions are largely influenced by the quality of corporate financial information released by firms in their financial statements, and that capital market participants use corporate financial information released by firms for investment decisions. Factors that influence the development of capital markets in developing markets include: appropriate legal and regulatory framework, effective securities exchange commission, an active stock exchange market, availability of accurate and reliable information about firms' financial performance and position. An improved financial reporting environment that produces accurate and high-quality financial reports on a timely basis contributes significantly to the development capital markets in developing economies. It is therefore important that the Institute of Chartered Accountants Ghana (ICAG), regulator of accounting practice in Ghana should strengthen its regulatory role to ensure that accountants in Ghana helping generate financial information for firms listed on the Ghana Stock Exchange are sufficiently knowledgeable and skilled in matters regarding financial reporting and provide financial reports guided by sound reporting ethics and the principle of integrity.**

**Key words:** Accounting standards, capital markets, financial reporting.

## INTRODUCTION

Extensive research has been done in the finance literature and the results suggest that investment decisions made by investors are partly influenced to a large extent by corporate financial information released by firms, and so capital market participants such as brokers and investors tend to follow closely the release of corporate financial information by corporate entities (Ball and Brown, 1968; Lev, 1989; Myring, 2006; Habib, 2008; Acquah-Sam and Salami, 2014). The corporate finance literature is replete with a number of theories, including: pecking order theories, arbitrage pricing theories, efficient market hypothesis theories, signaling models, capital asset pricing theories, and theories on dividend policy (Frank and Goyal, 2003; Larcker and Lys, 1987; Malkiel and Fama, 1970; Myers and Majluf, 1984; Sharpe, 1964; Skinner, 2006). All these important theories suggest that stock prices change in response to knowledge of a number of financial variables obtained from corporate financial information. Some of the important variables that are obtained from corporate financial information include earnings, dividends, cash flow projections, net assets, returns on investments, levels of debt among others.

*Corresponding author. E-mail: atuilik@yahoo.com.

These variables are either reported in the financial statements or are derived from information contained in the financial statements. The purpose of this paper is to address the role of financial information in capital market development and use this as basis to argue the need for ensuring improved quality of disclosures in financial statements.

## Factors that influence the development of capital markets

The capital market refers to interactions among firms or organisations with funding needs and investors with surplus funds for investments whereby firms raise debt and equity capital for their operations, and investors make funds available to firms either in the form of debt or equity investments at a return. In highly developed capital markets, firms are able to raise debt or equity capital from the market much easily and investors are able to place their surplus funds much easily. The converse is the case for less developed capital markets where it is difficult for firms to raise capital and those who have surplus funds do not have readily available channels for placing those funds for productive ventures. There are a number of factors that may possibly influence the level of development of capital markets. According to Osei (1998) and Gnanarajah (2015), the appropriate legal and regulatory infrastructure, such as an effective Securities Exchange Commission, an active stock exchange market, and the availability of accurate and reliable corporate financial information about firms' financial performance and financial position are key influencers of the level of development of the capital market. Thankfully, Osei (1998) observed that there seems to be appropriate and effective legal and regulatory structures in Ghana to promote the development of the Ghanaian capital market. What was found to be a problem is non-reflection of all available financial information on stock prices (Salami and Acquah-Sam, 2013). Embedded in this problem is the question of the reliability of the financial information generated by firms listed on the Ghana Stock Exchange. It is in this regard that it is necessary to take steps first to improve the credibility of the financial information generated by firms listed on the Stock exchange, and then to ensure that the financial information available is actually used by investors to make investing decisions. Generating reliable financial information by firms listed on the Ghana Stock exchange is thus a necessary step towards uplifting Ghana's capital market.

## The role of financial information in capital markets development

Firms usually provide financial information through the financial reports they publish. The financial reports often comprise: financial statements, management discussion of those financial statements and other regulatory filings. Some firms engage in additional voluntary communication, such as management forecasts, analysts' presentations, other corporate reports and press releases on key issues. Some publish these reports in hard copy and file same with the regulators while other firms additionally post all this information on their web sites. There are also some disclosures about firms provided by information intermediaries, such as financial analysts, industry experts, and the financial press. There is a preponderance of evidence in the finance literature indicating that capital market participants depend on financial information to make various decisions (Agyei-Mensah, 2013; Bernard, 1992; Bernartzi et al., 1997; Bhattacharya, 1979; Fama, 1965; Fama, 1970; Gnanarajah, 2015; Kothari, 2001).

It has been suggested that no perfect stock market exists anywhere in the world, and that most stock markets exhibit weak form market efficiency (Hasanov and Omay, 2007; Magnusson and Wydick, 2002). Weak form efficiency imply that the market uses historical corporate financial information in making investment decisions. The implication is that through the financial reports and disclosures prepared by accountants for firms, capital market participants are provided with information that forms a basis for making fair decisions regarding stock prices in order to make and execute reasoned investment and financing decisions. There is overwhelming evidence from the literature that argues that market participants including, regulators, creditors, and the investing public often rely on corporate financial information to value stock prices and make investment decisions (Appiah-Kusi and Menyah, 2003; Bennard, 1992; Chambers and Renman, 1984; Fama, 1965; Fama et al., 1969; Gnanarajah, 2015; Habib, 2008; Healey and Palepu, 2001; Holthausen and Larcker, 1992; Osei, 2002). What this means is that steps need to be taken to ensure that firms prepare their financial statements in a credible manner. This has implication for the regulation of the practice of accountancy in Ghana.

The regulators of accountancy practice must ensure that persons who prepare the financial statements of firms are qualified to do so, and do actually prepare the financial statements of firms in line with appropriate standards. The questions that beg for answers are: Does the regulator of accounting practice in Ghana ensure that only qualified persons are engaged to prepare financial statements for firms listed on the stock exchange? Do the firms use the appropriate standards to prepare their financial statements? Are the financial statements of listed firms audited by qualified accountants in line with appropriate standards for auditing? It is only when these questions are answered in the affirmative that that one can begin to expect quality corporate financial information from listed firms that should subsequently induce high quality capital market decisions.

Nyor (2012) asserts that financial statements prepared using global financial reporting benchmarks help investors better equip and appreciate risk associated with decisions about flows of economic capital. This is confirmed by the findings that market participants use financial information to make general investments decisions to reduce financial risks and optimize returns on investments (Healey and Palepu, 2001; Onulaka, 2014). From the foregoing, one can only conclude that the disclosure of reliable financial information by corporate entities is a "sine qua non" for the development of the capital market. Against the background of the critical role of quality financial information in the development of capital markets, it is critically important to improve the quality of the financial disclosures by listed firms through improved financial reporting. The question is, how can this be done? This can be achieved by requiring listed firms to report in line with approved accounting standards and ensuring strict compliance by the regulator of the practice of accountancy.

**Accounting standards**

Accounting standards prescribe the accounting treatment for financial transactions and the minimum disclosure requirements with respect to those financial transactions. Having a standardized set of prescriptions for purposes of reporting eliminates arbitrariness and opportunities for manipulation in terms of reporting and consequently improves the quality of financial reports. Hail et al. (2010) argued that high-quality accounting standards lead to improved financial reporting which in turn leads to improvement in corporate decision making. It is thus expected that the application of Financial Reporting Standards (IFRSs) should lead to improved financial reporting.

**Improving Financial Reporting**

According to Kothari (2000), the rise in the volatility of stock returns across the globe in the past couple of years has been of concern to many commentators and has led to the questions as to whether greater transparency in financial statement information could reduce volatility and produce more accurate stock valuations? And whether more transparent financial statements of financial services firms (for example, banks) could improve lending and credit evaluation decisions and contain the risks of a banking crisis? These issues are of central interest to all market participants and, in particular, to the Securities and Exchange Commission (SEC). It is for these reasons that Institute of Chartered Accountants Ghana (ICAG) in collaboration with SEC (and other regulatory bodies) mandated all listed companies in Ghana to adopt the International Financial Reporting Standards (IFRSs) as their financial reporting framework since 2007. It is important that financial reports presented by firms communicate corporate performance accurately and reliably. Barton (2005) and Agyei-Mensah (2013) suggested that for financial information to be useful, they must possess the characteristics of relevance, reliability, comparability, and understandability. One mechanism for ensuring improved financial reports is the adoption of International Financial Reporting Standards (IFRSs) by reporting firms. The need for improving financial reporting with particular respect to firms listed on the Ghana Stock Exchange is more urgent against the findings that the Ghana Stock Exchange exhibits weak form market efficiency (Ntim et al., 2007; Osei, 1998; Salami and Acquah-Sam, 2013).

**Advantages of adoption of IFRS**

The adoption of IFRS by reporting entities present tremendous advantages. Epstein and Jermakowicz (2010) and Onulaka (2014) argued that convergence facilitates the free flow of capital across boundaries as it eliminates accounting risk and reduces listing requirements and costs on international stock exchanges. Marfo-Yiadom and Atsunyo (2014) advanced a similar argument, that financial statements presented in compliance with IFRS facilitate the integration of international markets. They argued that IFRS-based financial statements are often more appealing to the international audience due to the higher level of comparability and quality. Given that national domestic accounting standards are harmonized with the IFRS, the likelihood of any unfamiliar national domestic accounting standards will be eliminated. Wyatt (1989) also found that convergence of Generally Accepted Accounting Principles (GAAP) with IFRS yields a number of benefits including: "increased cross- border financing; emergence of true multinational companies; a heightened willingness to cooperate across borders to enhance national, regional and even global economic strength; an awareness by securities regulators around the world of the necessity for comparable data" (p. 108). Epstein (2009) confirms that "there is certainly empirical research evidence to support the notion that uniform financial reporting standards will increase market liquidity, decrease transaction costs for investors, lower cost of capital and facilitate international capital formation and flow" (p. 31). There are however some challenges in implementing IFRSs in the form of the cost to migration, the problem of change, the need to close the knowledge gap between existing reporting regime and IFRSS, and keeping up with constant changes in IFRSs. The benefits seem to outweigh the disadvantages.

**The Ghana's experience**

Recognizing the important role of quality financial reports in the development of the capital market in Ghana, ICAG being the body responsible for regulating the practice of accounting in Ghana made a number of interventions towards promoting good financial reporting practices in general.

According to Assenso-Okofo et al. (2011), in January 2007, the ICAG, in collaboration with other Regulatory Bodies -Bank of Ghana, National Insurance Commission, and Securities and Exchange Commission- launched the adoption of IFRS in Ghana. By this adoption, all Public Interest Entities [PIEs] (the banks, insurance companies, listed companies and profit-oriented state-owned enterprises) are required to apply IFRS as their financial reporting framework. The adoption of IFRS was led by ICAG with great support from the Regulatory Bodies mentioned above. It is gratifying to note that as at end of April 2013, all the listed entities had adopted IFRSs as the framework for preparing and presenting their financial statements.

Agyei-Mensah (2013) analysed the pre-adoption and post adoption financial statements of firms listed on the Ghana Stock Exchange and concluded that all firms had substantially complied with the reporting requirements of the adopted IFRSs framework. He concludes also, that there was significant improvement in the quality of information in the financial statements of listed firms after the adoption of IFRSs. It thus be concluded that the adoption of IFRSs by listed firms has resulted in the presentation of more credible financial statements, consequently leading to increased investor confidence in the Ghanaian capital market.

ICAG has also introduced audit Quality Assurance Monitoring unit (QAM) to ensure that auditors apply the appropriate auditing standards; the International Standards on Auditing (ISAs) and require their clients to comply with IFRSs as the framework for financial reporting. The introduction of the QAM unit is an important step aimed at fulfilling ICAG's regulatory obligation. The results from a survey conducted by the ICAG in 2016 ON Small Medium Size Audit Practices (SMPs), confirmed by the reports of QAM, indicate that all of the listed companies on the Ghana Stock Exchange are audited by one of the Big Four audit firms (ICAG, 2017). This imply availability of high quality resources for the conduct of the audit of listed firms.

These interventions are expected ultimately to improve the quality of financial disclosures by listed firms and hence provide more accurate and reliable information to capital market participants for decision making. The quarterly publication of financial statements supported by the 'facts behind the figures' regime encouraged by the Ghana Stock exchange adds to the timeliness of information available to market participants. As Chambers and Renman (1984) suggest, the timeliness of availability of financial information to capital market participants is critical to capital market development.

Similarly, Abedana and Gayomey (2016) found that timely publication of financial information significantly enhances the quality of accounting numbers and their value relevance to investors, thereby impacting positively on capital markets. The extent to which listed companies should provide interim reports is another important issue in the discussion on disclosure requirements. The annual reporting regime where financials are released annually is on its way to becoming less useful and in its place, is quarterly reporting regimes. The main critique on mandatory quarterly reporting regimes from a practical point of view, however, is the disproportionate costs associated with the higher reporting frequency, which according to opponents, is not compensated by potential benefits (especially for smaller firms). For example, Ozturk (2008) has identified high costs including cost of sponsoring staff attending conferences and seminars, organizing in-house training, personnel cost for preparers and auditors of financial statements that are IFRSs compliant, as the major hindrances to frequent reporting.

**The way forward**

Having adopted IFRSs, one critical issue that needs the attention of listed firms is compliance with the recognition, measurement and disclosure requirements of the IFRSs. Listed firms need to train their reporting accountants on the IFRSs. Audit firms also need to insist that the financial reports of their clients, especially those listed on the stock exchange are in compliance with the requirements of IFRSs. In this regard, the joint efforts of ICAG, SEC, the Stock Exchange and other regulators at ensuring compliance cannot be over emphasized.

The findings of the SMPs survey conducted by ICAG in 2016 (ICAG, 2017) reveals that accounting practitioners who practice in the Small to Medium Size practice firms need a lot of support to improve the quality of practice. Most of the practitioners requested support from ICAG in the form relevant CPDs that provided current updates on IFRSs, provision of implementation frameworks for IFRSs, regular and increased quality assurance and monitoring service by QAM to support small firms to improve their practices, regular reviews of firms to weed out non-qualified firms that practice illegally. Whiles as has been noted already, the SMPs do not audit the listed firms, accountants that work for the listed firms share similar characteristics and have some influence on the quality of financial reporting of the listed firms. It is therefore important that ICAG as regulator pay more attention to the work of QAM and possibly expand the ambit of QAM to oversee the work of accountants in industry. This will ensure that accountants are well resourced and motivated to keep proper books of accounts, prepare appropriate and credible financial statements from those books of accounts in compliance with relevant standards.

Perhaps a reporting regime that should be considered by listed entities going forward is integrated reporting. According to the International Integrated Reporting Committee (IIRC), integrated reporting is a process that results in communicating the value creation of an entity over time through an Integrated Report. The IIRC defines an Integrated Report as “a concise communication about how an organization’s strategy, governance, performance, and prospects lead to the creation of value over the short, medium, and long-term” (www.theiirc.org) Integrated reporting provides information not only on the financials of an entity, but also information on strategy, governance, performance, and prospects. The primary benefit of integrated reporting is that it allows a company to better understand, manage and report on multiple dimensions of value. A properly designed set of performance measures often included in integrated reports will give management the incentive and urge to improve performance. For other stakeholders, the report is intended to provide more and better information to increase stakeholder understanding of the company—its management, strategy and operations, and its perils and prospects. It has been suggested that the integrated report will become an organization’s primary report, which links in with various supporting, more detailed, reports.

## Conclusion

Improved financial reporting that produces accurate high-quality financial reports on a timely basis is critically important for the development of capital markets especially in developing capital markets as good investment decisions are anchored on high-quality corporate financial information. In this regard, the regulator of the accounting profession should take concrete steps to ensure that accountants who keep the financial records and prepare financial reports for listed firms are sufficiently knowledgeable and skilled in the matters of financial reporting and are guided by sound reporting ethics and the principle of integrity when preparing financial statements. This should be done through collaboration with all relevant stakeholders, especially, other regulatory bodies such as the Securities & Exchange Commission, the Insurance Commission, the Bank of Ghana, and the Ghana Stock Exchange. ICAG should also strengthen its quality assurance and monitoring function and extend it to cover accountants working for firms listed on the Ghana Stock Exchange.

## CONFLICT OF INTERESTS

The authors have not declared any conflict of interests.

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