Financial Reporting Gap in Developing Countries: The Case Study of Iran

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Abstract

This paper examines financial reporting gap in Iran. Legal financial reporting model is determined by using fact documents and the actual reporting model is explored by applying interviews through purposive sampling. Finally, the potential gap is determined by comparing the reporting models (legal vs. actual). The research results indicate that the Iranian investors as well as legal sources of information (financial, audit and TSE's reports) use informal sources of information in their decision making process. These sources include brokers, friends, financial analysts' reports, media, companies' websites, and corporate staff. Using the other sources of information suggest that there is a gap between the legal and actual financial reporting models in Iran. This implies that the legal reporting system does not meet the needs of the users; therefore the users use the other sources to overcome this failure. The findings also show that the reporting gap is caused by the following factors: the inadequate disclosure of non-financial information in the financial statements, inability of the financial statements to provide on time information, and advances in technology, which facilitates access to more and real time information. This case study would be of value to regulators, financial analyst, brokers, investors, and researcher especially in developing and emerging markets.

Keywords: Actual financial reporting model, Legal financial reporting model, Financial reporting models gap, Fact Documents, Purposive Sampling, Tehran Stock Exchange (TSE)

1. Introduction

The main expected role of the financial reporting is to meet the external users' varying needs. Users of financial reports in general and particularly investors require useful information for their decision making. Over the time, changes in the needs impel changes in the types of information required and the dissemination of such information, i.e. financial reporting (Salvary, 1998). It seems that recent changes in the users' needs are too fast for financial reporting to cope, which may result in the users' dissatisfaction. Therefore, the users may seek other sources of information. Traditional financial reporting provides specific type of information, i.e., financial information in a specific format while
nowadays users decide individually on the type of information that is important to them (Behets, 1998) as well as its proper format (Baker and Wallage, 2000).

Although providing audited financial statements are required by the law and accounting standards, global capital markets may not rely on this type of traditional financial reports as they may not be directly relevant to their decision making process (Frost and Pownall, 1996). Investors need information on real time but financial statements are provided a few times to users. This delay may not be accepted as global decision making requires real time and on-line information. This may encourage investors to seek other sources of information such as firms' websites, financial analysts’ forecasts, unaudited interim earnings’ announcements, and privately obtained information for investment decision-making (Williams, 1996). As a result, financial reporting process may be affected by new players in the market (e.g., financial analysts and advances in information technology), which may have not been considered in the traditional (legal) financial reporting model. All of this may result in a gap between legal and actual financial reporting models. This gap may be bigger in developing countries such as Iran in which the legal reporting system is mainly affected by external factors (e.g., US accounting standards) rather than contextual factors.

2. Institutional Environment

Contextual factors such as, culture, legal systems, nature of the relationship between the providers of capital and business enterprises, tax laws (systems), inflation levels, political and economic ties, levels of economic development, and education levels affect the development of financial reporting in each country (e.g., Gray, 1988; Perera, 1989; Meek and Saudagaran, 1990; Perera and Mathews, 1990; Zeff, Wel, Camfferman, Limperg Instituut., and Raad voor de Jaarverslaggeving (Netherlands), 1992; Perera, 1994; Douplnik and Salter, 1995; Baker and Wallage, 2000; Jaggi and Low, 2000; International Accounting Standards Committee Foundation., 2004; Askary, 2006).

Prior research has established a link between these influential factors and differences in national accounting systems as well as financial disclosures (Saudagaran and Meek, 1997; Salter, 1998; Jaggi and Low, 2000). Financial disclosures are also significantly affected by corporate ownership, corporate capital structure and capital markets (e.g., Adhikari and Tondkar, 1992; Zarzeski, 1996; Salter, 1998).

Iran has its own unique contextual characteristics such as culture, capital market, corporate ownership, corporate capital structure, and political and economical ties while these contextual factors are less considered in development of its legal financial reporting model (e.g., Noravesh, Dianati Dilami, and Bazaz, 2007; Audit Organization of Iran, 2008). This may result in a gap between legal and actual financial reporting models in Iran, which may be different from the potential gap in developed countries.

According to Hofstede (1980), Iran has a high level of uncertainty avoidance as well as power distance and a low level of individuality. Pourjalali and Meek (1995), study the effects of the Islamic Revolution (1979) on cultural and accounting values in Iran. Their findings indicate that the Revolution has increased collective culture, power distance, uncertainty avoidance, and masculinity. The results also show that the Revolution has decreased professionalism by terminating professional Iranian accounting associations (with a corresponding increase in statutory control), increased adaption and application of conservative measurement approaches in accounting, and decreased the need for transparency (increasing the preference for confidentiality), which restricts the disclosure of the financial information.

The TSE is an emerging institution in the early stages of its development and, as such, is different from stock exchanges in developed markets (Bagherpour Velashani, 2007). Emerging markets often have less protection for shareholders and creditors (LaPorta, Silances, Shaleifar, and Vishny, 1998) and are less efficient than developed markets (Walczak, 1999). As a consequence, the type and level of conflicts of interest are different from those in developed markets (Gul and Qiu, 2002). For example, in emerging markets, the risk of expropriation of minority shareholders by large shareholders is higher than in developed markets (Claessens, Djankov, and Lang, 2000 and 2002).
Therefore, in an emerging market such as the TSE, the type of information and the level of disclosures required, as a means of reducing conflicts of interest, can be different from developed markets. Consequently, different financial reporting model may be applicable.

In companies with large shareholders, who have significant influence or control over the company, agency problems may arise between large and minority shareholders (Shleifer and Vishny, 1997; Fan and Wong, 2002). The agency problem emerges because large shareholders are able to increase their interests or extract benefits without bearing the full cost of their actions (Lemmon and Lins, 2003). In the TSE context, public sector agencies are the major shareholders in most companies and they have significant influence or control over the companies (Bagherpour Velashani, 2007). As a result, the agency problems that may arise between large and minority shareholders (Shleifer and Vishny, 1997; Fan and Wong, 2002) may have different characteristics compared with those that arise when the dominant shareholder is more strictly profit-oriented. According to Claessens, Djankov, & Lang (2000, p.109), ‘…the direct participation by government officials in the control of a large part of the corporate sector opens up the possibility of widespread conflicts between public and private interests…’ For example, public sector shareholders may apply the company’s resources to the provision of cheaper goods and services, which may impair profit-seeking private sector shareholder interests. The conflict of interest between public and private sector shareholders in the TSE context may require different type of financial reporting, which can be different from those in developed markets as well as other emerging markets.

Although accounting standards are usually set by professional institutions such as the FASB in developed markets the first Iranian National Accounting Standards (INAS), which are mainly translations of the International Accounting Standards (IAS), were issued by a governmental organization i.e., Audit Organization of Iran (AOI) in March 2000 (Noravesh et al., 2007; Audit Organization of Iran, 2008). The AOI is legally responsible for setting accounting and auditing standards, legal inspection, and auditing of state-owned companies. Because of a lack of national accounting standards, the Iranian financial reporting was based on a combination of the UK, the USA, and the IAS till 2000. According to Baker and Wallage (2000), international statements of accounting standards are also similar to those issued by the FASB and the UK Accounting Standards Board. This implies that the implementation of the INAS has not also made a big change in the Iranian legal financial reporting model.

The Iranian education system is also similar to the US and the UK systems in which foreign accounting books are the main textbooks. This contributes to more similarity between the Iranian legal financial reporting model and the western’s model (Roudaki, 1996; Anonymous, 2002). All of these indicate that the Iranian financial reporting is mainly affected by the external factors rather than the contextual factors although it has its unique context, which may result in a potential gap between the legal and actual financial reporting models in Iran.

3. Prior Research

According to Baker and Wallage (2000, p.174) ‘financial reporting consists of those customary and legally required reports that managing directors of companies provide to shareholders and other interested parties’. However, there may be a gap between the legal (accepted based on laws and rules) and what is actually followed as financial reporting model. The legal financial reporting model may not fully reflect the actual financial reporting system in use. This implies that the users may consult with other sources of information, which may not be considered by the legal financial reporting model.

Ashbaugh, Johnstone and Warfield (1999) examined the application of internet by the companies as a means of improving the relevance of their financial reporting. They found that firms’ websites provides more timely financial information and in some cases, more financial and nonfinancial data than traditional paper-based reporting method. Moreover, Frost and Pownall (1996) found that large multinational companies, sophisticated financial analysts and portfolio managers who follow them, operate mostly in an environment where audited financial statements are not directly
relevant to their decision-making process. For example, institutional investors may broadly rely on financial analysts for information concerning potential investments (Byrne, 1998). Furthermore, financial analysts and other information providers use on-line and real time information that enables them to have updated information immediately (Baker and Wallage, 2000).

Financial analysts apply unaudited earnings forecasts by management to revise their own earnings forecasts, which may in turn become a primary source of information for investors’ decision-making (Williams, 1996). Seeking other alternatives of validating information by institutional investors is the reason that the role of the financial analysts and other information providers is becoming increasingly important (Baker and Wallage, 2000). Therefore, financial analysts not only are users of information which are provided by corporate managers but also they are one of the information providers to other users particularly investors and creditors.

Financial analysts gain valuable insights about the current performance and future prospects of a firm when they analyze a firm (Palepu, Bernard, and Healy, 1996). They are the most important information mediators between firms and investors that usually collect and process a vast amount of information from corporate insiders and subsequently distribute this information to current and potential investors. An analyst’s report is the end of a process that includes the collection, evaluation, and distribution of information related to a firm’s future performance (see also Smith, 1992). In fact, many investors rely on the information provided by financial analysts when they do portfolio selections and revisions (Chung and Jo, 1996). The financial analysts as information mediators increase the investors’ knowledge about the factors that can influence share prices such as company’s performance (Kuperman, Athavale, and Eisner, 2003)¹.

In summary, it can be said that the legal model of financial reporting may not fully reflect the manner in which information actually flows to the users, especially investors. This may be partly related to advances in information technology, which enables investment decision-makings to become on-line and in real time (Baker and Wallage, 2000), and partly related to new players in financial market. Based on the above discussion the purpose of this study is to examine whether there is any gap between the legal and the actual financial reporting models in Iran. For doing so, the reporting models are identified and then by comparing them the potential gap would be determined. The following section will discuss how this research is conducted.

4. Research Strategy
Qualitative research method is applied in this research due to the stage to which knowledge about the research topic has advanced (Cavana, Sekaran, and Delahaye, 2001). Lack of the research available about the gap between legal and actual financial reporting in Iran causes a situation, which leads the research to be at a descriptive and exploratory stage. Therefore, consistent with Denscombe (2003) and Yin (2003) fact documents and surveys are used as the research strategy of choice. Fact documents is used to determine the legal and survey is applied to explore the actual financial reporting model in Iran. These methods are explained in more details in the following sections.

4.1.1. Fact Documents
Legal financial reporting process is identified by rules and regulations including corporate laws and accounting standards. In Iran, the Iranian Commercial Code as the Iranian corporate laws (ICL), Direct Taxes Act, the Iranian accounting standards, and TSE rules and regulations (for TSE listed companies) are the influential rules and regulations on the process of financial reporting.

For example, chapter 2 of the TSE rules and regulations (Articles 6-17) present the TSE rules about listed companies’ duties in relation to accounts and financial reporting. According to Article 6,
the company has to prepare its annual financial reports as well as consolidated financial reports based on the published TSE format. Companies are required to send the annual financial reports within a time which is no longer than the time specified in Article 1 (i.e., 10 days prior to the general meeting date). Article 7 requires the company to prepare its accounts and documents based on accepted principles and rules. It also requires that productive companies should have cost accounting systems to calculate the cost of their products.

Article 11 requires that companies have an internal control system based on the requirements of the auditor and statutory inspector. According to article 8, those listed companies which own more than 50% of other companies’ shares have to prepare consolidated financial reports. Article 9 requires that the listed companies and their subsidiaries be audited by members of the Iranian Association of Certified Public Accountants (IACPA). According to article 15, the listed company has to send a report every three months to the TSE of its production and sales statistics, the manner of using allocated rates of exchange, necessary financial reports based on TSE requests including comparing approved budget items with actual performance, the most recent tax situation, progress of development plans, and information about important contracts. Article 16 emphasizes that the listed companies have to send all information about their new plans to the TSE. Article 17 requires that the listed companies send the annual budget for the next year to the TSE.

Consequently, the Iranian legal financial reporting model is drawn based on the above rules and regulations as it is shown in the figure 1. The quality of influence of different rules and regulations on the Iranian legal financial reporting model as well as the interaction among them is explained in the analyzing section.

4.1.2. Survey
To explore the actual financial reporting model in Iran survey is used as the research strategy because of the type of research questions (which are what and how much), lack of researcher’s control over events, focus on current events on financial market (Yin, 2003). Purposive sampling is used because the research process is discovery rather than hypotheses testing (Cavanaugh, Sekaran, and Delahaye., 2001; Denscombe, 2003). In addition, it enables the researcher to focus on those groups of investors who will provide important and related information as well as focusing on different cases to clarify the research question at hand (Dane, 1990; Denscombe, 2003).

The necessary data is collected by conducting interview for a number of reasons. Firstly, the interview is the most common method in data collection in qualitative and business research (Cavanaugh, Sekaran, and Delahaye., 2001). Secondly, the researcher is interested in knowing investor’s beliefs, attitudes, values, knowledge, and other mental contents (Sellitz, Cook, Wrightsman, and Society for the Psychological Study of Social Issues., 1976; Gorden, 1980). Thirdly, because of its advantages such as providing the opportunity to encourage the interviewee to give accurate and complete information, to help the interviewee to know the aim of the questions, and providing flexibility in the asking of questions by the researcher (Sellitz et al., 1976; Gorden, 1980; Patton, 1990).

Semi-structured interview is used for data collection because it allows the researcher to collect detailed perceptions from the interviewees about a particular topic or question. The researcher can also follow up the interesting topics, which have emerged during the interview by asking further questions (Smith, 1995). The advantages of applying the semi-structured interview to explore the sources of information used in the decision making process by the investors are: firstly, a detailed picture of the financial reporting process in use would be gained. Secondly, the research questions have ‘what and how much’ format. These questions are expected to be best answered by using the semi-structured interview within the limited time agreed. It is also assumed that the interviewees will give their views

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2 The Iranian Government applies a restricted exchange rate policy for different purposes in different rates. As a result, there is an official and a block market exchange rate in the market. The Government allocates exchange in the lower price to companies to import their needed plants and equipment to support them. Consequently, this is important for investors to know as to how the company expended its allocated exchanges.
if a good initial relationship between the researcher and the interviewee is established during the interview process (Smith, 1995).

4.1.3. Sample
In this research, the goal is identifying the potential gap between the legal and actual model of financial reporting by which investors obtain their required information. The investors are considered as the population of interest because the Iranian financial reporting conceptual framework states that whenever the financial needs of this group are met the needs of the other financial information users would be satisfied. In other words, the information provided to the investors is the main reference for all the users (Article 5-1).

The criteria to select the research sample were defined as: the investor is i) a person who buys and sells TSE listed companies’ shares, ii) a person who personally follows the effects of different factors on the market price. In selecting the investors to be interviewed, the criteria of selecting interviewees proposed by Gorden (1980) is also considered. These criteria are the interviewee must possess relevant information, physically and socially be accessible, be willing to give the information, and also be able to give the required information. Accordingly, 40 investors were selected by using purposive sampling.

Based on the goal of the research the main question of the research is raised as: Is there any potential gap between the legal and actual financial reporting models in Iran? In designing the interview questions the researcher used Smith’s (1995) suggestions as a guide (see also ArabSalehi, 2005; and 2006). Based on the research question and Smith’s suggestions, the following interview questions were asked from interviewees:

1. What is the necessary information for your decision making regarding to buy or sell TSE listed companies’ share?
2. What are the sources of the necessary information in your decision making?
3. How much do you rely on financial reports in your decision making process?
4. What is the reason for using other sources in addition to legal (formal) sources?

The main questions in this research are the second and the forth one but the researcher asked the first and the third questions only to find the in-depth information about the main question.

4.1.4. Conducting the Interview
A pilot study was conducted with three investors to check the reliability and validity of the survey questions and identify potential practical problems such as recording difficulties, potential weaknesses of the survey in regard to question format, wording and order (Cavana, Sekaran, and Delahaye, 2001; Yin, 2003). In conducting the interviews to obtain relevant information from the interviewees and increase the validity and reliability of the information Gorden (1980) and Smith’s (1995) suggestions were followed. They suggest that the role of the researcher in the semi-structured interview is to act as a facilitator for the interviewee rather than to dictate exactly what happens during the interview process. This is because investors as volunteer interviewees are not used to be interviewed. By acting as a facilitator, the researcher can expect the investor to give the relevant information about the interview questions.

4.1.5. Recording and Transcribing Interviews
Before starting the interview, the interviewee is asked whether the interview can be tape-recorded because it is the best way of interview data collection. Tape-recording allows a much fuller record than notes and the researcher has the opportunity to concentrate on the topics of the interview and the dynamics of the interview (Smith, 1995). The tape-recording request was accepted by all the interviewees. In transcribing taped interviews into written text, the suggestions of Breakwell (1995) and Kvale (1996), such as selecting the related parts to be transcribed, summarizing and interpreting them to be a useful tool for given purposes, were considered.
5. Analysis
The first aim of data analysis is to obtain relevant answers to the research question which is the reason for the study. The goal of this research was to determine the legal and actual models of financial reporting in Iran and identify any potential gap between them. Based on the collected data the legal model of financial reporting is determined and the actual model of financial reporting is explored as it is discussed in the following sections. Comparing these two models shows a gap between the legal and actual financial reporting process in Iran.

5.1. The Iranian Legal Financial Reporting Model
The Iranian rules and regulations provide a framework for the currently legal model of financial reporting (Fig 1). According to this model, financial reports have to be provided periodically to shareholders of joint stock companies. These financial reports include mainly audited financial statements prepared in accordance with the INAS identified by the AOI (Article 232-233 and 242 of ICL). The financial reports are the main source of information for the shareholders as they do not have direct access to the companies’ information systems. The law requires that an inspector (auditor) submits a report on the accuracy and reliability of the financial statements and other information provided by the board of directors to the general meeting each year (Article 148). The inspector is elected by shareholders once a year at the annual general meeting (Article 144) and its general function is to serve as a watch dog over the interests of shareholders and third parties (Article 154).

In addition, listed companies also adhere to the listing rules of the TSE. It is common on stock exchanges, as Miller (1993) argues, that the stock exchanges emphasize on expanding the range of financial disclosure and improving the frequency and timeliness of reporting. In addition to the audited financial statements the companies are required to provide the following information to the TSE:

- the board and auditors’ report at least one week before the general meeting,
- any changes in board of directors, chief executive officer (CEO), and auditor
- all information about their new plans, and the annual budgets

Generally, listed companies are required to inform the TSE immediately of any necessary information to avoid the establishment of a false market in the company’s securities and shares or any information that has a probable important effect on the price of a company’s securities and shares (see Tehran Stock Exchange, 2008). Therefore, for the purpose of this study the legal financial reporting model for TSE listed companies was drawn based on the above discussion as it is shown in Figure 1. For doing so, fact documents were used.

**Figure 1:** The Iranian legal financial reporting model
5.2. The Iranian Actual Financial Reporting Model

The data were collected through semi-structured interviews as it is previously explained. The collected data indicates that interviewed investors use different sources of information for their decisions (Table 1). These are: financial reports, TSE's reports, audit reports, brokers, friends, financial analysts’ reports, media, companies’ websites, corporate staff (especially board of directors and CEOs). It can be seen from the table that all of the investors use financial reports, TSE’s reports, audit reports, brokers and friends’ information in their decision making process. 87.5 percent of the investors use financial analysts’ reports in their decision making while 37.5 percent of them use corporate staff as a source of information. Media as a source of information is used by 75 percent and corporate websites by 55 percent of the investors. Therefore, the actual model of the Iranian financial reporting is as shown in Figure 2.

Table 1: Investors’ sources of information

<table>
<thead>
<tr>
<th>Actual sources of information</th>
<th>No.</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial reports</td>
<td>40</td>
<td>100</td>
</tr>
<tr>
<td>TSE's reports</td>
<td>40</td>
<td>100</td>
</tr>
<tr>
<td>Audit reports</td>
<td>40</td>
<td>100</td>
</tr>
<tr>
<td>Brokers</td>
<td>40</td>
<td>100</td>
</tr>
<tr>
<td>Friends</td>
<td>40</td>
<td>100</td>
</tr>
<tr>
<td>Financial analysts’ reports</td>
<td>35</td>
<td>87.5</td>
</tr>
<tr>
<td>Media</td>
<td>30</td>
<td>75</td>
</tr>
<tr>
<td>Companies' websites</td>
<td>22</td>
<td>55</td>
</tr>
<tr>
<td>Corporate staff</td>
<td>15</td>
<td>37.5</td>
</tr>
</tbody>
</table>

Figure 2: The Iranian actual financial reporting model

5.3. Determining the financial reporting gap

Comparing legal (figure 1) and actual (figure 2) financial reporting models indicates that there is a financial reporting gap in Iran. The investors apply some new sources of information (brokers, friends, financial analysts’ reports, media, companies’ websites corporate staff) in their decision making
process, which are not included in the legal reporting model. 3 This suggests that the legal model of reporting do not meet the investors’ needs. Therefore, the investors apply the other sources, which can result in a more informed decision.

The investors expressed different reasons for using the other sources. These reasons, which are consistent with the prior research in other countries (e.g., Frost and Pownall, 1996; Byrne, 1998; (Ashbaugh, Johnstone, and Warfield, 1999; DiPiazza and Eccles, 2002), include inability of the financial statements to provide on time information, the inadequate disclosure of non-financial information in the financial statements, advances in technology such as internet, which facilitates access to more and real time information.

6. Conclusions
The main objective of this research was to explore financial reporting gap in an emerging market, i.e TSE. It was argued that the legal financial reporting model fails to satisfy varying needs of the investors, especially in developing countries in which the legal reporting model is mainly affected by the external rather than contextual factors. Therefore, the investors consult with informal sources of information resulting in a financial reporting gap. The results of the research support this argument. The findings indicate that the Iranian investors use information provided by brokers, friends, financial analysts' reports, media, companies' websites, and corporate staff in their decision making process, which are not included in the legal reporting model. The investors require more (especially non-financial) and on time information, which help them to make better decisions in new global markets. The results also imply that the traditional financial reporting is losing its position as a main source of information for the investors. This may require revision in current financial reporting regulations and standards.

3 Prior research in Iran (ArabSalehi, 2006) also indicates that financial analysts as well as legal sources use additional sources of information such as friends, media, and personal relationships with corporate managers for their analysis.
References


