Investment Decisions By Users Of Annual Financial Reports

John Gartchie Gatsi & Richard Akoto

Abstract

The study focuses on the use of annual financial report information as a basis for investment decisions by individual educated investors in Ghana. This is informed by the assumption inherent in financial reporting standards that investors allocate funds to portfolio firms based on information from the annual reports. It is a descriptive study which uses legitimacy and agency theories as the theoretical foundation.

The study concludes that individual investors in Ghana do not use information from annual reports for their investment decision making. They depend instead on media adverts on the companies and daily stock price movements.

Keywords: Financial reports, investor decisions, legitimacy and agency theories

Introduction

The increasing sophistication of investors and the investment environment, both domestic and international, is primarily due to globalisation which is thriving on information technology. The increasing effects of globalisation and information technology in the world markets coupled with both formal and informal business education place demand and supply pressures on the information content of annual reports by stakeholders including shareholders. All financial reporting standards assume that the information provided by financial reports systematically influence the investment decisions of individual users. This assumption is in line with the assertion of behavioural finance which focuses on how investors interpret and act on information to make investment decisions. Weetman (2006) posits that investors as owners have a fixed expectation that dividend and capital gains will be earned as a result of investing in a particular entity and therefore rely on the financial information in the annual reports to decide whether to reduce or increase their investments in the entity. She further explained that the financial reports may also attract potential investors to invest in the entity. Stolowy and Lebas (2004) explain that investors do not make their investment decisions contingent only on the improved figures but also on how trustworthy the report is in the face of recent accounting and financial scandals in major corporations such as Enron.

According to Levy and Post (2005) , awareness of the risks inherent in corporate activities and the recent corporate scandals, led investors, both existing and potential , to place a high premium on the kind of financial information provided by corporate managers.

From the above, it can be argued that one good source of such information is the financial statement of firms. Saunders et al. (2004), state that a financial statement of a firm consists of two basic documents. These are the profit and loss account and the report of condition or the balance sheet. Research findings have shown that financial statements are value relevant and assist investors in making prudent investment decisions (Barth et al. 2001; Kothari 2001). The fact is that investors place greater

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emphasis on the relevance of financial reports in forecasting firms' future earnings or financial position. The relevance, reliability and consistency of financial information have been the key characteristic requirements of accounting standards in the world

It has been generally accepted in finance literature that financial information assists institutional investors in making excellent investment decisions. Nonetheless, despite the numerous benefits that financial information can provide, it is not clear whether financial information of firms affects individual investment decisions in Ghana. This paper therefore explores whether financial information influences individual investor decisions in Ghana.

Generally, financial reports provide relevant and timely corporate information that guides existing and potential investors to make informed investment decisions. It is, however, not known if educated individuals make investment decisions based on financial information from the annual reports. The study therefore focuses on the use of financial information by educated individual investors when making investment in companies in Ghana. This paper will then set the pace for a focused behavioural finance research in Ghana in the face of increasing patronage of equity investment.

Equity investment has been increasing in Ghana to the extent that most of the initial public offerings undertaken so far, except Golden Star Resource Ltd, did not meet their expectations though others, especially banking stocks, were over subscribed. Financial misreporting and scandals are being reported in Ghana. The paper also provides value added research information to the Ghanaian financial literature I chose only educated individual investors located in Accra. The time frame within which the work is supposed to be submitted could not allow me to consider at least individual investors from across the entire country to provide untainted generalisation of the findings to represent the link between financial reports and investor decisions in Ghana. Also, the work is limited, in that, it considered only listed companies, even though, there are many companies involved in the preparation of financial reports which are not listed. It therefore implies that the findings could not be practically applicable to non-listed companies in Ghana.

Literature Review and Theoretical Framework

The theoretical foundation and review of prior literature were discussed from the perspective of financial reports, globalisation and information technology, investors and investor expectations as well as legitimacy and agency theories

Financial Reports

Financial reporting is an important component of financial accounting. Financial accounting focuses on monetary transactions by recording , analysing and reporting to stakeholders in accordance with the requirements of given accounting standards and other regulatory demands (Stolowy and Lebas , 2004). This is commonly referred to as mandatory reporting. Even though financial accounting which provides corporate financial information to stakeholders, is a response to mandatory requirements, the annual reports provide both mandatory and voluntary information to stakeholders (Deegan and Voght , 2000). The mandatory reports in the annual reports discuss quantitative information such as the income statement, balance sheet and the cash flow statement while the voluntary reports discuss information beyond what is required by relevant standards. According to Van Der Lean (2004), voluntary information is normally engaged by firms to foster their good image and market them to stakeholders. Weetman (2006) also explains that preparers of accounting reports engage in accounting manipulation to position their performance to attract investors and please their existing shareholders. The financial reports are therefore the main communication conduit being utilised by corporate entities to inform stakeholders about the performance of managers, the firm and the business prospects in the future. A financial report can also be described as the gathering and dissemination of economic information to stakeholders for the purpose of making informed decisions about the reporting entity. This description does not provide non-economic information which is

crucial in the present global business environment. The non economic data about the firm such as the number and experience of board of directors as well as the operating environment of the firm are very important for investor analysis and decision making. Reports on political environment and contribution to communities and social institutions form part of the voluntary report. As a result of the argument above the study considers a financial report to be a corporate document that reports both non-economic and economic information relevant to the decision making of stakeholders covering a defined period. Thus in accordance with accounting standards and other market regulatory provisions we have annual, semi-annual and quarterly financial reports. Sutton (2004) explains that while the financial report provides a timely and reliable source of both quantitative and qualitative information to stakeholders, it is the main proof of accountability by the stewards of the corporation. The corporate stewards are the managers. In contributing to accounting manipulation, Sutton (2004) further outlined that reduction in tax and regulatory burden, reduction in cost of capital, avoidance of debt contracts and improvement in wealth maximisation for managers are some cogent reasons for the engagement in creative accounting by the preparers of financial reports. This implies in the presence of taxation and the agency conflict creative accounting remains a permanent part of financial reports even if they are not detected. The International Financial Reporting Standards[(IFRS, 2004)] explain that it adopts principle based reporting standards while the Financial Accounting Standards Board of the United States of America is rule based in the sense that IFRS provides comprehensive but discretionary approach to standard setting, application and interpretation. Tracy (1999) explains that since financial reports can contain honest mistakes and intentional dishonesty, external auditors must provide their independent professional judgment on the financial reports before publication and utilisation by stakeholders. This adious challenge is required at a time in the global financial world where scandals affected not only corporate preparers of financial reports but also auditing firms. This paper does not consider implication of accounting firms in accounting and financial scandals to reduce the role of external auditing in the credibility of published financial reports. Tracy (1999) further argued that even though the annual reports contain both financial statement reports and non-financial statement reports, the financial statement is the most important document primarily because it is the only direct source of information on profit and financial condition of the firm.

Financial reports provide direct input to corporate governance of the firm since management's financial actions are audited by independent external auditors. Corporate governance has now become a key component of corporate discussions because it is believed that improved performance is a function of quality decision making by experienced and qualified managers who act in the interest of corporate wealth creation.

Investor Decision

Sutton (2004) and Walker (2006) classify users of financial reports as management, employees, creditors, government agencies, shareholders and potential investors. These writers further imput that all these stakeholders make their investment decisions based on information from the financial reports. It is a fact that institutional investors are normally guided by information from the financial reports, however, many individual investors lack the ability to understand the reports and end up not using it. Improved education especially in business, may enhance the ability of individual investors to make their investment decisions based on information from the financial reports. Hooke (1998) argued that data from accounting reports provide limitations and make it unreliable for investors to base their investment decisions on such reports. He argued further that preparation of accounting reports is too flexible to produce a perfect reliance. He explained that when auditors audit the accounts, they return to management for discussions and exchange of ideas and information to bridge any gaps hence by the time the report is prepared it is highly diluted. The question, however,

is not about the reliability of the reports but whether investors both existing and potential make their investment decisions by relying on financial report information. He also argued that different methods in estimating profits, sales and costs weakens the reflection of the true nature of the firm's performance. In terms of investors using financial reports information, Hooke (1998), believes many do but are perhaps relying on incomplete information. Levy and Post (2005) explain that investor decision based on the financial reports is largely explained by their risk disposition. Investors who are risk averse tend to rely heavily on financial reports to make asset allocation decisions especially when the financial reports are analysed by analysts.

Even though corporate financial reports are the main source of performance information about the future prospects of the firm, it is possible for many individual investors to make investment decisions without referring to them. Normally these individual investors are carried by adverts about the initial public offerings of the firm or analysts discussions and by the image mere of the firm. It is, therefore, not a fact that all investors will depend on the reports to make investment choice in firms.

The economy of Ghana

The Ghanaian economy started improving since the late 1980s due to the focused review of economic policies and many structural reforms (for example, Financial Sector Adjustment Programme I & II) that have been put in place since the late 1980s and the increased macro-economic stability the Country has begun to chalk up from the 2000s. Specifically, real GDP surged from about 4.0% to 4.5% between 1998 to 2002. By the end of 2006, real GDP recorded 6.2% (Ghana Banking Survey, 2007). Furthermore, the upsurge of growth in 2001 and thereafter is also due to a recovery in agricultural production aided by improvement in macroeconomic management. Improvement in economic management was underlined by significant improvement in public finances. As a result of greater domestic tax effort and prudence in government spending, the country's budget achieved its highest ever primary balance in 2001. The agricultural-led growth is attributable to the strong performance of Cocoa and Gold exports. Currently, agriculture leads the growth of the Ghanaian economy with 6.1% followed by industry at 5.6% and services at 5.24% (Ghana Banking Survey, 2007). It is argued that economic growth would have been better had it not been for the drag from high world crude prices and further, the energy crises towards the end of 2006.

It is also important for us to know that Ghana has benefited from immediate debt relief from the World Bank and the IMF as well as most other bilateral creditors as part of the HIPC debt relief initiative since 2002 which might also have contributed to Ghana's economic growth. As part of the HIPC initiative, Ghana has also finalised a poverty Reduction Strategy Paper (GPRS), which is expected to enhance the considerable stride already made in reducing poverty since the early 1990s.

Monetary discipline, underlined by growing confidence in domestic assets and a deepening in financial intermediation, has contributed to reduction in inflation and interest rates as well as a return of relative stability in the foreign exchange market. For example, year-on-year inflation generally trended downward from 15.2% in 2002 to 10.96% by the close of 2006. The Cedi also remained fairly stable against the currencies of the Country's major trading partners. For example, in 2004, the cedi traded at an average of ¢9,047 to the United States dollar on the Inter-bank market. At the end of 2006, the Cedi traded at ¢9,210.23 to the dollar. Thus over the two year period, the Cedi depreciated by less than 2% against the dollar which is better as compared to the 1990s.

It is crucial for us to note that, Ghana's macroeconomic policy in 2001 was dictated by the weakening of the country's economic fundamentals in the 1970s and 80s and thus a collective attempt to redeem the economy. In fact by 1981, the World Bank and the IMF had described Ghana as a "collapsed state" due to enormous and worsening balance of payment deficits. The evidence is that before 1983, the Government of Ghana controlled and regulated almost all sectors of the economy especially the financial services sector. What this means is that there was absolutely no trade

liberalisation in Ghana before 1983. The IMF and the World Bank blamed the Country's economic woes at the time on this economic ideology. The government's macroeconomic policies in 2001 and beyond achieved marked improvement in both the fiscal and monetary spheres, which enhanced reductions in inflation and interest rates and created some stability in the foreign exchange market as noted above. Consequently, macroeconomic policies for 2002 aimed at laying the foundations for sustained economic growth, are to build on the progress made in 2001, particularly towards a sustained financial stability and intensifying efforts to strengthen public sector financial management.

Currently on the fiscal front, prudence has led to overall fiscal deficit decline from 11.2% in 2002 to 4.9% by 2006. Domestic debt-to GDP ratio also reduced from 29% in 2002 to 10.1% by 2006 (Ghana Banking Survey, 2007). This fiscal prudence paid off as the reduction in domestic borrowing by Government meant that there was more liquidity available to lend to the private sector and thus prevented the crowding-out effect which is detrimental to the private sector of every economy. This marked a tremendous departure from the past where over 50 per cent of budget deficits have to be financed through borrowing from the banking sector. This shift from dependence on the banking sector contributed to easing interest rates. On the average, banks currently lend in Ghana at 20% per annum with the Bank of Ghana's prime rate at 17.1%. On the revenue side, tax revenue increased by nearly 40 per cent in absolute terms in response to several new taxes and changes in the tax structure since 2001. As a percentage of GDP the tax effort increased from 16.3% in 2000 to 17.2% in 2001. The major yields in taxes in Ghana include VAT collections, the imposition of a concessionary 5 per cent tax rate on all previously zero-rated imports (except some materials for manufacturing and manufacturing raw materials); the removal of import tax exemptions on all NGO imports or imports of gifts of charitable nature except in areas of health and education; and the imposition of an import duty of 5 per cent on the *cif* value of previously exempted materials for manufacturing and processing of timber contributed to significant increase in import duties. It is important to mention that Government expenditure has also increased over the years. For example, millions of dollars has been spent on road construction, the building and renovation of stadia and other facilities to host 'CAN 2008'; the lavish spending on Ghana at '50 celebrations'; and the increase in the government's wage bill due to increase in the salaries of workers' among others.

Ghana's monetary policy since 2001 has focused on reducing the rate of inflation and the rate of depreciation of the cedi. This was necessitated as a result of the turbulence in 2000, which saw the rate of inflation at 40.5% at the end of December 2000 and the depreciation of the Cedi by 49.5% in 2000. In order to refocus the operations of the BOG to ensure the maintenance of price stability, the formulation and implementation of monetary policy and support for the general economic policy of the government, Parliament passed a new Bank of Ghana law in December 2001. The law also commits the government to fiscal discipline by limiting the total government borrowing to an amount not exceeding 10 per cent of total revenue at the close of the fiscal year in which the advances were made. Presently, to create a monetary environment that is favourable for business expansion, the Bank of Ghana (BOG) has reduced its prime rate from 24.5% in 2002 to 12.5% in 2006; and abolished the 15% secondary reserve requirement of banks and has thus freed up significant liquidity for lending to businesses (Ghana Banking survey 2006, and 2007). However, by mid 2008, the Bank of Ghana's prime rate stood at 17.1%. Nonetheless, it has been argued that it is in response to the continual increase in the World's food and energy prices.

From the foregoing discussion, it is clear that the macro-economy in Ghana has been fairly stable and liquidity has increased than ever before. With all these evidence in hand, one would therefore expect a surge in economic activities or more specifically an increase in both institutional and individual investment activities. However, the issue of concern is to investigate whether this increase in investment activities is done based on the influence of the financial information provided by the companies into which these investments are made.

Legitimacy Theory

Many theoretical frameworks are utilised in both accounting and finance literature to explain the investment decisions of investors. Agency, complementarities and legitimacy theories are some of the common ones. For the purpose of studying whether individual investors use financial information to make investment decisions in Ghana, legitimacy and agency theories are considered most appropriate.

According Van Der Lean (2004), legitimacy theory is one of the widely utilised theories to explain why corporate entities report relevant information to their stakeholders. Many accounting standards clearly indicate that the purpose of the existence of corporations is to act on behalf of their stakeholders and in adherence to accounting standards and other financial regulations, corporate entities are to prepare and publish both economic and social performance to these stakeholders to be well informed about the investment made and compare the performance to their expectations about the companies. In contributing to the legitimacy literature, Lindblom (1994) claims corporate entities seek to operate in the best interest of their stakeholders. In referring to Lindblom (1994), Gatsi and Debrah (2005) argued that legitimacy theory assumes that the action of an entity should respond to some socially constituted system of norms, values and definitions such that the entity acts in congruence with the socially constituted system. In the pursuance of the going concern of all businesses, Guthrie and Parker (1989), firmly elaborate that corporations are bound by social contracts both written and unwritten in which they agree to act in socially desired ways in return for continual approval of its objectives and other rewards. In the recent past companies' legitimacy was derived from profit performance and adherence to legal requirements. Mathews (1993), however, indicates that corporate legitimacy is now inclusively derived based on economic, social including environmental performance, abiding by legal requirements as well as toeing the line of norms and values of stakeholders. Levy and Post (2005) posits that the overriding corporate goal of the firm is to maximise shareholder value. Companies need the investment support of their shareholders by maintaining their shareholdings, vote in favour of enhanced investment and fundraising strategies of their portfolio firms. By these actions shareholders provide the legitimacy corporate entities need to foster the going concern objectives of corporations. Thus, shareholders can remove their legitimacy if financial reports provide contrary information to shareholders, on the other hand shareholders may support or maintain corporate legitimacy by increasing investment in portfolio companies.

Our paper agrees with Deegan (2000) and Gray et al. (1996) that legitimacy is greatly system oriented in that it considers corporate entities as part of a larger society within which they exist, and ensure that their operations are perceived by the outside stakeholders as legitimate. Legitimacy is thus stakeholder support for corporate entities. The investor is part of the stakeholders of any entity.

Failure to comply with the expectations of outside stakeholders such as creditors, shareholders, environmentalists and media groups is likely to result in the revocation of the social contract that implicitly and explicitly exist between the entity and its stakeholders (Deegan and Rankin, 1996). Willingness by investors to pay a premium to corporate entities for complying with socially constituted norms and values has been indicated by Pava and Krauze, (1996) and Toms, (2000).

Legitimacy is so important that when corporations are facing legitimacy problems, they quickly take remedial measures to mitigate the problems in order to meet shareholder expectations.

Legitimisation Strategies

Gatsi and Debrah (2005) explain that legitimacy theory has been identified as system-focused hence there is the need to carve workable strategies to ensure that corporations maintain or do not entirely loose their legitimacy. Legitimisation is the process of gaining legitimacy. They further state that legitimisation strategy is all about managing the core issues inherent in gaining and loosing stakeholder support for continuous operation by manipulating stakeholder perception. The effectiveness of

legitimisation strategy depends on the effectiveness of corporate communication. Potential individual investors also grant legitimacy to the firm as soon as they allocate capital to the firm.

Agency Theory

Agency theory is a common and important theory being utilized in finance, economics, political economics and can be explored in the demanding field of corporate reporting and investor decisions. According to Jensen (1976) there is principal agent relationship between investors and corporate entities.

Agency theory argues that in the modern corporation, in which share ownership is widely held, managerial actions depart from those required to maximize shareholder returns (Berle and Means 1932; Pratt and Zeckhauser 1985). In the agency theory, the owners are principals and the managers are agents and there is an agency loss which is the extent to which returns to the residual claimants, the owners, fall below what they would be if the principals, the owners, exercised direct control of the corporation (Jensen and Meckling 1976). The individual investor is thus part of the body of principals of a corporate entity.

Agency theory specifies mechanisms which reduce agency loss (Eisenhardt 1989). These include incentive schemes for managers which reward them financially for maximizing shareholder interests. Such schemes typically include plans whereby senior executives obtain shares, perhaps at a reduced price, thus aligning financial interests of executives with those of shareholders (Jensen and Meckling 1976). Other similar schemes tie executive compensation and levels of benefits to shareholders returns and have part of executive compensation deferred to the future to reward long-run value maximization of the corporation and deter short-run executive action which harms corporate value. In addition to incentive schemes, quality board characteristics is also crucial in ensuring shareholder value maximization. Board independence is one typical component of board quality which reduces agency costs. This is due to the independent views and monitoring they bring to bear in the running of corporations. Another mechanism specified is the use of debt from the financial markets, which subject managers to external monitoring, thereby reducing the extent of managerial power in taking decisions that maximize shareholder wealth (Donaldson and Davis, 1991).

Segregation of ownership from management does not come without cost. Berle and Means (1932), introduced the conical agency problem by suggesting that dispersed ownership leads to less corporate monitoring. Jensen and Meckling (1976), further spurred interest in the theoretical and empirical aspects of modern corporate finance by formalizing agency cost as a conflict between managers and shareholders.

Agency Costs

As with any other costs, agency problems will be captured by financial markets and reflected in a company's share price. Agency costs can be seen as the value loss to shareholders, arising from divergences of interests between shareholders and corporate managers. Jensen and Meckling (1976) defined agency costs as the sum of monitoring costs, bonding costs, and residual loss. These agency costs are explained in turn.

Monitoring Costs

Monitoring costs are expenditures paid by the principal to measure, observe and control an agents behaviour. They may include the cost of audits, writing executive compensation contracts and ultimately the cost of firing managers. Initially these costs are paid by the principal, but some academics argue that they will ultimately be borne by an agent as their compensation will be adjusted to cover these costs. Certain aspects of monitoring may also be imposed by legislative practices. In the UK companies are required to provide statements of compliance with the Cadbury (1992) and Greenbury (1995) reports on corporate governance. Non-compliance must be disclosed and explained, and the attention brought by statements of non-compliance represents an additional source of monitoring. Such monitors must have the necessary expertise and incentives to fully monitor management, in addition such monitors must provide a credible threat to managements control of the company. Such

monitors include institutional or block shareholders who at will can elect representatives onto the board to represent their interests. These block holders may also sell or offload their shares to prospective takeover bids if they are satisfied that managers are not doing a good job. Burkhart et al. (1997) provide a contradictory view of monitoring, arguing that too much will constrain managerial initiative. In this sense, the extent of monitoring will have to seriously consider its benefits and costs in a bid to reduce managerial opportunism.

Bonding Costs

Given that agents ultimately bear monitoring costs, they are likely to set up structures that will see them act in shareholders best interests, or compensate them accordingly if they do not. The cost of establishing and adhering to these systems are known as bonding costs. They are borne by the agent, but are not always financial. They may include the cost of additional information disclosures to shareholders, but management will obviously have the benefit of preparing these themselves. Agents will stop incurring bonding costs when the marginal reduction in monitoring equals the marginal increase in bonding costs. Denis (2001) argues that the optimal bonding contract should aim at enticing managers into making all decisions that are in the shareholders best interests. However, since managers cannot be made to do everything that shareholders would wish, bonding provides a means of making managers do some of the things that shareholders would like by writing a less than perfect contract.

Residual Loss

Despite monitoring and bonding, the interest of managers and shareholders are still unlikely to be fully aligned. Therefore, there are still agency losses arising from conflicts of interest. These are known as residual loss. They arise because it is generally observed that the cost of fully enforcing principal-agent contracts would far outweigh the benefits derived from doing so. Since managerial actions are unobservable ex ante, to fully contract for every state of nature is impractical. The result of this is an optimal level or residual loss, which may represent a trade-off between overly constraining management and enforcing contractual mechanisms designed to reduce agency problems (Denis et al, 2001).

Sources Of Agency Conflicts In Firms

The occurrence of agency conflict is due to certain conditions that exist within the firm. Circumstances under which agency conflict occur fall under four themes namely moral-hazard, earnings retention, risk aversion and time horizon (McColgan, 2001).

Moral-Hazard Agency Conflicts

Jensen and Meckling (1976) first proposed a moral-hazard explanation of agency conflicts. Assuming a situation where a single manager owns the firm, his incentive to consume private perquisites, rather than investing in positive net present value (NPV) projects, increases as his ownership stake in the company declines. This framework is easily applied in companies where ownership structure is diverse and the majority of the company's shares are not controlled by corporate managers. Shleifer and Vishny (1989) argue that rather than not investing, managers may choose investments best suited to their own personal skills. Such investments increase the value to the firm of the individual manager and increase the cost of replacing him, allowing managers to extract higher levels of remuneration from the company. However it is important to note that Moral-hazard problems are likely to be more paramount in larger companies. While larger firms attract more external monitoring, increasing firm size expands the complexity of the firms contracting nexus exponentially. This will have the effect of increasing the difficulty of monitoring, and therefore, increase these costs.

Furthermore, Jensen (1986) argues that in larger and mature companies, free cash flow problems will heighten the difficulties created by moral hazard. Where managers have such funds at their disposal, without any strong requirements for investment, the scope for private perquisite consumption is vastly increased, as it becomes more difficult to monitor how corporate funds are utilized. Moral-hazard problems are also related to a lack of managerial effort. That is, managers become effort averse as they own smaller equity stakes in their companies.

Agency Conflicts Due to Earnings Retention

Moral-hazard based theories over-simplify the agency problem as one of effort aversion. High-flying managerial visions and cash distribution to shareholders may be of more concern. Here, the problem of over-investing may be more paramount than that of perquisite consumption and under-investment. Studies of compensation structure have generally found that director remuneration is an increasing function of company size, providing management with a direct incentive to focus on size growth, rather than growth in shareholder returns. Jensen (1986) furthers this, arguing that managers prefer to retain earnings, whereas shareholders prefer higher levels of cash distributions, especially where the company has few internal positive NPV investment opportunities.

Managers benefit from retained earnings as size growth grants a larger power base, greater prestige, and an ability to dominate the board and award themselves higher levels of remuneration, Jensen (1986, 1993). This reduces the amount of firm specific risk within the company, and therefore, strengthens executive job security. Empirical evidence suggests that such a strategy is ultimately damaging to shareholder wealth. Lang and Stulz (1994) find that returns to shareholders in undiversified firms are greater for those who had attempted to reduce their exposure to risk through this diversification. Also, they found that the value of these firms is reduced as they diversified further. Such earnings retentions reduce the need for outside financing when managers require funds for investment projects. However, despite the potential costs of raising new capital, external markets provide a useful monitoring function in constraining flamboyant managerial investment policies (Easterbrook,1984). Earnings retention reduces the likelihood of this external monitoring. This study is premised on the agency conflicts resulting from the retention of earnings. The amount of earnings retained is inversely related to dividend payout. Therefore, if firms make higher payout, retained earnings will be reduced and effectively reduce agency costs of retained earnings.

Time Horizon Agency Conflicts

Conflicts of interest may also arise between shareholders and managers with respect to the timing of cash flows. Shareholders will be concerned with all future cash flows of the company into the indefinite future. However, management may only be concerned with company cash flows for their term of employment, leading to a bias in favour of short term high accounting returns projects at the expense of long-term positive NPV projects. The extent of this problem is heightened as top executives approach their retirement, or has made plans to leave the company. Dechow and Sloan (1991) examine research and development (R&D) expenditures as top executives approach retirement and find that these tend to decline. R&D expenditures reduce executive compensation in the short-term, and since retiring executives will not be around to reap the benefits of such investments; this could explain the above findings. Such a problem may also lead to management using subjective accounting practices to manipulate earnings prior to leaving their office in an attempt to maximize performance-based bonuses (Healy, 1985). Weisbach (1988) finds that accounting earnings tend to be significantly higher in the year prior to a Chief Executive Officer (CEO) leaving their position, and attributes such findings to the problem of earnings manipulations.

Agency Conflicts due To Managerial Risk Aversion

Conflicts relating to managerial risk aversion arise because of portfolio diversification constraints with respect to managerial income. Should private investors wish to diversify their holdings they can do so at little cost. However, company managers are more akin to individuals holding a single or very small number of stocks. Denis (2001) comments that the majority of company directors human capital is tied to the firm they work for, and therefore, their income is largely dependent upon the performance of their company. As such, they may seek to minimise the risk of their company's stock. Therefore, they may seek to avoid investment decisions which increase the risk of their company, and pursue diversifying investments which will reduce risk(Jensen, 1986). Demsetz and Lehn (1985) document an inverse relation between the risk of a firm's stock and levels of ownership concentration. Executives in high-risk companies

prefer to place a smaller fraction of their personal wealth in the company. This problem may be heightened when executive compensation is composed largely of a fixed salary, or where their specific skills are difficult to transfer from one company to another. In addition, risk increasing investment decisions may also increase the likelihood of bankruptcy. Such a corporate event will severely damage a manager's reputation, making it difficult to find alternative employment. Managerial risk aversion will also affect the financial policy of the firm. Higher debt is expected to reduce agency conflicts, (Jensen,1986), and also carries potentially valuable tax shields, (Haugen and Senbet, 1978). However, Brennan (1995) contends that risk averse managers will prefer equity financing because debt increases the risk of bankruptcy and default.

In summary, both internal and external mechanisms have been suggested by financial economists as solution to the agency problem. Internal mechanisms include compensation, bonding and monitoring activities within the firm. External mechanisms include activities by capital markets, legislators, investment professionals and investors. The focus of this study is to establish whether compensation as an internal mechanism can help reduce agency costs.

The agency theory provides a coordinated relationship between individual Ghanaian investors and management of their portfolio firms. However, the individual investors are much dispersed and lack the potent mechanisms recommended by (Jensen, 1986) to reduce the agency problem. Infact this relationship further promotes deeper agency problems if the individual shareholders do not make use of financial reports information. Information asymmetry will deepen as a result. Therefore the overall corporate governance inherent in principal agent relationship is totally weakened.

Our position is that the agency conflict is basically due to information asymmetry because managers tend to be acquainted with corporate activities and possess relevant corporate information than principals. Gathering information from the annual reports helps investors to align their expectations with the corporate financial results.

Methodological Issues

Researchers argue that no meaningful research is conducted without a particular or combination of research method(s). Among writers of research methodology, Amaratunga et al. (2001) describe research as a process of enquiry and investigation in a systematic and methodical way to increase knowledge while Remenyi et al. (1998) advance that research methodology is the procedural framework within which research is conducted.

Qualitative and quantitative methods are the main methodological approaches applied in accounting and finance research. Silverman (1997) explains that methodology is about a general approach to studying research topics while method is a specific research technique or tool to gather empirical data.

We have chosen a combination of both qualitative and quantitative research methods for the purpose of studying the research problem. The methodological issues will now consider mainly the views of prior researchers on quantitative and qualitative methods.

Researchers believe that quantitative methods of conducting research have been broadly associated with American researchers while qualitative methods are common with European researchers. It is, however, obvious that quantitative and qualitative research have advantages and disadvantages. Gilmore and Carson (1996) in reviewing the work of Patton (1980) explained that qualitative method of conducting research is flexible and adaptable throughout the research process. It also consists of detailed descriptions of events, situations and interactions between people and things which help to provide in-depth findings. In the view of Van Maanen (1979), qualitative research concentrates on unfolding the process rather than on the social structures. He claimed qualitative research lays emphasis on data interpretation, holistic picture or outlook of issues, describes, decodes, translates and come to terms with the meaning of certain naturally occurring phenomena in the social world. He further stated that in utilising qualitative research, interviews, visual recordings, written reports and or questionnaires are used. We have used questionnaire to collect data for the analysis.

Fitzgerald and Rumrill (2005) reported that quantitative research is very important to conducting a study because it is quick, simple and objective to assess effective relationship observed among a set of related studies to produce empirical findings. They acknowledged that quantitative research involves the use of mathematical and statistical techniques to establish relationships that exist between or among variables. Even though, qualitative research is holistic, they claimed it is a subjective evaluation of accumulated evidence from a set of studies. Whatever method is preferred should be informed by the research question and objective (Rimmel, 2003). Cook (1992) suggests that quantitative research is limited in the sense that it produces a generalisation premised on restricted specific settings, times, concepts and research populations that only explain one small piece of a larger phenomenon.

It is believed that both quantitative and qualitative forms of research are very important to increase the understanding of any research projects . Precision of research problems and prior research findings determine the choice of research approach. Research approach can be of exploratory, descriptive or hypothesis testing characteristics.

In order to provide well informed understanding about financial reports and investor decisions in Ghana, a descriptive study is preferred. A descriptive study is used in order to discover and describe the characteristics of the variables of interest in a certain situation. The goal is to offer a profile or to describe relevant aspects of the phenomena of interest to the researcher from an individual, organisational, industry-oriented or other perspective (Sekaran, 2003). Descriptive studies may or may not have the potential for drawing powerful conclusions and do not explain why an event occurred or why variables interact the way they do (Cooper and Schindler, 1998). In brief a descriptive study provides comprehensive understanding of research event. According to Aaker et al. (1995), a descriptive study seeks data about a well-defined question; the purpose is to describe how the present situation looks without explaining why. In line with the explanations given by Sekaran (2003), Cooper and Schindler (1998) and Aaker et al. (1995), we described the specific financial reporting issues peculiar to investor decision - making.

Data Collection

Sekaran (2003) presents different techniques on how to collect data. The chosen alternative depends on which method best answers the question of the research.

Data collection is done through primary and secondary sources. Primary data is deemed necessary to study the investor decision based on the annual financial reports in Ghana while secondary data broadly reviewed the thoughts and findings of earlier researchers to lay a firm basis for the paper.

Primary Data

Primary source is a record of events as they are first documented without interpretations. Also, primary data refer to information obtained firsthand by the researcher on the variables of interest for the specific purpose of the study (Sekaran, 2003). Some examples of sources of primary data are individuals, focus groups, panels of respondents specifically set up by the researcher and from whom opinions may be sought on specific issues from time to time. The internet could also serve as a primary data source when questionnaires are administered over it (Sekaran, 2003).

In order to collect the primary data, openended and close-ended questionnaires were administered to some selected educated individual investors in Accra in order to explore the use of annual financial information by users. The respondents are largely those who have some business education. The questionnaire was designed to ensure maximum response from respondents who are individual investors who at least made some investment in any of the recent IPOs in Ghana. The questionnaire was chosen for the data collection because it would help collect relatively quick, standardised and objective responses from respondents. The self administered questionnaire is useful for the work since respondents can answer the questions after reflecting on them very well and at their own comfort. To ensure a high response rate, few straightforward questions were asked to achieve the objectives of the paper.

The questions asked in the questionnaire were informed by information gathered in the review of prior research, the annual reports and other reports on investment decision making by investors.

Selection of Respondents

One hundred and six individual investors were selected which implies that the sample size is (106). We chose to work on only eighty individual investors to be able to do in-depth studies of their investment decisions.

The results obtained from the completed questionnaire were analysed and interpreted using descriptive analysis, tables and graphs. These descriptive statistical tools were chosen to display a quick visual impression of the responses given by the respondents.

Data Analysis

Table 1: Categories of Survey

Respondents	Number of Questionnaire sent
Senior High School Graduates	56
Graduates from tertiary Institutions	50
TOTAL	106

Analysis of Responses

From Table 1 above, one hundred and six questionnaires were administered to individual investors. Their responses are now analysed. Each table below studies and analyses a question from the questionnaire sent out. A total of one hundred and six questionnaires were administered on individual investors who completed senior High School and Tertiary Institutions such as universities and polytechnics.

Table 2: Responses by category of individual investors

Category	Number of questionnaires Administered	Number of responses received	Percentage of responses received
Senior High School Graduates	56	43	76.78%
Tertiary Graduates	50	35	70%
Totals	106	78	73.58%

Source: Authors' Survey (2008)

Table 2 above displays the responses received from senior high school graduates and tertiary graduates. Forty three(43) responses were received out of fifty six from the senior high school graduates forming 76.78% .Thirty five (35) were received from tertiary graduates forming 70%. Therefore, in terms of aggregate, we are working with seventy eight questionnaires making 73.58%.

Table 3: Study of a Business course

Individual Investor Category	Number Responding to this question	Number Responding Yes	Number Responding No	Percentages	
				Yes	No
Senior High School Graduates	43	31	12	72.09	27.91
Tertiary Graduates	35	28	7	80	20
Totals	78	59	19	75.64	24.36

Source: Authors' Survey (2008)

From table 3 below, respondents were asked to indicate whether they have previously studied a business course. This would indicate whether they had some idea about businesses. A total of seventy eight individual investors responded to the question. More than 75% of the respondents claimed they had studied a business course before. Only about 24% did not have any prior knowledge of a business course at both

Table 4: Study of portfolio firm's financial reports

Individual Investor Category	Number Responding to this question	Number Responding Yes	Number Responding No	Percentages	
				Yes	No
Senior High School Graduates	43	2	41	4.65	95.35
Tertiary Graduates	35	7	28	20	80
Totals	78	9	69	11.54	88.46

From the above table, respondents were asked if they ever studied the financial reports of their portfolio firms. This question is at the core of the research problem. In responding to this question, more than 95% of secondary school graduates and about 80% tertiary graduates have never studied the financial reports of their portfolio firms.

Cumulatively, more than 88% of the respondents never studied the financial reports of their portfolio firms indicating that they do not rely on the information provided by the financial reports. Thus, the financial reports have no effect on their investment decisions such as asset allocation and granting of investment legitimacy. This revelation is crucial because most accounting standards have the inherent assumption that investors make use of information from the financial reports to guide their investment decisions in a firm. This implies that Ghanaian entities who think investors will find positive information about them to invest and grant them legitimacy should adhere to Caruthers (1995) that companies are not only granted legitimacy by their stakeholders but they also go out for it through proactive voluntary information disclosures by manipulating social perceptions by associating themselves with symbols, values or institutions which possess a strong legitimacy base. Hence Ghanaian firms should devise alternative means of letting their investors get relevant information from them.

Table 5 confirms that individual investors do not rely on the financial reports to make investment decisions in Ghana.

Table 5: Investment Decisions based on financial reports

Individual Investor Category	Number Responding to this question	Number Responding Yes	Number Responding No	Percentages	
				Yes	No
Senior High School Graduates	43	2	41	4.65	95.35
Tertiary Graduates	35	7	28	20	80
Totals	78	19	56	11.54	88.46

From table 6 above, about 64.10% of respondents indicate that they depend on adverts in the media to make investment decisions in firms while 35.90% do not but did not state what guide their investment decisions. More of secondary school graduates (69.77%) rely on adverts in the media while 57.14% of tertiary graduates do same.

Table 6: Investment because of Adverts in the Media

Individual Investor Category	Number Responding to this question	Number Responding Yes	Number Responding No	Percentages	
				Yes	No
Senior High School Graduates	43	30	13	69.77	30.23
Tertiary Graduates	35	20	15	57.14	42.86
Totals	78	50	28	64.10	35.90

Table 7: Investment Drive in Firms

Individual Investor Category	Number Responding to this question	Financial Reports (FR)	Daily Stock Prices (DSP)	Percentages	
				FR	DSP
Senior High School Graduates	28	1	27	3.57	96.43
Tertiary Graduates	29	3	26	10.34	89.66
Totals	57	4	53	7.55	92.98

When asked what drives their investment decisions in a firm, the respondents clearly indicated daily stock prices which accounted for more than 92%. This indicates that individual investors tend to understand stock price movements than financial reports which need some technical knowledge to understand. Again, 3.57% and 10.34% for financial reports by senior high school graduates and tertiary graduates respectively indicate that higher education does not influence the propensity to use financial reports.

Findings

The purpose of this paper is to find out the effects of financial reports on investor decision by users in Ghana since financial reports are prepared for the consumption of stakeholders including shareholders.

Accounting standards impose the obligation of preparing and publishing financial reports in a manner that provides adequate, reliable, timely and consistent information believed to form the basis of investor decision making.

The findings consider the analysis of the data in relation to the research problem.

The notion that financial reports provide useful information to guide the investment decision by investors is not supported by the findings.

While it is empirically correct that investor decision affects the legitimacy of corporate entities, the finding of this research is not in line with the theoretical framework proposition that if financial reports do not project the interest of shareholders then there will be legitimacy problems. Hence the quest by companies in Ghana to disclose voluntary Information mainly to earn, maintain or improve legitimacy from their stakeholders may not be effective from the perspective of individual investors since they do not read or study the financial reports. However, to attract the interest of individual shareholders to make use of financial reports and drive the objective of legitimisation, Ghanaian firms can make use of

various types of media to communicate with stakeholders.

It has been empirically established from the study that respondents have some idea about business studies but do not use information from financial reports because they do not appreciate it.

From the theoretical framework, we posited that companies' main purpose of voluntary disclosure is to earn, maintain and improve their legitimacy with their stakeholders.

Individual investors in Ghana prefer to fashioning their investment decisions about a company on adverts in the media to finding information from the financial reports. A few respondents who did not indicate media adverts as their preferred information guide for investment explain that their investment in firms is either based on the reputation of the firm or advice from friends and relatives. They also seem to understand the implication of improvement in the stock prices than studying to get some meaning from income statement and balance sheet figures.

Conclusions

The study set out to find out whether educated individual investors in Ghana depend on financial reports to make investment decisions by utilising the legitimacy and agency theories as the theoretical foundation. The issues investigated were based on the general reasons for voluntary disclosure by prior researchers such as Meek and Gray (1989) and Deegan et al. (2000).

Descriptive study which is part of qualitative methods was adopted for broader and comprehensive understanding of the effects of financial reports on investor decision in Ghana. Primary data was used through open and closed ended questionnaires administered on educated individual investors within Accra.

The analysis provided tables that captured simple percentages of responses collected for the primary data which were related to the research question and the theoretical framework.

Generally, the findings are not in consonance with the view that financial reports guide investor choice in Ghana but that they rather rely on daily stock price movement and adverts in the media to allocate their investment capital.

Since the work was specifically based on a few educated individual investors who are in Accra , it is impractical to generalise it across the country though it can be argued that Accra captures more business minded investors than other parts of the country. The study however, indicates that investors follow share price movements.

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ABOUT THE AUTHORS

John Gartchie Gatsi is a lecturer at the School of Business, University of Cape Coast and currently pursuing Doctoral of Finance Programme at the Swiss Management Center, Switzerland. He can be reached on **0246435952** or nyagart@yahoo.com

Richard Akoto is an MPhil candidate in Finance of the Kwame Nkrumah University of Science and Technology, Kumasi. He can be reached on **0244133682**