Improvement in Transparency & Disclosure in the ISE:

Did IFRS Adoption and Corporate Governance Principles Make a Difference?

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July, 2006

Preliminary draft. Please do not quote. Comments welcome

* I would like to thank Utpal Bhattacharya and Burcin Yurtoglu for their invaluable comments on an earlier version of the paper and the seminar participants at the EFMA'06 conference in Madrid for helpful comments and suggestions. The list of attributes and the scoring methodology were in most part obtained from Standard and Poor's and is gratefully acknowledged. We are also thankful to Aydos Özel, Erkin Solak, Esra Aksu, Meriç Bıçakçı, Oznur Ozdemir, our dear assistants, for their careful and competent reading of the annual reports and web-sites, to Amra Balic of S&P, London for her expertise in rating and for training the assistants, and finally, to the Corporate Governance Forum of Turkey for financial support.

Keywords: corporate governance, transparency and disclosure index, Istanbul Stock Exchange, IFRS, CG principles

JEL Codes: G14, G32, G34, G38, O52

Abstract

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The purpose of this study is to investigate if the transparency and disclosure level of a sample of Istanbul Stock Exchange firms is enhanced by the promulgation of a set of local Corporate Governance (CG) Principles and by the voluntary adoption of the International Financial Reporting Standards (IFRS), an international best-practice. The Capital Market Board's CG principles are promulgated on a "comply or explain" basis and have been effective since the fiscal year 2004. Fırst, the year 2003 Transparency & Disclosure (TD) index previously created in collaboration with Standard and Poor's is replicated for the fiscal year 2004. Using this short panel data of transparency and disclosure scores for our sample of 52 large and liquid Istanbul Stock Exchange firms, the improvement in the scores over the two years is measured. Second, with appropriate control variables in the model, we analyze the determinants of the significant improvement. We use the voluntary adoption of IFRS as an indicator of and commitment to TD, and find that the scores and their relationship with performance are higher in early adaptors. We then create a parsimonious 3-attribute Commitment-to-Better-Disclosure Index and observe a high correlation between the two indices. Finally, using a matched pairs design and controlling for IFRS adoption, we are able to attribute the improvement in the TD scores to the CG principles. The paper finally scores the sample firms' Compliance Report and presents some preliminary statistics on the first year compliance level of ISE firms with these local CG principles. The study should be of interest to researchers, managers, analysts, boards, policy makers and regulators at a time when debate on convergence to IFRS and the impact of local CG guidelines has become intense.

I. Introduction

As a result of the post-Enron heightened awareness of the economic benefits of good corporate governance (CG) and transparency and disclosure (T&D), many countries have been increasing their mandatory disclosure requirements through new laws and regulations. Companies have also been poring out additional voluntary disclosures such as the voluntary expensing of employee stock options since 2000 in the US.[1] Parallel to these developments, there has been a proliferation of country-level evidence that the origin of legal rules and the quality of their enforcement in a country are good proxies for differences in investor protection which, in turn, affects the efficiency of its financial markets and its access to foreign capital (see for ex. La Porta et al., 1996, 1997, Schleifer and Wolfenzon, 2002). Firm-level empirical evidence has corroborated these findings: firms with better corporate governance practices have been found to have lower cost of capital (Sengupta, 1998; Mazumdar et al., 2002; Ashbaugh et al.,2004), lower credit rate spreads (Yu, 2005); higher values, profitability, and lower risk (Gompers et al., 2003; Brown and Caylor, 2004 and 2005).

Full disclosure and transparency (T&D) of financial information are vital components of the CG framework (OECD, 1999) and are regarded as an important indicator of CG quality.[2] Indeed, Beeks and Brown (2005) find that firms with higher CG quality make more informative disclosures. In this study, we follow S&P's definition of T&D: timely and adequate disclosure of the operating and financial performance of the firm and its corporate governance practices related to its ownership, board, and management structures and processes. Understandable, relevant, transparent, reliable, timely, and full disclosure of the results of economic activities and the structure and processes used in its organizational units entrusted to operate in shareholders' interests, gives the stakeholders a true and fair view of the firm and the quality of the CG standards it follows. In this sense, good T&D mechanisms are set in place to essentially protect the rights of the minority

[1] Some local examples of mandatory and voluntary disclosures are the recent resolve to rewrite the *Turkish Commercial Code* that has been in effect since 1957, the new *CG Principles of the CMB*, and the voluntary use of IFRS by many public firms before 2005 when it became mandatory for Turkish public firms.

[2] In their official report titled "Corporate Governance: the Turkish Transparency and Disclosure Survey" Standard & Poor's states that they view corporate transparency as an important factor affecting a company's attractiveness to investors, and as a vital element of corporate governance.

shareholders, creditors and other outside decision makers who do not have first hand knowledge about the firm and its prospects, from extraction of private benefits by insiders based on their superior information. This, in turn, is expected to minimize informational asymmetry and the probability of fraud, also enhancing its easier detection, leading to lower cost of capital and hence higher firm value. A related informational advantage of good T&D practices is that it increases investor awareness and trust which will reduce the uncertainty of the returns to capital suppliers which, again, is expected to reduce the firm's cost of external capital and hence increase its value (see, for ex., Berglof and Pajuste, 2005). A third advantage is that compliance with good T&D practices mitigates the political costs of non-compliance and hence reduces the risk of higher taxes, litigation and too much regulation.[3]

These relationships and expected benefits of T&D are more important for emerging markets such as Turkey because they are in urgent need of external capital as their economies are growing faster than that of more developed nations. First of all, Turkey faces a specific type of agency problem that creates an impediment to external capital. It has a financial system with many banks owned by the business-groups; highly concentrated, pyramidal, family-based ownership structures characterized by substantive inter-corporate shareholdings; and resulting low float rates and dividend payments [4] This kind of a structure leads to expropriation of minority shareholders' rights by ultimate owners, with or without owning the cash flow rights in the firm. A recent (4/12/2005) report of the Institute of International Finance (IIF) discusses these agency problems and states: "Turkish companies are often controlled through the use of founders' shares that carry multiple voting rights and/or board nominating rights. As a result, the protection of minority shareholder interests rests primarily on full disclosure and accurate financial reporting". Hence the T&D component of CG is very important in mitigating this important agency problem in the ISE.

Furthermore, due to the concentration of ownership and power with influential families, its French legal origin and its deep-rooted tax-based accounting rules, Turkey has also been slow in the

[3] Using simultaneous equations to control for the endogeneity between disclosure and litigation, Field et al. (2004) find that disclosure deters certain types of litigation.
[4] Please see, Yurtoglu, 2000 for an in-depth description of ownership structure of ISE firms and its drawbacks in terms of firm value

development and enforcement of CG and T&D principles and best practices. However, the prospect of accession to the European Union and the need to tap external capital sources due to Turkey's high growth rate is now changing this trend. Recently, the Capital Market's Board of Turkey promulgated its Corporate Governance Principles, on a comply or explain basis and in line with the OECD standards, and required a Compliance Report to appear as a separate section of the annual reports of public companies starting with 2004 annual reports. Similarly, an increasing number of publicly traded companies have started to adopt IFRS for financial reporting purposes since 2002. In this study, we exploit the sequential timing of these two events in our empirical design to examine the impact of these two recent developments on the TD quality of ISE firms.

This paper is an output of the 2nd phase of the TD project undertaken by S&P and the CG Forum of Sabanci University since 2003. As such, it uses the same 106 attribute TD survey, scoring methodology and the 2003 T&D scores of a sample of 52 large and liquid Turkish public firms, previously created by S&P and Sabanci University CG Forum researchers. The formation of this T&D index is described in detail in S&P's online newsletter RatingsDirect dated 6/6/2005 and in Aksu and Kosedag (2005), which compares the T&D scores of Turkish public firms with those in other countries where similar S&P surveys were conducted and explores the firm-specific determinants of the T&D scores. The list of 106 attributes in three sub-categories of T&D - ownership rights, financial disclosure and board and management structures and processes- is reproduced here in Appendix 1.

The first objective of the paper is to replicate the study for 2004 in order to measure the TD scores by searching for the disclosure of these attributes in their 2004 annual reports and company web-sites.[5] Using the same S&P methodology, we measure the overall T&D scores and the scores in the three sub-categories. The results show significant improvement in the scores in the year 2004.

The second objective of the paper is to investigate if voluntary IFRS adoption is a determinant of the TD scores. We use early voluntary adoption of IFRS in 2003 and 2004 as an

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[5] We explore TD quality using data from a single country because multi-country studies may yield mixed results as a result of their differences in terms of the sizes and liberalization of their markets, political and economic risk exposure, the average market capitalization, and their reporting standards. By using only ISE data, we control for these differences that are expected to affect both the TD scores and the variables we use as proxies for performance and agency conflicts.

observable indicator of commitment to better disclosure and transparency, and test if the T&D scores are higher in these early adaptors.[6] Use of IFRS is a very significant reform for Turkey whose accounting rules have been traditionally shaped by tax considerations until recently and inflation accounting and consolidation of group accounts have never been used even though they have been crucial in an economy plagued with incredibly high inflation rates and composed of many family-based holding firms. In line with Turkey's accession to the EU and the EU Directive mandating adoption of IFRS by the EU countries by 2005, the CMB of Turkey and the Turkish Accounting Standards Board have promulgated the use of IFRS for public companies, to be effective for the first time, in the financial statements prepared for the fiscal periods starting on Jan. 1, 2005. However, some publicly traded companies have already started using the IFRS voluntarily since 2002. The results show that the firms that have voluntarily adopted IFRS have significantly higher TD scores.

Third, we exploit the sequential timing of the voluntary adoption of IFRS by ISE firms in 2003 followed by the promulgation of the mandatory CG Principles of the Capital Markets Board (CMB) in 2004. These local CG principles are promulgated on a "comply or explain" basis and became effective for the first time in fiscal year 2004. Using a matched pairs design and controlling for IFRS adoption, we are able to attribute the improvement in the TD scores to this first attempt by public firms to comply with the CG principles. Having established the incremental explanatory power of the CG Principles, we next generated a survey of 9 questions, presented in Appendix 2, to investigate the sample firms' level of compliance with these local CG principles. We directly examine the Compliance Reports in the 2004 annual reports and web sites of our sample firms. We score the firms based on their compliance with the CG principles and present some descriptive statistics on the first year compliance level of ISE firms.

We finally create a new parsimonious Commitment to Better Disclosure (CBD) Index which includes early voluntary adoption of IFRS, existence of a CG Charter, and presentation of the

[6] In a broader context, IFRS adoption could also be a proxy for commitment to accession to the European Union and for the demand for external capital.

annual report on the company website as the only three attributes out of our 106 attribute T&D index. During the two sample years, all three were voluntary and costly disclosures that indicate a strong commitment to transparency and full disclosure on the part of our sample firms, and we believe that the web site presentation is a very important disclosure media which enhances accessibility of the information, especially for foreign investors. We observe a high correlation between the two indices but weak evidence that the determinants of CBD and TD indices are the same. The results support some previous studies that use factor analysis to come up with only a few significant variables rather than using an index with many heterogeneous attributes.

The study has several contributions. It provides the first empirical evidence that the TD scores of ISE firms have improved over the two years and provides strong evidence on the determinants of this improvement in Turkey. As such, it provides a benchmark for future comparative studies and we hope that the survey results and the publicity it has attracted will provide incentives for all firms to improve their TD practices and level of compliance with the CG Principles. Second, to our knowledge, this is the first study that examines the effect of voluntary IFRS adoption and mandatory CG Principles simultaneously in this context. The matched sample design exploits the timing of voluntary IFRS adoptions and mandatory CG principles in Turkey to come up with strong results. The evidence provided on the relationship between voluntary and mandatory disclosure mechanisms and TD scores is expected to serve as a guideline and monitoring device for managers, creditors, shareholders and local and international regulators. Third, for the first time, we create a parsimonious Commitment to Better Disclosure Index (CBDS) based on three voluntary disclosure items and a Compliance with CG Principles Index based on the mandatory Compliance Report in annual reports. Finally, T&D studies carried out in emerging markets with different legal origins, political, regulatory and cultural traditions, and different types of agency conflicts also provide an input to regulatory reforms and serve as out-of-sample tests for the robustness of the results obtained in developed economies. Undoubtedly, the results will yield interesting conclusions both at the individual company and country level and should be of interest to researchers, practitioners, market participants and regulators. The remaining part of the paper is organized as follows: Section two discusses prior research and motivates the study. In section three, we generate our model of the CG/T&D framework and its relationship to the local and global economy through firm performance. We also develop our hypotheses in this section. The sample, data requirements and methods of analysis are described in Section four. The results are presented in section five and section six concludes and presents some ideas for future research.

II. Prior Research and Motivation

In this section, the firm-level research that investigates the relationship between CG, and more specifically T&D, and firm performance is reviewed. We also discuss the specific political, economic, regulatory impediments to T&D quality in Turkey that have motivated this research.

II.1 Prior research

This paper is closely related to a large body of accounting and finance literature on the incentives for and consequences of regulated and voluntary disclosure. Motivated by the theoretical work on mandatory disclosure (Watts and Zimmerman, 1986; Beaver , 1998) and discretionary disclosure (Verrechia, 1983; Darrough and Stoughton, 1990; and Feltham and Xie,1994), researchers have mostly focused on the effect of corporate disclosure quality on cost of capital, security prices, and other firm specific variables. A recent example is the Brown and Caylor (2004) study that relate Gov-Score, a composite measure of 52 factors encompassing eight governance categories, to five measures of performance using Compustat and Crisp data. They find that better governed firms are more profitable, more valuable, less risky, less volatile, and pay out more cash to their shareholders.

Here we particularly review the studies that use the S&P's T&D database because this study uses a slightly modified version of the 98 attributes and the methodology developed by S&P to rate disclosure practices in various countries around the globe. Apart from the country reports published by S&P at the conclusion of each of their surveys on T&D practices in many emerging and developed markets starting in 2001, the first set of papers using their T&D score database were written by S&P researchers themselves. Patel and Dallas (2002) document significant correlations between T&D rankings of US firms and determinants of expected returns: market risk, size, and the price-to-book ratio. Patel et al. (2002) relate the T&D scores and firm value in 19 emerging markets (354 firms followed by the S&P/IFCI Index) and it is the only study that includes Turkey in their sample. They find that, on average, firms with higher T&D scores have higher price-to-book ratios.[7] However, their study suffers from small sample sizes. Their sample consists of less than 25 firms for 14 of the 19 countries they cover. They document that the average T&D score of the 12 Turkish companies they studied is 34%, the 7th lowest in their sample.[8] Another study that utilizes the T&D database of S&P on S&P 500 firms is Cheng et al. (2003). They find that stronger T&D reduces the firm's market beta and leads to increased risk-adjusted abnormal returns and earnings response coefficients around the release of the S&P scores. They also find that the three different T&D dimensions have different effects on these market metrics. Finally, Khanna, Palepu and Srinivasan (2004) use the S&P scores in 24 Asia Pacific and European countries to unveil a positive relationship with cross-border economic interactions after controlling for firm size, performance, and legal origin.

We also review some relevant studies that investigate the impact of convergence to IFRS and local CG principles. In the first phase of our T&D study, we had found the highest scores, 7 out of 10, but very little variation in the financial information and disclosure category of TD,. We had conjectured that this may be due to companies disclosing only what is required by the Turkish Uniform Accounting Standards and the Capital Markets Board (CMB), and not going beyond current requirements--voluntary disclosure was found to be limited. The one exception to this is the voluntary adoption of IFRS and its several separate standards such as the use of inflation accounting or consolidations by about two thirds of our sample firms prior to 2005, the effective date of adoption in the EU, Russia, and in Turkey.[9] Thus, it is interesting to see if the voluntary adoption of IFRS is associated with better disclosure in general.

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[7] They find a negative relation between T&D scores and market value in Brazil, Poland, and South Africa.

[8] The only other study on the performance effect of CG on Turkish firms is Kula (2005). He examines the impact of the role, structure, and process of the boards and finds that effectiveness, info access, performance evaluation, and resource acquisition roles of the board are associated with performance.

[9] A recent (4/12/2005) report of the Institute of International Finance (IIF) comments on the recent CG improvements in Turkey and mention the adoption of IFRS, inflation accounting and consolidated reporting as some of these areas.

IFRS is typically assessed to be more credible and conservative than most local accounting standards. The economic contracting theory suggests that this should decrease the info asymmetry component of the firm's cost of capital. Since IFRS is expected to impact the information environment of the firm favorably, in this study, we consider voluntary adoption of IFRS before its effective date, a strong but costly commitment to better disclosure. There are quite a few studies have looked into the disclosure quality and performance impact of the voluntary or mandatory adoption of IFRS. Two of these studies are country-level studies. Jorgensen and Sabino (2002) explore the relationship between legal origin, level of development, information availability in 57 countries and the CIFAR index of disclosure and find that the observance of the IAS/IFRS

requirement in a country is not related to disclosure variables. Hope et al. (2005) report that countries with weaker investor protection mechanisms and that provide better access to their local capital markets are more likely to adopt IFRS, consistent with bonding theory. Leuz and Verrecchia (2000) report that German firms that switched to IFRS had lower bid-ask spreads and higher transaction volume, indicating a decline in cost of capital. Ashbaugh and Pincus (2001) examine analysts' earnings forecast accuracy before and after a sample of non-US firms adopt International Accounting Standards (IAS) and find that analysts' forecast accuracy is improved with IAS adoption for firms in countries where domestic-GAAPs require less disclosure and allow more measurement options relative to IAS. Recently, Cuijpers and Buijink (2005) investigate the determinants and consequences of voluntary adoption of IAS and US GAAP by the Euopean Union firms. They find that while adaptor firms, especially early adaptors, start attracting a higher number of financial analysts, their cost of capital, stock return volatility, and forecast dispersion did not improve. Thus, they find very weak evidence that the level of information asymmetry improved for these firms.

We use a customized set of disclosure attributes based on the S&P survey to measure disclosure practices in the ISE and a larger sample of 52 ISE firms that constitutes- --- % of the market capitalization. We also use the non-aggregated scores for S&P's three different categories of disclosure as suggested by Botosan and Plumlee (2000) and Cheng et al. (2003). Furthermore, we measure the impact of voluntary IFRS adoption, a parsimonious 3 attribute T&D index and the

Capital Market Board's CG Principles on the firm's disclosure level and on the link between disclosure and performance.

II.2.The poor regulatory framework and the CG and T&D culture in Turkey

The first legislation concerning a commercial law was enacted for the first time in the Ottoman Empire in 1850 and was based on the French Code of Commerce of 1807. Under the legal reforms of 1926, this was replaced by a system based on Swiss Civil Code and Code of Obligations, the Italian Penal Code, and the German Code of Penal Procedure. Neither these, nor the present Turkish Code of Commerce dated back to 1957 are based on the principles of accounting and auditing and hence do not regulate financial reporting. They highlight the strength of the civil law tradition, weak enforcement of rules and the lack of a disclosure philosophy in the Turkish business culture, expected to lead to poor corporate governance and T&D practices. This seems to be an important factor in the historic difficulty with which Turkish firms have attracted external capital. In fact, La Porta et al. (1997) places Turkey in the French origin legal systems which has had the lowest access to external capital markets and the weakest rule of law and investor rights protection indices among the 3 other civil law and the common law traditions. In their cross country comparative tables, they show that even though GDP growth is stronger in Turkey than in all legal origins, access to external capital and measures of investor rights are even lower than the average of the French origin countries. Hence, while the fast growth rate underscores the need to tap external debt and equity capital in the Turkish economy, the table highlights the difficulty of accessing external capital when enforcement of the rule of law and protection of investors rights are weak. The solution to this dilemma through observance of good CG and T&D practices has been one of the motivations for this study.

Recent studies have observed that the weak CG and disclosure tradition in Turkey have continued until very recently. Ararat and Ugur (2003) describe Turkey's civil law tradition and its inefficient and inconsistent regulatory framework and the ensuing paucity of the rule of law and enforcement; the concentrated and pyramidal ownership structure dominated by families; the inconsistent and opaque accounting and tax regulations and the investor misinformation caused by the absence of inflation and consolidation accounting in a highly inflationary economy and where most of the traded companies are holding companies. As a result of this infrastructure, corporate governance problems are concentrated around weak minority shareholders' and creditors' rights, inconsistent and opaque disclosure policies and lack of voluntary disclosure, and convergence (inseparability) of ownership and management. These create an environment that fosters corruption, share dilution, asset stripping, tunneling, insider trading, and market manipulation.

We expect that the aforementioned bleak picture will change in the near future as a result of the reforms in the financial reporting and disclosure environment on the one hand, and the recent developments in Turkish politics, economic reforms, new regulation, and more effective enforcement, on the other. Some of these developments have been the accelerated privatization, the implementation of pension reforms and creation of private pension funds, the monitoring of banks by BRSA, the CMB's commitment to the improvement of the regulatory framework, the provision of incentives for better governed companies, the recent Corporate Governance Code developed by the CMB in the areas of disclosure, minority rights, board structure and management oversight. Alongside IFRS adoption, we also measure the impact of compliance with these principles on the TD quality of sample firms. Of course, Turkey's progress in achieving full membership of the EU will provide the strongest inertia in establishing the "rule of law" and ethical conduct in business transactions and better corporate governance practices.

III. Our Model and Hypotheses:

In our simple model in Figure 1, we envision good CG/T&D practices as mechanisms of checks and balances that have evolved to mitigate the costly agency problems that arise due to separation of ownership and management in public firms. In terms of TD, the lower the reliability, timeliness, relevance and understandability of disclosure, the higher the uncertainty of its returns to capital suppliers and the stronger the signal that there is hidden bad news about the company. This in turn, would increase the cost of capital, reduce the demand for the company's shares and thus reduce firm value. The CG/T&D mechanisms are shaped by both the legal traditions and regulations in the firm's country of domicile – such as the CG Principles of the CMB - and by international laws and the global economy that not only impose new rules and best-practices on the firm -such as the IFRS-, but also create opportunities in the form of positive NPV investments and access to foreign capital. Since undertaking positive NPV projects depends on the firm's ability to tap the equity and debt markets, and since capital will flow to the safest and highest return investments, firms have the incentives to minimize their perceived risk and maximize the return to their capital suppliers by putting in place optimal CG mechanisms. The ability to attract funds and take advantage of positive NPV projects is then bound to increase firm performance and the returns to capital, in the absence of appropriation by insiders which are again mitigated through good CG/T&D practices. So in our model, best CG/T&D practices are used by firms not only to signal their quality, but also as monitoring tools to maintain their good quality.

(Place Figure 1 around here)

In a prior study (Aksu and Kosedag, 2005), we have explored the left side of the model, i.e., the relationship between potential agency problems and the T&D scores in the ISE crossectionally, at a point in time. In this study, we again investigate the same side of the model by extending our data set for one more year and by examining whether an international best-practice, IFRS, and a local regulation, CG Principles of the CMB, had an impact on TD scores, Accordingly, we have the following testable hypotheses, presented in the alternative form:

H1: Firms are expected to have higher T&D scores in 2004 than in 2003 due to more and more firms adopting IFRS and because 2004 is the first year when a report of compliance with CG Principles is required.

H2: Firms that have voluntarily committed themselves to a higher quality governance and disclosure by early adopting the IFRS are expected to have higher T&D scores.

H3: Since these firms are expected to present more transparent and value relevant information in their financial statements, we also expect to observe a more significant link between their T&D scores and financial performance.

H4: Firms' first time compliance with the CG Principles in 2004 is expected to impact the TD Scores positively, after controlling for IFRS adoption.

H5: Our parsimonious commitment to better disclosure (CTD) index is a good proxy for our TD ındex.

IV. *Sample, Data Requirements and Methods of Analysis*

In this study, we use a database of T&D scores in three categories for 52 large (based on market capitalization) and liquid (based on trade volume) Turkish firms, previously created by S&P and Sabanci University, CG Forum researchers. The creation of this database of T&D scores is described in detail in S&P's publications RatingsDirect dated June 6, 2005 and June 25, 2006 and in Aksu and Kosedag (2006) which also compares the T&D scores of Turkish public firms with those of firms in other countries where the same survey had been conducted by S&P and also explores the firm-specific determinants of the T&D scores. The sample in this study consists of the same 52 corporations because our objectives is to investigate whether the average TD scores have increased in 2004, the relationship between these firm's TD scores and their voluntary adoption of IFRS in 2003 and 2004 and whether the improvement in the scores can be attributed to mandatory compliance with CG Principles required for the first time in 2004 financials.

Using the same scoring methodology adopted from S&P as we did in 2003, we first measure the transparency and disclosure quality of the sample firms in 2004 by objectively searching for 106 mandatory and discretionary information items disclosed in company annual reports and websites. We basically count the 'Yes', 'No', 'N/A' answers (yes = 1 pt.) as a % of the maximum possible 'yes' answers in each category of TD:

$$\mathbf{TDS} = \sum_{j}\sum_{k} \mathbf{S}_{jk} \,/\, \mathbf{TOTS} \qquad \mathbf{(1)}$$

where:
j = the attribute category subscript,
k = the info item (attribute) subscript, and
TOTS = the total maximum possible "yes" answers for each firm. [i]
S_{jk}= the number of info items disclosed (answered as "yes") by the firm in each category.

Following an extensive accounting literature on corporate disclosure quality, we use our T&D rankings to represent the market participants' assessments of the completeness, clarity, transparency, and reliability of firms' disclosure policies and employ matched pair t-tests to measure the significance of the improvement in the scores.

Second, we employ regression analysis to examine the relationship between the T&D scores and the firm-specific variables that explained the changes in the scores in 2003 (Aksu and Kosedag, 2006). These significant variables were size (lnMVE), growth potential (market-to-book-equity), leverage (TL/TA) and firm performance (excess-returns and ROE). Next, we compare the TDS of the firms that have and that have not voluntarily adopted IFRS and then go on to compare the effect of IFRS adoption on the TD scores by adding IFRS adoption as a dummy variable to our regressions. Next, we also add a year dummy to our regressions to measure the effect of 2004 CG Principles, while controlling for the effect of IFRS.

$$TDS = \alpha + \beta_1 \text{ Perf} + \beta_2 \text{ controls} + \beta_4 \text{ IFRS}_{dummy} + \beta_5 \text{year}_{dummy} + \varepsilon \qquad (2)$$

Finally, alongside IFRS adoption, we select three relevant attributes out of 106 attributes to come up with a new parsimonious Commitment to Better Disclosure (CBD) Index which we use to rescore our sample firms. We analyze the substitutability between the two T&D indices and examine if the relationship of TD scores with performance is stronger with this index.

V. Results

V.1. Descriptive Statistics:

Table 1 presents the descriptive statistics of our sample and their T&D scores for 2003 as reported in Aksu and Kosedag (2006). The table reports the mean, median, min. and max. values of firm-specific agency, risk and performance variables likely to impact the TDScores. Turkish companies had slightly negative returns in 2003 due to the continuation of the economic slump of 2002; their return on assets and return on equity ratios have been moderate about 5-10% even though the mean ROE is quite high at 17%; and their mean leverage is about 50%.

(Place Table1 around here)

V.23. Evidence on the improvement in TD Scores:

Table 2 depicts the descriptive statistics on the TD Scores in 2003 and 2004 in a comparative format. The table indicates that the transparency and disclosure scores of ISE companies were not impressive in 2003, especially in terms of the board and management structure and processes sub-category of TD. The highest scores are obtained in financial transparency and information. This is not surprising given that this category mostly questions compliance with mandatory IFRS and Turkish GAAP disclosures for public firms. The average scores in all three sub-categories of TD has increased and the average overall TD Score has increased from 41 to 57. We employ matched pair t-tests of the difference in means to unveil that the scores in all categories are significantly higher in 2004 as the corresponding *p*-values are all less than 1%.

(Table 2 about here)

Table 3 gives a comparative account of the TD quality of the Turkish sample compared to other countries and regions where S&P had used the same attributes and scoring methodology. The table is meaningful as the attributes and methodology are held constant, but the scores of the other countries are mostly measured in 2002. In 2003, Turkish companies have a pattern similar to Emerging Asia but have higher Financial Disclosure, but lower Board & Mgmt. scores. In comparison to European countries' with an overall T&D score of 6/10 in deciles, Turkey has a somewhat lower average score 5/10 which is comparable to many civil law tradition European countries. By 2004, the overall score of Turkey has become 6/10, comparable to Europe, Asia Pacific, and US annual reports even though the Board & Mgmt scores are still on the low side.

(Table 3 about here)

V.3. The relationship between voluntary IFRS adoption, T& D scores, and performance:

Although the CMB of Turkey and the Turkish Accounting Standards Board have promulgated the use of IFRS for public companies, to be effective for the first time, in the financial statements prepared for the fiscal periods starting on Jan. 1, 2005, some publicly traded companies have already started using the IFRS voluntarily since 2002. In Table 4 we use the early voluntary adoption of IFRS (65 % of sample firms), as a signal of and commitment to better T&D, and we measure its effect on the T&D scores of our sample firms and on the relationship between their T&D scores and performance.

(Table 4 about here)

The table depicts the results of univariate tests and provides descriptive statistics on the effect of IFRS adoption on the overall T&D scores and the scores in its three categories. As we hypothesized, FinDisc, (t-value = 5.90) and the overall T&D scores (t-value= 2.87) are significantly higher in the sub sample that have voluntarily adopted IFRS in their financial statements. There is no significant difference in the OwnStr and BrdMgmt scores of the two subsamples, perhaps because IFRS adoption mostly effects financial disclosure component overall TD scores.

We next run our regressions of TD scores on our performance measures using 2003 and 2004 data and the results are presented in Table 5. This time, we add a dummy variable for IFRS adoption, alongside other control variables which have been found to explain the variation in TD Scores of ISE firms in an earlier study (Aksu and Kosedag, 2006). As reported in Table 5, we find that the coefficient for IFRS dummy is significant and that the relationship between TDS and performance is enhanced when IFRS dummy is included in the model. Specifically, we find that performance, especially market and risk adjusted excess returns explain the variation in TDScores *(p-value=0.10);* IFRS adoption explains the variation in TDScores *(p-value=0.025);* and IFRS adoption has a positive impact on the relationship between performance and TDS in that R^2 increases from 22% to 31% and the coefficient of our performance measures becomes more significant.

(Table 5 around here)

V.4. The relationship between mandatory CG Principles and the T D scores

We next measure the impact of the CG principles that became effective in 2004 financials while controlling for the impact of IFRS on the scores. Pooled regressions are run on all firms over the 2 years with IFRS adoption dummy in the model and also a year *dummy=1 if* t= 2004 and 0 if t =2003. This design allows us to hold the country, time and firm specific factors constant and to control for the impact of IFRS while varying only the year. Table 6 shows that both the IFRS dummy and the year dummy are highly significant in explaining the changes in the scores and the R^2 is for the first time as high as 50%.

(Table 6 around here)

V.5. Commitment to Better Disclosure Index as a substitute for the T&D index

Finally, we create a parsimonious Commitment to Better Disclosure Score (CBDS) for each company in our sample based on the following voluntary disclosure items. We use IFRS adoption as a commitment to more prudent, comprehensive, reliable, consistent, and comparable financial disclosure; adoption of a CG charter as a commitment to ethical behavior and to higher levels of transparency in the structures and processes of all organizational units entrusted with protection of shareholders' and other stakeholders' rights; and finally, the presence of the annual report on the company web site as a commitment to have all this firm-specific information easily accessible to all the stakeholders.

In Table 7, Panel A, we first provide descriptive statistics on the frequency of sample firms adopting IFRS in its entirety (65%) and using only inflation accounting (89%) and consolidated financial statements for group firms (75%). The latter two are very important and relevant accounting standards for Turkey and for our sample firms, in particular. First, until recently, Turkish economy has been experiencing a very high inflation rate in the last two decades. Second, although most of our sample firms are group firms (41), they have never consolidated the subsidiaries' financial statements with that of the parent because the Turkish accounting standards did not require consolidation until IFRS was required for public firms in 2005. In Panel A, we also provide the frequency of sample firms that disclose the existence of a CG charter, whether the charter is presented in the annual report, and whether the annual report itself is included on the company web site since these additional important disclosures also signal a strong commitment to better disclosure.

(Please place table 7 around here)

In Panels B and C, we investigate the substitutability between our 106 attribute overall T&D index and our 3-attribute simple CBD Index by comparing their means and by looking at the correlations between the CBD scores (CBDS) and our categories of TD (TDS) scores. We find that there is a significant correlation between FinDisc scores and CBDS (79%), and hence a high correlation with the overall TDS.(55%). We then measure the impact of IFRS adoption, which is a component of our CBD index, on the CBDS. As expected, the firms that use IFRS in the preparation of their financial statements have a mean CBDS of 84.62 % while those that follow only local accounting standards have a statistically different mean score of 26.83% (see Table 7, Panel D).

Table 8 tests whether the same firm-specific determinants explain the changes in CBDS as they do in the case of TDS. Aksu and Kosedag (2006) have found that larger and more profitable firms, as well as firms with higher information asymmetry exhibit higher TDS to partially resolve the conflict with minority shareholders and regulatory institutions while free cash flow available to management and leverage do not have explanatory power. The explanatory variables found to be significant were, lnMVE (natural log of market capitalization), MTB (market value of equity/book-value of equity), Debt/TA (total liabilities/total assets) and ROE (net income/owner's equity) ratios, measured as of Dec. 31, 2003. In this study, we regress the CBD scores on the same independent variables as well as excess returns, defined as average monthly stock returns in excess of the return to ISE-100 during years the two years 2002 and 2003. The results are promising in terms of the substitutability of our simple index for the 106 attribute TD index. Size and market-to-book ratio are still significant with respective p-values of 0.05 and 0.03. However, as a performance measure, average excess returns are only weakly significant (p=0.14) and the R^2 of the regressions go down to 15%

VI. Summary and Concluding Remarks

This paper examines a sample of large capitalization and liquid ISE firms and creates an TD index in collaboration with S&P, based on objective examination of their 2003 and 2004 annual reports and company web sites for the inclusion of 106 TD attributes in three sub-categories. The results are in the hypothesized direction. First, the 2004 TD scores are significantly higher than those of 2003. Multiple regression analysis results show that the main reason for the improvement in the scores is the first time requirement of CMB to include a compliance report in the financial statements in 2004. Second, the companies with higher scores, especially in the category of board and management structures, have higher returns and accounting measures of profitability. Third, firms that have voluntarily adopted IFRS in the preparation of their 2003 and 2004 financial statements have higher TD scores and commitment to better disclosure (CBD) scores, a 3-attribute parsimonious index we create and compare with the TD index. We also find a strong correlation between the CBD and TD scores, especially in terms of the overall TD scores and its component, financial disclosure scores.

We conclude that voluntary IFRS adoption seems to be a credible signal of commitment to transparency and full and reliable disclosure as it is, by itself and together with 2 other good disclosure practices, strongly associated with the TD scores of sample ISE firms. Furthermore, sample firms' mandatory inclusion of a several pages of Compliance Report in their 2004 annual reports in compliance with the CMB's CG Principles have significantly improved their TD scores.

There are various limitations of the study. Sample size is too small and we have only two years' data. We also have low R^2 in the regressions of TDS on performance measures, control variables, and the IFRS dummy, probably due to omitted variables. Finally, our results are biased by our choice of the 106 attributes in our TD index and the 3 attributes in our parsimonious CTD index.

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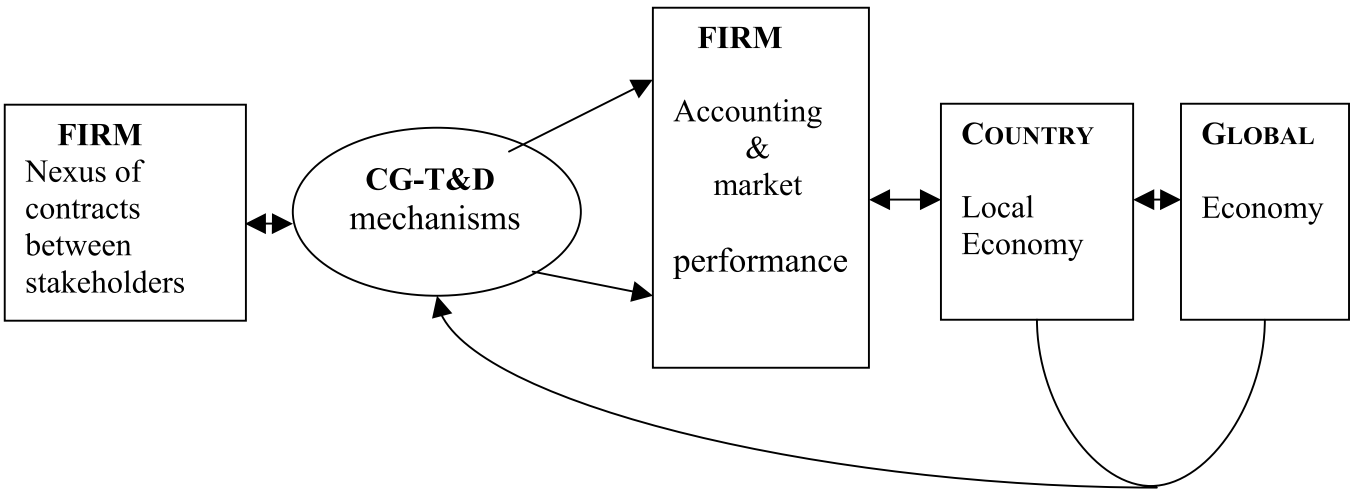
Figure 1

Incentives for good CG/TD practices



Conflicts of interest	TDScores	ROE	Laws & regulation
Asymmetric info	IFRS Adoption	Excess Returns	Opportunities
	CG principles		Threats

Table 1

Descriptive Statistics for 52 ISE firms

Excess returns, profitability, and leverage: *(Source: Aksu and Kosedag, 2006)*

Variables[a]	**N**	**Min.**	**Max.**	**Mean**	**Std. Deviation**
ExRet'04	52	-19,70	64,52	0,81	10,05
ExRet'03	52	-6,18	17,90	-0,17	3,84
ExRet'02	52	-4,75	12,67	2,02	3,20
ExRet-AllYrs.	52	-5,69	14,43	0,90	3,02
ROA	50	-0,17	0,24	0,065	0,07
ROE	50	-0,332	1,89	0,175	0,274
Market-to-book (MTB)	47	0,009	18,10	1,96	2,76
Debt ratio (DTA)	50	0,02	0,89	0,51	0,24

[a] ROA = Net income/Total Assets for the year t-1.(yr t = 2003)
ROE = Net Income/Owner's Equity for the year t-1
DTA = Total Liabilities/Total Assets as of Dec. 31, 2002.
ExRet = Excess returns are calculated as market adjusted average monthly returns for the year 2003 and for the average of 2002, 2003, and 2004 excess returns.

Table 2

Comparison of 2003 and 2004 T&D Scores of ISE firms

The TD Scores are measured based on the inclusion of 106 T&D attributes in three transparency and disclosure sub-categories in the hardcopy annual reports and company web sites of a sample of ISE firms for the fiscal years 2003 and 2004. See Aksu and Kosedag (2006) for the 2003 results on Turkey

T&D scores:	OwnStr.	FinDisc	Board&Mgmt	Overall
Average:				
2003	**38.57**	**64.21**	**20.42**	**41.11**
2004	**60.69**	**72.53**	**38.38**	**57.15**
Difference in means:				
***t*-value**[a]	**-7.13**	**-3.64**	**-7.82**	**-7.75**
Std. deviation:				
2003	18,26	14,25	12,18	11.06
2004	17.89	11.98	15.37	11.47
Min:				
2003	3,13	19,44	2,70	16.19
2004	25.00	44.44	5.41	28.30
Max:				
2003	88,00	86,11	54,05	71.43
2004	96.55	94.59	74.19	82.22
sample size :				
2003	52	52	52	52
2004[b]	51	51	51	51

[a] The t-values are those of paired two sample t-tests for equality of means of 2003 and 2004 T&D scores. One-tailed tests are used as we hypothesize an improvement in the scores in 2004. Since the corresponding *p*-values for the three categories and overall T&D scores are all less than 1%, it can be said that the average improvement in the scores in 2004 is not due to chance, it is, statistically, highly significant.

[b] The decline in sample size in 2004 is due to the unavailability of a sample company's annual reports and website as of December, 2005.

Table 3

Comparison of Turkish T&D Scores with those of other countries/regions surveyed by S&P

	Composite Score	Owner Str.	Fin Disclosure	Board&Mgmt	# of firms
Europe	58	46	73	51	351
U.K.	70	54	81	70	124
Non-U.K.	51	41	69	41	227
U.S. (annuals)	42	25	66	31	500
U.S. (combined data sources)	70	52	77	78	500
Japan	61	70	76	37	150
Asia-Pacific	48	41	60	42	99
Latin America	31	28	58	18	89
Emerging Asia	40	39	54	27	253
Turkey (‘03-‘04)	**41-57**	**39-61**	**64-73**	**20-38**	**52-51**

Source: S&P’s *Transparency and Disclosure Study, 2002.*

Table 4

The Effect of Voluntary IFRS Adoption on TD Scores

Descriptive statistics *(std.dev in parantheses)* for overall TD Scores and the scores in three sub-categories of TD for firms that voluntarily comply with IFRS and those that do not

	IFRS			No IFRS				
	mean *(std.dev)*	**min**	**max**	**mean** *(std.dev)*	**min**	**max**	**Diff.**	**t-value**
OwnStr Score	40.34 *(18.79)*	9.38	88	35.23 *(17.23)*	3.13	58.07	5.11	0.98
FinDisc Score	71.36 *(8.10)*	57.14	86.11	50.69 *(13.64)*	19.44	66.67	20.67	**5.90**
BrdMgt Score	21.19 *(13.34)*	2.7	54.05	18.98 *(9.80)*	5.41	41.67	2.21	0.62
Overall TD Score	44.11 *(10.66)*	26.21	71.43	35.44 *(9.71)*	21.91	49.23	8.67	**2.87**

Table 5

The Determinants of TDS and the Incremental Effect of IFRS Adoption on TDS

Financial Performance (FinPerf) is proxied by return on equity (ROE) and average monthly stock returns in excess of the return to ISE-100 (AvgExRet) during years *t-1, t (year 2003 for which* the T&D scores are measured) and *t+1*. MVE is measured at the end year *t-1*as the market capitalization and MTB as MVE/ book-value of equity. The relationship between TDS and its determinants is measured as a linear regression model specified as:

Panel A: $TDS = \alpha + \beta_1\ ROE + \beta_2\ lnMVE + \beta_3\ MTB + \beta_4\ IFRS_{dummy} + \varepsilon$

	Coefficients		p-value	
	w/out IFRS	with IFRS	w/out IFRS	with IFRS
Intercept	– 44.888	– 36.263	0.101	0.167
ROE	6.389	7.160	0.244	0.173
lnMVE	4.150	3.475	**0.002**	**0.009**
MTB	– 0.063	– 0.033	0.205	0.490
$IFRS_{dummy}$		**7.416**		**0.023**
R^2	**0.201**	**0.291**		

Panel B: $TDS = \alpha + \beta_1\ AvgExRet + \beta_2\ lnMVE + \beta_3\ MTB + \beta_4\ IFRS_{dummy} + \varepsilon$

	Coefficients		p-value	
	w/out IFRS	with IFRS	w/out IFRS	with IFRS
Intercept	– 48.847	– 39.871	0.073	0.128
AvgExRet	1.148	1.158	**0.102**	**0.085**
lnMVE	4.263	3.585	**0.002**	**0.006**
MTB	– 0.138	– 0.110	**0.039**	**0.087**
$IFRS_{dummy}$		**7.175**		**0.025**
R^2	**0.224**	**0.309**		

Table 6

The impact of the CG principles of 2004 while controlling for IFRS adoption

Pooled regressions on all firms over the 2 years (year *dummy=1 if* t= 2004, 0 if t =2003)

$$TDS_t = \alpha + \beta_1\, ROE_t + \beta_2\, lnMVE_t + \beta_3\, MTB_t + \beta_4\, IFRS_{dummy} + \beta_4 year_{dummy} + \varepsilon$$

	Coefficients	**p-value**
Intercept	- 13.41	0.50
ROE	5.98	0.19
lnMVE	2.38	**0.02**
MTB	-0.032	0.11
$IFRS_{dummy}$	**8.18**	**0.001**
$Year_{dummy}$	**14.52**	**0.0001**
Adj. R^2	**0.49**	

Table 7

Comparison of Commitment to Better Transparency & Disclosure Scores (CTDS) and TD Scores

CTDS is the commitment to better disclosure scores measured based on adoption of IFRS and a CG Charter and on existence of annual reports on company web sites in 2003 reports.

Panel A: ***Sample proportions for the CTD attributes***

	IFRS	Only Inf Acc	Only Consolid.	CG Charter Existence	CG Charter Reproduction	Web report
% of sample	0.65	0.89	0.75	0.6	0.25	0.71

Panel B: ***Comparison of Overall CTD and TD Scores***

	mean	std.dev	min	max
Overall CTDS	64.25	30.01	0.00	100.00
Overall TDS	41.11	11.06	16.19	71.43
Diff. (t-value)				

Panel C: ***Correlation Coefficients (between TDS and CTDS)***

	Overall TDS	OwnStr TDS	FinDisc TDS	BrdMgt TDS
Overall CTDS	0.5467	0.2546	0.7862	0.2178

Panel D: ***Effect of IFRS on CTD Scores***

	mean	std.dev	min	max
IFRS (n = 34)	**84.62**	10.3	71	100
No IFRS (n = 17)	**26.83**	15.61	0	42.86
Difference	57.79		71	58.14
Diff. (t-value)				

Table 8

The Determinants of CTD Scores

CTDS is the commitment to better disclosure score measured based on adoption of IFRS and a CG Charter and on existence of annual reports on company web sites in 2003 reports. Financial Performance (FinPerf) is proxied by return on equity (ROE) and average monthly stock returns in excess of the return to ISE-100 during years *t-1, t (2003 for which* the T&D scores are measured) and *t+1.* MVE is measured at the end year *t-1*as the market capitalization and MTB as MVE/ book-value of equity. The relationship is measured as a linear regression model specified as:

$$\mathbf{CTDS = \alpha + \beta_1\ FinPerf + \beta_2\ lnMVE + \beta_3\ MTB + \varepsilon}$$

	ROE		AvgExRet	
	Coef.s	**p-value**	**Coef.s**	**p-value**
Intercept	-72,688	0,333	-76,235	0,292
FinPerf	5,232	0,729	2,157	0,144
lnMVE	6,772	**0,065**	7,018	**0,049**
MTB	-0,245	**0,076**	-0,575	**0,030**
R^2	**0,114**		**0,153**	

Appendix I-List of attributes used in the T&D survey (based on 98 S&P attributes)

Ownership

1) # of issued and o/s ordinary common shares?
2) # of issued and o/s other shares (preferred, non-voting, founders, recap)?
3) Par value of each ordinary share?
4) Par value of each other share (pref, non-vot, recap)?
5) # of auth but unissued ordinary shares?
6) # of auth but unissued other shares?
7) Top 1 shareholder?
8) Top 3 shareholders?
9) Top 5 shareholders?
10) Top 10 shareholders?
11) # and identity of shareholders holding more than 3%?
12) # and identity of shareholders holding more than 5%?
13) # and identity of shareholders holding more than 10%?
14) Identity of shareholders holding at least 50%?
15) Float %
16) Descriptions of share classes?
17) Review of shareholders by type?
18) Percentage of cross-ownership?
19) Existence of Corp Gov Charter or Code of Best Practice?
20) Reproduction of its Corp Gov Charter/Code of Best practice?
21) Mention of Articles of Association?
22) Details about Articles of Assn. (i.e. Charter Articles of Incorporation)?
23) Voting rights for each voting share?
24) How or who nominates directors to board?
25) How shareholders convene an EGM?
26) Procedure for putting Inquiry Rights to the board?
27) Procedure for proposals at shareholders meetings?
28) Review of last shareholders meeting? (e.g. minutes)
29) Calendar of important shareholder dates?
30) Any (in) formal voting agreements or blocks (relevant to family ownership)?
31) Shareholding by senior managers?
32) Ultimate beneficiaries in case of institutional, co. or cross shareholdings?

Financial Disclosure

1) Its accounting policies?
2) Acctg standards it uses for its accounts?
3) Accounts according to the local acctg standards?
4) Accounts according to internationally recognized acct standard (IAS/GAAP)?
5) B/S according to int'l acctg standard (IAS/GAAP)?
6) I/S according to int'l acctg standard (IAS/GAAP)?
7) C/F according to int'l acctg standard (IAS/GAAP)?
8) Accounts adjusted for inflation?
9) Basic earnings forecast of any kind?
10) Detailed earnings forecast?
11) Financial information on a quarterly basis?
12) Segment analysis (broken down by business line)?
13) Name of its auditing firm?
14) Reproduction of the auditors' report?
15) How much it pays in audit fees to the auditor?
16) Any non-audit fees paid to auditor?
17) Consolidated financial statements (or only the parent/holding co)?
18) Methods of asset valuation?
19) Info on method of fixed assets depreciation?
20) List of affiliates in which it holds a minority stake?
21) Reconciliation of its domestic acctg standards to IAS/US GAAP?

22) Ownership structure of affiliates?
23) Details of the kind of business it is in?
24) Details of the products or services produced/provided?
25) Output in physical terms disclosed? (# of users, etc.)
26) Characteristics of assets employed?
27) Efficiency indicators (ROA, ROE, etc.)?
28) Any industry-specific ratios?
29) Discussion of corporate strategy?
30) Any plans for investment in the coming year(s)?
31) Detailed info about investment plans in the coming year(s)?
32) Output forecast of any kind?
33) Overview of trends in its industry?
34) Its market share for any or all of its businesses?
35) List/register of related party transactions?
36) List/register of group transactions?
37) English Annual report on the web site?

Board and Mgmt

1) List of board members (names)?
2) Details about directors (other than name/title)?
3) Details about current employment/position of directors provided?
4) Details about previous employment/positions provided?
5) When each of the directors joined the board?
6) Classification of directors as an executive or an outside director?
7) Named chairman listed?
8) Details about the chairman (other than name/title)?
9) Details about role of the board of directors at the company?
10) List of matters reserved for the board?
11) List of board committees?
12) Existence of an audit committee?
13) Names on audit committee?
14) Existence of a remuneration/compensation committee?
15) Names on remuneration/compensation committee?
16) Existence of a nomination committee?
17) Names on nomination committee?
18) Existence of other internal audit functions besides Audit committee?
19) Existence of a strategy/investment/finance committee?
20) # of shares in the company held by directors?
21) Review of last board meeting? (e.g. minutes)
22) Whether they provide director training?
23) Decision-making process of directors' pay?
24) Specifics of directors' salaries (e.g. numbers)?
25) Form of directors' salaries (e.g. cash, shares, etc.)?
26) Specifics on performance-related pay for directors?
27) Decision-making of managers' (not Board) pay?
28) Specifics of managers' (not on Board) salaries (e.g. numbers)?
29) Form of managers’ (not on Board) salaries?
30) Specifics on performance-related pay for managers?
31) List of senior managers (not on the Board of Directors)?
32) Backgrounds of senior managers?
33) Details of the CEO's contracted?
34) # of shares held by managers in other affiliated companies?
35) Whether board members are employees of parent co.? (in case co. is a consolidated affiliate/subsidiary.)
36) Whether any grp policies exist re. nature of relationship between parent and affiliates? (w/respect to CG of affiliates/subsidiaries)
37) Whether any members of senior mgmt are related (family, joint business, etc.) to any major shareholder?

Appendix II-List of attributes to measure compliance with CG Principles of the CMB

1) Is the existence of a CG committee disclosed?

2) Is the Compliance report in the annual report? On the website?

3) Is the report placed before the Financial .Statements and footnotes?

4) Does the company state that it fully complies with the principles?

5) Are the names of at least 2 individuals responsible for public disclosure disclosed?

6) If no full compliance, have they adequately stated the reasons why? (use majority rule)

7) Greatest number of reasons cited for non-compliance is related to which section of the Compliance Report?

a) are the greatest number of reasons for non-compliance related to Shareholders' rights?

b) to Transparency and Disclosure?

c) to other stakeholders'rights?

d) to the Board of Directors?

8) If there is non-compliance, do they mention the resulting conflicts of interest ?

9) If they state that they have conflicts of interest, do they describe them with adequate detail?