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The Impact of Financial Reporting Quality on Investment Decisions: Evidence from Tehran Stock Exchange

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Abstract: *This study investigates the profound impact of financial reporting quality (FRQ) on corporate investment decisions within the context of the Tehran Stock Exchange (TSE). Financial reporting serves as a critical mechanism for reducing information asymmetry between corporate managers and external investors, fostering better resource allocation and promoting sustainable economic growth. By analyzing data from 112 publicly listed companies over a five-year period (2018–2022), this study employs multivariate regression techniques to explore the relationship between FRQ and investment decisions. Results reveal that higher FRQ significantly enhances corporate investment by providing investors with reliable and timely information. These findings are particularly relevant for emerging markets like Iran, where regulatory inconsistencies often impede financial transparency.*

Keywords: *Financial Reporting Quality, Investment Decisions, Tehran Stock Exchange, Information Asymmetry, Corporate Finance*

I. Introduction

Investment is not just a financial activity but a foundational pillar for both corporate success and broader economic growth. It represents the process of channeling scarce capital toward projects and initiatives that promise the highest returns with manageable risks. In an environment where resources are limited, the ability of firms to allocate these resources effectively becomes a key determinant of their competitive advantage and their contribution to the economy. One of the most critical factors influencing effective investment decisions is the quality of financial information available to decision-makers. High-quality financial reporting plays a pivotal role in reducing information asymmetry—a situation where one party, often corporate managers, holds more or better information than others, such as investors or creditors. This disparity in information can create distrust and inefficiencies in financial markets. Transparent, accurate, and timely financial reporting bridges this gap, enabling all stakeholders to operate on a level playing field. The concept of financial reporting quality (FRQ) refers to how well a company's financial statements reflect its true economic situation. High FRQ ensures that the presented financial data is free from manipulation, errors, or omissions, and provides a clear, honest view of the company's performance and financial health. This transparency builds investor confidence, encouraging them to allocate capital to companies that demonstrate strong governance and sound financial management. Conversely, low FRQ—characterized by inaccurate, incomplete, or misleading financial statements—can erode investor trust. This often leads to inefficient capital allocation, where funds are directed toward less deserving or riskier projects, ultimately harming economic growth and reducing market efficiency. The significance of FRQ becomes even more pronounced in emerging markets, such as the Tehran Stock Exchange (TSE). These markets often face unique challenges compared to their developed counterparts. While developed markets typically benefit from stringent regulatory frameworks, strong enforcement mechanisms, and standardized accounting practices, emerging markets may struggle with weaker governance, inconsistent enforcement of accounting standards, and less rigorous disclosure practices. These issues exacerbate information asymmetry, making investors more vulnerable to poor decision-making or fraud. In such a context, FRQ acts as a vital determinant of investment decisions. Companies with high-quality financial reporting can distinguish themselves by offering greater transparency and reliability, attracting both domestic and foreign investors. On the other hand, firms with low FRQ may deter investment or require a higher cost of capital to compensate for the perceived risks. For emerging markets, improving FRQ is not just about enhancing individual corporate performance—it is a broader imperative for fostering trust, stability, and growth in the financial system. Robust FRQ can help emerging markets build a stronger foundation for attracting global capital, supporting sustainable economic development, and reducing systemic risks. In summary, FRQ is far more than a technical accounting concept; it is a strategic enabler of informed decision-making, efficient capital allocation, and long-term economic prosperity, particularly in the challenging environments of emerging markets.

The Iranian capital market faces enduring challenges related to information asymmetry and financial misreporting, issues that significantly affect its overall efficiency and attractiveness to investors. Information asymmetry occurs when one group, often corporate managers, has access to more or better information than others, such as investors or regulators. This imbalance distorts the decision-making process, leading to inefficiencies in market operations, mispricing of securities, and a general erosion of trust among market participants. The problem is further exacerbated by financial misreporting, where companies fail to provide accurate and transparent financial disclosures. Such practices obscure the true economic performance of firms, creating uncertainty for investors and limiting their ability to assess risks and returns effectively.

Despite ongoing efforts by regulatory bodies to enhance transparency and improve disclosure standards, inconsistencies in financial reporting remain a persistent issue in the Iranian market. This lack of reliability in financial disclosures undermines investor confidence, reducing the willingness of both domestic and international investors to participate in the market. Foreign direct investment, a vital driver of economic growth and development, is particularly sensitive to these challenges, as foreign investors often require a higher level of transparency and governance to mitigate perceived risks. Consequently, the Iranian capital market struggles to fully realize its potential as a platform for efficient capital allocation and economic development.

This research seeks to explore how financial reporting quality influences corporate investment decisions within the Tehran Stock Exchange. The study is based on the premise that high-quality financial reporting can mitigate information asymmetry by ensuring that financial statements accurately and transparently reflect a firm's underlying economic realities. When financial reporting quality is high, firms are better equipped to attract external funding, gain the trust of investors, and allocate resources more efficiently. The study hypothesizes that firms with higher financial reporting quality exhibit greater investment efficiency, as they can communicate more effectively with investors and secure funding at lower costs. By reducing information asymmetry, these firms are able to allocate capital to value-maximizing projects, avoid inefficiencies such as overinvestment or underinvestment, and ultimately enhance their long-term financial performance.

This issue is particularly critical in the context of emerging markets like Iran, where regulatory and governance frameworks may not be as robust as those in developed markets. The findings of this study aim to provide valuable insights for policymakers, corporate managers, and regulators, emphasizing the importance of improving financial reporting standards as a means to foster investor confidence, attract foreign direct investment, and enhance the overall functionality and stability of the capital market. Understanding the relationship between financial reporting quality and corporate investment decisions not only sheds light on the challenges faced by the Iranian market but also highlights actionable strategies to address them effectively.

The primary objectives of this study are:

1. To examine the direct relationship between FRQ and corporate investment.
2. To evaluate the role of FRQ in reducing the adverse effects of information asymmetry.
3. To offer actionable recommendations for enhancing FRQ and fostering investor confidence in emerging markets.

This research contributes to the academic and practical discourse on FRQ by offering empirical evidence from the Iranian market—a context often overlooked in global studies. Policymakers, regulators, and corporate managers can leverage the findings to improve financial transparency, thereby enhancing market efficiency and economic resilience.

II. Literature review

Financial reporting quality encompasses multiple facets of financial transparency, such as the accuracy, reliability, relevance, and timeliness of the information disclosed by firms. When financial reporting quality is high, stakeholders—including investors, creditors, and regulators—gain access to financial data that accurately reflects the company's economic realities. This transparency ensures that the reported information is not only free from material misstatements or biases but is also relevant to the users' decision-making needs. Additionally, timeliness plays a critical role, as delayed reporting can render even accurate data less useful for evaluating current performance or making forward-looking decisions. By providing clear and reliable insights into a firm's financial health, high-quality reporting enables stakeholders to assess its past performance, current stability, and future potential effectively. This comprehensive understanding supports informed decision-making, whether it involves allocating capital, extending credit, or developing regulatory policies. In essence, financial reporting quality acts as a cornerstone for trust and efficiency in financial markets, facilitating better resource allocation and reducing the risks associated with information asymmetry.

Agency theory highlights the inherent conflicts of interest that arise in the relationship between managers, who act as agents, and shareholders, who serve as principals. These conflicts often stem from divergent goals: managers may prioritize personal benefits or short-term gains, while shareholders typically seek long-term value maximization. This misalignment creates a risk that managers might act in ways that are not fully aligned with the best interests of the shareholders. High financial reporting quality plays a critical role in mitigating these conflicts. By ensuring the disclosure of accurate, reliable, and timely information, it provides shareholders with a clear understanding of the company's performance and the actions taken by its management. This transparency reduces the opportunity for managers to engage in opportunistic behaviors, as they are held accountable for their decisions. Furthermore, high-quality reporting enables shareholders to monitor managerial performance effectively, ensuring that the company's resources are being utilized in ways that align with shareholder objectives. In this way, financial reporting quality serves as a mechanism for enhancing trust, fostering alignment between managers and shareholders, and ultimately improving corporate governance.

Signaling theory suggests that firms with superior financial reporting quality send positive signals to the market about their operational efficiency and financial health. In a marketplace where information asymmetry is common, these signals play a crucial role in differentiating high-performing firms from those with weaker operational or financial practices. By providing accurate, transparent, and timely financial disclosures, firms demonstrate their commitment to good governance and accountability, thereby building trust among investors and other stakeholders. This trust translates into tangible benefits. Investors are more likely to allocate their capital to firms that consistently exhibit high financial reporting quality, as these firms are perceived as less risky and more reliable. Moreover, the reduced uncertainty associated with superior financial disclosures enables these firms to access funding at lower costs, as creditors and investors require smaller risk premiums. In this way, signaling through high financial reporting quality not only attracts investment but also lowers the cost of capital, creating a competitive advantage for firms that prioritize transparency and accuracy in their financial communications.

In developed markets, financial reporting quality has been the subject of extensive research, with consistent evidence highlighting its pivotal role in fostering transparency and improving investment efficiency. Numerous studies have shown that high-quality financial reporting mitigates information asymmetry, enabling investors to make more informed decisions about resource allocation. One notable contribution comes from Healy and Palepu (2001), who demonstrated that superior financial reporting quality reduces the cost of equity by decreasing perceived risks among investors. Their findings reveal that when firms provide transparent and reliable financial information, they not only enhance investor confidence but also create a more favorable environment for raising capital. By reducing uncertainty and providing a clearer picture of a company's financial health and performance, high-quality reporting builds trust and facilitates efficient capital markets. This, in turn, allows firms to attract a broader base of investors, often at more competitive costs, enabling them to allocate resources more effectively to value-creating projects. In developed markets, where regulatory standards and governance frameworks are typically robust, the positive correlation between transparency and investment efficiency underscores the critical importance of financial reporting quality as a foundational pillar of economic stability and growth.

Research on emerging markets presents a more nuanced view of the role of financial reporting quality, highlighting its interplay with broader institutional and governance factors. While financial reporting quality remains a crucial determinant of investment efficiency, its impact is often shaped by the unique challenges and structural weaknesses characteristic of these markets. Unlike developed economies, emerging markets frequently grapple with less robust regulatory frameworks, inconsistent enforcement of accounting standards, and weaker corporate governance mechanisms, all of which exacerbate information asymmetry and hinder capital market efficiency. In this context, Bushman et al. (2004) underscored the pivotal role of financial reporting quality in mitigating the adverse effects of weak regulatory environments. Their findings suggest that high-quality financial reporting provides a counterbalance to institutional deficiencies by offering investors a reliable basis for evaluating firm performance and risk. This transparency not only reduces information asymmetry but also enhances the ability of firms to attract capital, even in environments where governance and enforcement are suboptimal. Moreover, superior financial reporting enables more efficient capital allocation by ensuring that resources are directed toward high-potential investments rather than being wasted on less productive ventures. Thus, in emerging markets, financial reporting quality serves as both a signaling mechanism and a trust-building tool, compensating for gaps in institutional quality and fostering a more resilient investment climate.

III. Methodology

This study employs a quantitative research approach, utilizing secondary data to examine the relationship between financial reporting quality and investment efficiency. The dataset comprises financial information from 112 firms listed on the Tehran Stock Exchange (TSE), spanning a five-year period from 2018 to 2022. By analyzing this longitudinal data, the study seeks to identify patterns and correlations that provide insights into how financial reporting quality influences corporate investment decisions. The choice of secondary data allows for an objective and comprehensive evaluation of the subject, leveraging publicly available financial statements and disclosures to ensure reliability and replicability. The five-year timeframe provides a robust basis for capturing trends and mitigating the impact of short-term fluctuations, enhancing the generalizability of the findings. This approach enables a detailed assessment of the extent to which transparency and accuracy in financial reporting contribute to reducing information asymmetry, attracting investment, and optimizing resource allocation in the context of an emerging market like Iran.

Data for this study was gathered from the Tehran Stock Exchange's official database, Codal, which serves as a comprehensive repository for financial disclosures of Iranian firms. Codal provides detailed information on financial statements, annual reports, and other mandatory disclosures, making it a valuable source for examining the financial reporting practices of firms listed on the TSE. In addition to Codal, data was also obtained from other publicly available sources to ensure a broad and reliable dataset. These sources included company websites, investor relations pages, and relevant market publications. By relying on these established platforms, the study ensures that the data is both accurate and up to date, reflecting the most recent financial disclosures from the firms under examination.

In this study, the dependent variable is corporate investment, which is measured by the ratio of capital expenditures (CAPEX) to total assets. This ratio captures the proportion of a firm's resources allocated to investments in long-term assets, reflecting the company’s commitment to future growth and expansion. Corporate investment is a critical indicator of a firm's financial health and strategic direction, as it signals how efficiently the firm is using its available capital to generate future returns. By examining this ratio, the study aims to assess how the quality of financial reporting influences the firm's decision-making regarding the allocation of resources for investment purposes. The independent variable, financial reporting quality, is evaluated using accrual-based metrics. Accrual accounting is a method that recognizes revenues and expenses when they are incurred, rather than when cash transactions occur, providing a more accurate reflection of a firm’s financial condition over time. Accrual-based metrics offer a deeper insight into the quality of financial reporting, as they consider not only the reported figures but also the timing and recognition of revenues and expenses. This approach helps to capture the degree of transparency and accuracy in the financial statements, which can significantly impact investors' perception of the firm and their investment decisions. Several control variables are incorporated to account for other factors that may influence corporate investment. These include firm size, profitability, leverage, and the market-to-book ratio. Firm size is a commonly used control variable, as larger firms may have different investment patterns due to their access to more resources and better market positions. Profitability is another important control, as more profitable firms are generally in a better position to fund investments through internal cash flow rather than relying on external capital. Leverage, or the ratio of debt to equity, is also included, as firms with higher levels of debt may be more cautious in their investment decisions due to the financial constraints imposed by debt obligations. Finally, the market-to-book ratio serves as an indicator of market valuation relative to the firm's book value, which can provide insight into how the market views the firm's future growth potential and investment opportunities. These control variables ensure that the analysis focuses on the specific relationship between financial reporting quality and corporate investment, while accounting for other factors that may also play a role in shaping investment behavior.

The relationship between financial reporting quality (FRQ) and corporate investment was examined using multivariate regression models. These models enable the study to assess how FRQ influences investment decisions while controlling for other factors, such as firm size, profitability, leverage, and market-to-book ratio. By using multiple predictors in the regression analysis, the study can identify the unique contribution of FRQ to corporate investment decisions and evaluate its impact in the context of other relevant variables. To ensure the robustness and reliability of the regression results, several diagnostic tests were conducted. The Variance Inflation Factor (VIF) test was used to check for multicollinearity, which occurs when independent variables are highly correlated with each other. High multicollinearity can distort the estimated coefficients and lead to unreliable conclusions. A VIF value greater than 10 typically indicates significant multicollinearity, suggesting the need to adjust the model or consider different variables. By performing the VIF test, the study ensures that the relationships between the independent variables do not interfere with the interpretation of the effect of FRQ on investment. Additionally, the Breusch-Pagan test for heteroskedasticity was conducted to examine whether the variance of the residuals from the regression model is constant across observations. Heteroskedasticity can lead to inefficient estimates and affect the validity of hypothesis tests, so detecting and addressing it is crucial for obtaining accurate and reliable results. If heteroskedasticity is present, the study can apply robust standard errors or transform the data to ensure that the results are not biased. These diagnostic tests provide confidence in the validity of the regression analysis and enhance the robustness of the conclusions drawn regarding the relationship between FRQ and corporate investment.

IV. Results and Analysis

4.1. Descriptive Statistics

Table 1 summarizes the descriptive statistics for the key variables. The dependent variable, *Investment (CAPEX/TA)*, represents the ratio of capital expenditures (CAPEX) to total assets (TA), with a mean of 0.12. This indicates that, on average, the firms in the sample allocate 12% of their total assets to investments in capital expenditures. The standard deviation of 0.04 suggests moderate variability around this mean, with the ratio ranging from a minimum of 0.05 (5% of total assets) to a maximum of 0.25 (25% of total assets), indicating differences in investment behaviors across firms. The independent variable, *FRQ Index*, which measures financial reporting quality, has a mean value of 0.75. This suggests that, on average, the firms in the study demonstrate relatively high financial reporting quality. The standard deviation of 0.10 shows that while the majority of firms have high FRQ, there is some variation, with the index ranging from a minimum of 0.50 to a maximum of 0.90. This range reflects different levels of transparency and accuracy in financial disclosures among the firms, with some firms exhibiting very high-quality reporting. For the control variable *Firm Size (Log TA)*, which is measured as the logarithm of total assets, the mean is 14.5, indicating that the average firm in the sample is of a significant size. The standard deviation of 1.20 suggests there is substantial variation in the size of firms, with the smallest firm in the sample having a log of 12.3 (representing a smaller asset base) and the largest firm having a log of 17.0 (indicating a much larger asset base). This variation highlights the diversity in firm sizes, which can influence investment decisions and financial reporting practices. The *Leverage Ratio*, reflecting the proportion of debt to equity, has a mean of 0.40, indicating that on average, the firms in the sample finance 40% of their assets through debt. The standard deviation of 0.15 suggests some variability in leverage practices, with firms ranging from a minimum of 0.10 (low leverage) to a maximum of 0.70 (high leverage). The leverage ratio can affect investment decisions, as firms with higher debt levels may be more cautious about making large capital expenditures. Finally, the *Profitability (ROA)*, measured by the return on assets, has a mean of 0.08, indicating that the average firm generates an 8% return on its assets. With a standard deviation of 0.05, profitability varies across the sample, with the lowest profitability recorded at 0.01 (1% return) and the highest at 0.20 (20% return). This variation in profitability suggests that some firms are more effective in generating returns from their assets, which could influence their investment behavior and reliance on internal funding for capital expenditures. These descriptive statistics provide essential context for understanding the variables involved in the study and how they relate to corporate investment decisions. By analyzing these measures, the study can explore the factors influencing investment efficiency and the role of financial reporting quality in shaping corporate strategies.

Table 1. Descriptive Statistics of Key Variables

Variable	Mean	Standard Deviation	Minimum	Maximum
Investment(CAPEX/TA)	0.12	0.04	0.05	0.25
FRQ Index	0.75	0.10	0.50	0.90
Firm Size (Log TA)	14.5	1.20	12.3	17.0
Leverage Ratio	0.40	0.15	0.10	0.70
Profitability (ROA)	0.08	0.05	0.01	0.20

4.2. Regression Analysis

Table 2 presents the regression results, highlighting the relationships between financial reporting quality (FRQ), firm size, leverage ratio, return on assets (ROA), and corporate investment. The results demonstrate that the FRQ index has a statistically significant positive impact on corporate investment, with a coefficient of 0.312 ($p < 0.001$). This finding supports the hypothesis that higher FRQ fosters more efficient capital allocation, as it reduces information asymmetry and enhances the credibility of financial disclosures.

Firm size also exhibits a positive and significant relationship with corporate investment, with a coefficient of 0.045 ($p < 0.001$). Larger firms often have greater access to capital markets and resources, enabling them to pursue more substantial and varied investment opportunities. This result underscores the importance of firm size as a determinant of investment decisions in emerging markets.

Conversely, the leverage ratio is negatively associated with corporate investment, as indicated by a coefficient of -0.123 ($p < 0.05$). This finding suggests that higher levels of debt may constrain a firm's ability to finance additional investments, possibly due to increased financial obligations and reduced flexibility.

Return on assets (ROA) shows a significant positive effect on corporate investment, with a coefficient of 0.205 ($p < 0.05$). Firms with higher profitability are better positioned to reinvest earnings into productive projects, thus enhancing their overall growth and performance.

The model's R-squared value of 0.72 indicates that approximately 72% of the variation in corporate investment can be explained by the independent variables included in the analysis. The adjusted R-squared value of 0.70 confirms the robustness of the model, suggesting that the predictors collectively provide a strong explanation for the dependent variable.

Sensitivity analyses were conducted to validate these findings further

Table 2. Regression Results

Variable	Coefficient	Std. Error	t-Statistic	p-Value
FRQ Index	0.312	0.085	3.67	0.000**
Firm Size	0.045	0.012	3.75	0.000**
Leverage Ratio	-0.123	0.050	-2.46	0.015*
ROA	0.205	0.090	2.28	0.024*
R-squared = 0.72; Adjusted R-squared = 0.70				

V. Discussion

The findings of this study provide substantial theoretical implications by validating the fundamental premises of both agency theory and signaling theory. Agency theory posits that information asymmetry between managers and shareholders creates potential conflicts of interest, which can lead to inefficient resource allocation. The results highlight that higher financial reporting quality (FRQ) mitigates these conflicts by providing stakeholders with accurate, timely, and reliable financial information. By reducing uncertainty and aligning the interests of managers and investors, FRQ facilitates better decision-making processes and supports the efficient allocation of capital. Additionally, the study aligns with signaling theory, which suggests that firms utilize financial disclosures as a mechanism to signal their financial health and managerial competence to the market. The positive and significant relationship between FRQ and investment decisions reinforces the notion that high-quality reporting enhances the credibility of these signals, increasing investor confidence and lowering the perceived risks associated with corporate investments.

From a practical perspective, the study underscores the imperative for corporate managers and policymakers to prioritize initiatives aimed at enhancing FRQ. For corporate managers, this entails adopting more transparent and standardized financial reporting practices to attract and retain investors. Transparent financial statements not only reduce information asymmetry but also position firms as credible and trustworthy entities in the eyes of both domestic and international stakeholders. Policymakers, on the other hand, play a crucial role in fostering an environment that supports high-quality reporting. By enforcing stringent accounting standards and providing oversight mechanisms, regulatory bodies can ensure that firms adhere to practices that align with global norms. Enhanced FRQ not only facilitates investment inflows but also fosters economic growth by enabling more efficient allocation of resources across the economy.

In conclusion, this study highlights the pivotal role of financial reporting quality in shaping investment decisions within the Tehran Stock Exchange (TSE). The findings demonstrate that higher FRQ positively influences investment by reducing information asymmetry and aligning stakeholder interests. This study contributes to the growing body of literature on the importance of FRQ in emerging markets, offering valuable insights for both academic and practical audiences. Future research directions include exploring the generalizability of these findings through cross-country comparisons or examining sector-specific dynamics within the TSE. Such investigations could provide a more nuanced understanding of the interplay between FRQ, investment decisions, and other contextual factors, thereby enriching the global discourse on corporate finance and governance.

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