

**ADDIS ABABA UNIVERSITY  
COLLEGE OF BUSINESS AND ECONOMICS**



**PROSPECTS AND CHALLENGES OF ESTABLISHING  
STOCK  
MARKET IN ETHIOPIA**

**A Thesis Submitted In Partial Fulfillment for the Award of  
Master in Accounting and Finance**

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**APPROVED BY BOARD OF EXAMINERS**

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## **DECLARATION BY CANDIDATE**

I, the undersigned, hereby declare that this thesis entitled “Prospects and challenges of establishing stock market in Ethiopia” is my own work and effort and that it has not been submitted anywhere for any award. Where other sources of information have been used, they have been acknowledged.

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## **ACRONYMS AND ABBREVIATIONS**

AABE	Accounting and Auditing Board of Ethiopia
AACCSA	Addis Ababa Chamber of Commerce and Sectoral Association
CBE	Commercial Bank of Ethiopia
CIA	Central intelligence Agency
EXC	Ethiopian commodity Exchange
EASC	East Africa Security Company
FDI	Foreign direct investment
GDP	Gross Domestic Product
OECD	Organization for Co-operation and Development
MOFEC	Ministry of Finance and Economic Commission
GDP	Gross Domestic Product
GOE	State owned Enterprise
ICT	Information and communication technology
IOSCO	International organization of security commission
IPO	Initial Public Offering
JLSRI	Justice and Law Systems Research Institute
NBE	National Bank of Ethiopia
PSD	Private sector development
PFEA	Public Finance Enterprises Agency
PPESA	private and public service Agency
SRO	Self regulatory organization
WB	World Bank

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## ***Abstract***

*The study assessed the prospect and challenges of establishing stock market in Ethiopia. To do so, descriptive analysis is utilized and data were gathered from both primary sources as well as secondary sources. Accordingly, Primary data collected from the employees and managers of Addis Ababa Chamber of commerce and Sectoral Association, Ministry of Finance and Economic Cooperation, National Bank of Ethiopia, Private Banks, Insurance Companies, Audit firms, Accounting institutions, shareholders and managers of share company and other credible sources through interview, online survey and also refer secondary data at large. The result revealed that the reluctance of the government, inadequate laws and regulations, insufficient technological infrastructure, and low level of public awareness as a challenge of establish stock market in Ethiopia. Also the prospects include the economic growth of the country, the agenda of poverty reduction, privatization effort and unexploited resources, thus the government need to take real pragmatic measures to establish stock market and further reforming the legal, institutional and the accounting and reporting requirements is necessary. Also the media should be seen reporting more on the advantage of Stock market.*

***Keywords:*** *Stock Market, Accounting and Auditing Standard*

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background

The increment of country's access to every financial service with boundary less over the world facilitates the development of strong and excellent socio-economic and political maintenance of the country and hence it has able to contribute to growth and poverty reduction. Hence, the development of stock market if implemented effectively becomes the back-bone of economic growth and national development.

It is widely believed that the development of stock markets would enable local companies to raise investment capital, make huge investments and create job opportunities in developing nations such as Ethiopia. Efficient stock market provides the public with investment opportunities and mobilizes savings, as well as international capital, for productive corporate financing. It is also argued that market forces serve to discipline management and public ownership thereby improving the accountability of the business sector. However, developing a robust and efficient securities regulation within which the stock market operates is a painstaking task for many developing countries.

Ethiopia had a securities market in the 1960s and 70s. For example, in 1897 Emperor Menelik II sold share in France to raise part of the 40 million francs needed to build the Ethio - Djibouti railways line. In 1906 the first bank in Ethiopia, Abyssinia Bank, floated its share in Addis Ababa, New York, Paris, London and Vienna. From 1960 to 1974 share companies were flourishing and share were traded by the National Bank of Ethiopia through the Addis Ababa share Dealing Group. Addis Ababa Bank, Ethiopia abattoirs, Bottling Company of Ethiopia, Indo Ethiopian Textiles, HVA Ethiopia, and Tendaho plantations were some of the share companies whose share were publicly traded during that time. All the companies were nationalized in the 1974/75 socialist revolution that shattered the private sector led economy.

The country does not have securities market currently. It has created only an agricultural commodity market which is owned fully by the government and operated outside the financial market. For more than forty years, Ethiopia has been trying to have its own financial market but didn't succeed. The need for stock exchange market development has, however, been continually discussed by various groups/stakeholders and academics. Accordingly, various studies have been carried out by these groups to initiate the establishment of capital market in the country.

For example, Professor Asrat Tessema conducted a research entitled "Prospects and Challenges for Developing Securities Markets in Ethiopia: An Analytical Review" in 2003. In his study he points out from the literature the benefits which can get from well functioning securities markets; costs and environmental requirements for securities markets development and environment for developing securities markets in Ethiopia which includes the challenges and prospects for the development of securities market in Ethiopia. Additionally, Abebe (2006) also conducts a research by focusing in stock exchanges role in relation to an alternate to term-loan financing and its development dubious. And in that specific article, entitled "An alternate to term-loan financing on the horizon, its development dubious: securities market, the missing link", Abebe tried to cover the benefits, the history of stock exchange in our country, its role in economic growth and the environment at that time.

Likewise, the other researchers Ruecker (2011) also showed National Bank of Ethiopia under took a study on the "Feasibility of Establishing Securities Exchange Market in Ethiopia" and prepared a draft Securities and Exchange proclamation which is awaiting endorsement.

Furthermore, the Addis Ababa Chamber of Commerce and Sectoral Association (AACCSA) had produced a research on the stock Market and recommend for establishing and still awaiting approval of the government.

Besides, different seminars and studies were undertaken by different scholars which emphasized on the need to establish stock market in Ethiopia. In 1995, a group of entrepreneurs organized as the Ethiopian Share Dealing Group under the Addis Ababa Chamber of Commerce and Sectoral Associations (AACCSA) and initiated a share dealing group similar to the former Addis Ababa Share Dealing Group of 1974. The group initiated the development of a Stock Exchange rules and regulations as well as bylaws of a share dealing group, and commissioned Ernst & Young to develop an international standard rules and regulations manual (Ruecker 2011).

In 2008, the NBE launched a capital market infrastructural development study by international consultants under the Financial Sector Capacity Building Project which was financed by the World Bank (WB) based on the potential interest of the government of Ethiopia which is under review by the concerned government body (Ruecker, 2011).

Beyond the studies conducted to initiate the need for stock market development, draft Proclamation was submitted to the government through the initiation made by the Addis Ababa Chamber of Commerce and Sectoral Associations (AACCSA) and commissioned to Justice and Law Systems Research Institute (JLSRI) in December 2001 named Monetary Instruments and Share Market proclamation. However, the proclamation was not endorsed by the government. Consequently, the Addis Ababa Chamber of Commerce and Sectoral Association (AACCSA) conducted a study on Position of the Business Community on the Revision of the Commercial Code of Ethiopia (AACCSA, 2008). Further, Justice and Law Systems Research Institute (JLSRI) started to revise the Commercial Code of Ethiopia (1960) to make it compatible to the existing domestic and international business environment (JLSRI, 2012).

However, this study was attempted to assess the comprehensive prospect and challenges of stock market establishment in Ethiopia by focusing on the role of accounting and auditing institution.

## **1.2. Statement of the Problem**

Ethiopia is one of the fast growing developing countries in the Sub Saharan Africa and the current government allocating substantial budgets on infrastructures to catalyze the growing economy with the aim of “rising Ethiopia to its former glory” (as it’s known, Ethiopia was one of the four origins of ancient great civilizations ever occurred on this planet) by setting stretched goals. To attain this stretched goal, the government is reforming sectors in the country to enhance their effectiveness and productivity. With this fact, The World Bank report has predicted that the country can join the lower middle income country by 2025, if the current trend/scenario to continue. To ensure this, the government has operated mega projects in Growth and Transformation Plan (GTP) I, and is operating in the GDP II. These projects require mobilizing financial resources.

Following the economic policy of the country, there are a growing number of share companies in formation that are promoting initial public offering in the primary market. However, there is no regulated primary or secondary stock market in the country that enables investors to create a market for these share companies in a secondary market. Another strong indication for the establishment of a stock market in Ethiopia is the recent privatization of public enterprises.

In Ethiopia, several studies were conducted to assess the infrastructural development required to establish stock market by different institutions, scholars, associations and consultants including NBE (1995), Asrat (2003), EASC (1995,1999), Ruecker (2011), PFEA (2012) have recommended to establish stock market upon fulfilling requirements required to establish stock market. Previous studies including Goldsmith (1969), McKinnon (1973), Shaw (1973), Fry (1988) and more recently, King and Levine (1993) have ascertained that financial development is a prerequisite for economic growth.

However, previous studies of Stock market focused on establishment and post establishment, with particular emphasis on its impact on the growth of a country economy, but offered only few insights into the accounting and auditing institution role.

This paper seeks to fill such an apparent gap in prior research by focusing on the role of accounting and auditing institution.

### **1.3. Research Questions**

Research question is the base of the study where the research is focused to investigate the problems and to achieve objective of the research. Accordingly, the following research questions forwarded to be addressed:

1. What are the benefits of establishing stock exchange to Ethiopia?
2. What are the prerequisites to establish stock exchanges?
3. Is there adequate demand to establish stock market in Ethiopia?
4. Is there adequate supply to establish stock market in Ethiopia?
5. How is the accounting, auditing and reporting standard in Ethiopia?
6. What are the prospects and challenges to establish stock market in Ethiopia?

### **1.4. Objectives of the Study**

#### **1.4.1 General Objective**

The general objective of the study is to assess the prospects and challenges for establishing stock market in Ethiopia.

#### **1.4.2 Specific Objectives**

Specifically, the research attempts to:

- Describe the advantages of establishing stock market in Ethiopia.
- Identify the necessary prerequisites to establish stock market in Ethiopia.
- Assess the demand for establishing stock market in Ethiopia.
- Assess the supply for establishing stock market in Ethiopia.
- To assess accounting, auditing and financial reporting standards in Ethiopia.
- Explore the challenges and prospects for establishing stock exchange in Ethiopia.

## **1.5. Significance of the Study**

The study has the following significance.

- The findings of the study provide accurate information to the policy makers, so that they can use it as input in their policy development.
- The study also provides information to the government to establish stock market.
- It serves as a reference for the upcoming new researchers on related topics in doing their research.

## **1.6. Scope and Limitation of the study**

The scope of this study delimited on the issue that were discussed, data sources as well as time frame. Accordingly, this study delimited to give justification on the prospects and challenges of establishing stock market in Ethiopia on the collected data of 2018. In this regard the study discussed four major related areas such as, the advantage of establishing stock market, potential demand and supply implication, environmental foundation such as, political ideology regarding with stock market, infrastructural factors, regulatory of stock markets, technological availability, and the status of accounting, auditing and reporting standard. Accordingly, the primary data collected from managers and officials of commercial banks, insurance companies, shareholders of banks, insurances, transport companies, petroleum Companies, schools, brewery companies, accounting and auditing firms and government officials like ministry of finance and economic cooperation, ministry of trade ,Accounting and Auditing board of Ethiopia, AACSA and scholars in the area on the other hand the study also extend its scope on the secondary materials such as, related arguments of scholars, forums reports etc. In this regard both the primary and secondary data were analyzed by mixing to provide relevant justification.

## **1.7. Organization of the Study**

The study organized in to five chapters. The first chapter have introduction, statement of the problem, objective of the study, significance of the study, scope of the study and organization of the study. The Second chapter covers Extensive literature survey. The third chapter focus on the methodology part, the fourth chapter has data presentation, analysis and interpretation and the fifth chapter summarizes the findings, conclusion and recommendation of the study.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

This review of literature provides both theoretical and empirical concepts regarding to the concept of Stock market development, its impact and its contributions for countries, companies and individual investors.

#### **2.1 THEORETICAL REVIEW**

##### **2.1.1. Definition of Stock Market**

Stock exchanges are formal organizations that are made up of members that use the facilities to exchange certain common stock (Fabozzi and Modigliani, 1996). According to **Avadhani (2002)**, Stock Exchange means anybody or individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities; it is an association of member brokers for the purpose of self-regulation and protecting the interests of its members. Stock exchanges are the most perfect type of market for securities whether of government, semi-government bodies or other public bodies as well as for shares and debentures issued by the joint-stock companies.

Likewise, Businessdictionary.com ([www.businessdictionary.com](http://www.businessdictionary.com)) defines stock market as an organized and regulated financial markets where securities (bonds, notes, shares) are bought and sold at prices governed by the forces of demand and supply.

Stock exchanges basically serve as primary markets where corporations, governments, municipalities, and other incorporated bodies can raise capital by channeling savings of the investors into productive ventures; and secondary markets where investors can sell their securities to other investors for cash, thus reducing the risk of investment and maintaining liquidity in the system. Stock exchanges impose stringent rules, listing requirements, and statutory requirements that are binding on all listed and trading parties.

In primary markets, new business can start by obtaining funds directly from households in which new stocks are sold to investors *via* the mechanism of under writing. The selling of common stock to the public through Initial Public Offering (IPO) in the primary market is an instance whereby widely held share companies under formation offer new shares to the investors. It is vital not to lose sight of the fact that secondary markets play an important role in the regulation of initial public offering of shares through the listing standards, subject to the discretion of stock exchanges. (Jetu, 2014)

On the other hand, in the secondary market, existing stocks are sold and bought among investors or traders in the stock market through stock exchange. Furthermore, secondary market could be either auction market or dealer market. While the stock market is part of an auction market, over the counter (OTC) is part of the dealer market. The difference between stock market and OTC is that the former exchange market operates in a structured manner and physical facility with a trading floor to which all stock transactions are supposed to be directed. However, OTC market traditionally operates in unstructured manner without any physical facility in which any qualified firm freely engages in the transactions of stocks.(Jetu, 2014)

### **2.1.2. The role of Stock Markets**

There are various literature written on the role of stock market. This may include the following:

#### **Enhanced saving mobilization and risk management:**

Stock issues serve to increase the national savings rate by creating incentives to invest. Since securities are risky investments, they generally earn higher returns than more secure instruments such as bank savings deposits. They also offer investors the option to diversify across industries, thus improving their risk/return tradeoff. (Tessema, 2003)

#### **Offering Liquidity to Investments:**

Stock markets provide comparatively higher returns without losing the liquidity of an investment desired most by investors. Liquidity in turn affects economic growth

positively by increasing incentive to invest and save. Levine (1996) found those countries with well-developed financial sector and a liquid capital market experience faster rates of capital accumulation and greater productivity gains. As liquidity increases, firms gain increased assurance that they will be able to exit from long-term investments. They therefore become more willing to make the permanent investments critical to development. Simultaneously, local consumers are more willing to mobilize domestic savings. However, Yartey and Adjaski(2007) say, increased stock market liquidity may have an adverse effect on the rate of economic growth by reducing the need for precautionary savings.

**Redistribution of wealth facilitated by diffused ownership:**

Stock markets give many people (especially the poor) a chance to buy shares of listed companies and become part owners of profitable enterprises. Many people sharing the profits of businesses in turn help to reduce large income inequalities. (Etienne and Vincent, 2008) Wider distribution of corporate profits develops a general sense of ownership and an assumption of responsibility on the part of the citizen. People will be united by their common defense of their business interests and ethnic and religious differences would gradually dissipate. (Tessema, 2003)

**Improved Corporate Governance:**

Self and external regulation of the stock exchange helps to ensure that the market is working efficiently, fairly and transparently. Over the decades, the stock exchange has been raising requirements for new corporations seeking listing. These requirements relate to the submission of all financial information regarding companies whose securities are sold on the stock exchange. Such requirements exercise a control on a company management; keep its malpractice in check; and improve corporate governance. (Etienne and Vincent, 2008)

**Efficient Resource Allocation:**

In a market economy, issues of securities help raise capital for projects whose outputs are in the highest demand by society, and those enterprises which are most capable of raising productivity. Thus, efficient enterprise management is rewarded by access to investment funds. (Tessema,2003) Without securities markets, companies must rely on internal resources (retained earnings) for investment funds, on bank financing or on government grants or subsidies. Such forced reliance on self-finance penalizes young companies whose products may have greater future demand. These new and growing enterprises often have little in the way of retained earnings. Bank lending to certain specified sectors (referred as priority sectors) leads to inefficient resource allocation and widespread loan delinquencies. The prevalence of these problems reduces the level of investments, productivity of capital and the volume of savings. Even if government grants and subsidies are available, they tend to introduce market imperfections that contribute to the distortion of financial prices. These imperfections subvert the positive allocation role of securities markets. Securities markets create better opportunities for small emerging companies to raise funds in the venture capital market since venture capitalists would be more comfortable investing in new ventures with the knowledge that possible future divestment can take place through a public offering at a potentially substantial profit.

**Competent and vibrant Financial System:**

Securities markets break the oligopoly that would be enjoyed by the banks in the absence of securities markets. Securities markets provide impetus for the establishment of financial prices based on scarcity values rather than on administrative fiat. Such market-determined financial prices and investment options, in turn, attract more savings, creating a virtual circle of innovation and mobilization that contributes to the overall efficiency of the financial system. (Tessema, 2003).

**Investor Education:**

Stock markets through the brokerage community, investment advisers, security analysts, and well-developed financial journalists serve to educate the investing public. Such institutions are critical to an economy. (Etienne and Vincent, 2008) Such educated investors will help in reducing unfair trade practices in securities markets. Efforts of stock brokers to accumulate wealth by speculation and short selling can be mitigated through investor education.

**Barometer of the Economy:**

At the stock exchange, shares rise and fall depending, largely, on market forces. Share prices tend to rise or remain stable when companies and the economy in general show sign of stability. Therefore, the movement of share prices can be an indicator of the general trend in the economy. (Etienne and Vincent, 2008)

**Alternative to Taxation:**

The Government and even local authorities may decide to borrow money in order to finance huge infrastructure projects by selling another category of securities known as bonds. These bonds can be raised through the bond markets whereby members of the public buy them. When the Government or the local authority gets this alternative source of funds, it no longer has the need to overtax the people in order to finance development. (Etienne and Vincent, 2008)

**2.1.3. Determinants of Stock Market Development**

In recent years exploring what determines stock market development has become a prominent area of research. Generally, the existing literature outlines two sets of factors affecting the development of stock / financial markets: “macroeconomic factors” and “institutional factors”.

Macroeconomic factors include economic development level, inflation and capital flows, etc., while institutional factors include variables that reflect the state of regulatory and supervisory institutions, such as legal frameworks and the protection of property rights,

etc. It is worth mentioning that these two sets of variables are interrelated. For instance, the evolution of the institutional environment is directly reflected in macroeconomic conditions and, by the same token, a favorable macroeconomic environment facilitates the development of institutions. Consequently, the mentioned division in the literature is, in the view of many, provisional, and does not imply alternative views on the determinants of stock/financial market development (Adarov and Tchaidze, 2011).

On the “macroeconomic factors” side of the question, the literature on stock market development has found that the more developed a country is, the more deeply entrenched will be its stock market (La Porta et al., 1997; Rajan and Zingales, 2003; La Porta et al., 2006). Several studies find that financial openness and liberalization increase stock market activity (Levine and Zervos, 1998b; Henry, 2000; Bekaert and Harvey, 2000; and Edison and Warnock, 2003). Garcia and Liu (1999) investigated the macroeconomic determinants of stock market development in a sample of Latin American and Asian countries. Their findings show that GDP growth, domestic investment and financial intermediary sector development are determinative in stock market development.

Domowitz and Steil (1999) highlight the direct impact of a reduction in trading cost on turnover and the much more important indirect effects of a reduction in trading cost on the cost of equity. Henry (2000) finds a strong relationship between the growth rate of investment and changes in stock market valuation measured by returns on the stock market, the turnover ratio, and the traded value as a share of GDP. On the other hand, McCauley and Remolona (2000) and Shah and Thoma(2001) find that the size of the economy is an important factor in the development of liquid and well functioning securities markets. Mishkin (2001) argues that financial liberalization promotes transparency and accountability, which reduces adverse selection and moral hazard. It thus tends to reduce the cost of borrowing in stock markets, which eventually increases their liquidity and size. A large pool of studies has investigated the impact of inflation on capital markets. An important finding of these studies has been that high levels of

inflation are associated with less liquid and smaller financial markets as financial intermediaries tend to lend less and allocate less efficiently.

Boyd et al. (2001) find negative effects of inflation on private credit and equity markets. Interestingly, they argue that the relationship between financial development and inflation could be nonlinear, with a particular threshold level after which the financial sector experiences an abrupt drop in performance. Claessens et al. (2001) find that privatization programs and foreign direct investment contribute to stock market development. Further, Perotti and Oijen (2001) argue that privatization has an indirect positive impact on stock market development through political risk reduction.

Yartey and Adjasi, (2007) found that financial intermediary sector development tended to increase stock market development in Sub-Saharan Africa, controlling for macroeconomic stability, economic development and the quality of legal and political institutions. In addition, Yartey (2008) has demonstrated that stock market development has a nonlinear relationship with banking sector development. That is, stock market development is initially supported by banking sector development through trade intermediation. Yet, as stock markets develop, they begin to compete with financial institutions in financing investment. In a later study, Andrianaivo and Yartey (2009) examined the impact of a range of macroeconomic factors on both banking sector and stock market development. Their findings show that stock market liquidity, domestic savings banking sector development and political stability are the main determinants of stock market development.

Overall, the range of economic factors underlying stock market development can be roughly aggregated to the level of economic development, the size of the economy in question, the level of financial openness, the inflation rate, privatization, domestic saving, banking sector development and economic growth. As for the “institutional factors” side of the question, the empirical literature shows that countries with better institutional framework tend to have more developed stock markets. North and Weingast (1989) show

that improved checks and balances, credible commitments and upgraded property rights in England during the seventeenth century led to the development of stable capital markets. Pagano (1993a) shows that regulatory and institutional factors could influence the efficient functioning of stock markets. That is, compulsory disclosure of reliable information and financial data on listed companies may increase investor participation, while regulations that enhance investor confidence in brokers could enhance investment and trading in stock markets.

Erb et al. (1996b) show that expected returns and the magnitude of political risk are positively related. They find that both in developing and developed countries, the lower the level of political risk, the lower and the required returns. The results suggest that political risk plays an important role in investment decisions and decreases the cost of equity, and consequently may have important implications for stock market development.

La Porta et al. (1997, 1998) argue that the origin of a country's legal system affects the level of financial development. A common law basis is more conducive to the development of capital markets than a civil law basis, as the flexibility of the common law legal system allows for protection of small investors. Moreover, they find that countries with a lower quality legal regime and poorer law enforcement exhibit smaller and narrower capital markets and that the listed companies on their stock markets are characterized by more concentrated ownership. La Porta et al. (2000, and 2002), Perotti and Van Oijen (2001), Galindo and Micco (2004) and Djankov et al. (2005) argue that strengthening property rights, credit protection and investor protection through company laws and commercial codes, as well as disclosure of companies' activities and proper accounting rules and practices are key determinants of the development of corporate securities markets.

More recent empirical research emphasizes as well the important role of access to international markets in fostering the development of local financial markets. Capital

account liberalization broadens the investor base, enhances efficiency by weeding out inefficient institutions and creates pressure to reform (Claessens et al, 2001).

Impavido et al. (2003) and Claessens et al. (2003) argue that the development and particularly the liquidity of financial markets depend also on the existence of a diversified class of institutional investors. Mutual funds, pension funds and insurance companies act as a stable source of demand for equity and debt securities. They foster competitiveness and efficiency in primary markets and create an incentive for the establishment of a robust regulatory and supervisory framework. In this regard, Catalan et al. (2000) examine the determinants of stock market development for OECD countries and for some emerging economies. Their findings suggest that, setting aside the issues of macro stability and legal rights, contractual savings institutions positively affect stock market development.

Yartey and Adjasi (2007) shows that political risk and institutional quality are strongly associated with growth in stock market capitalization. The results suggest that the establishment of quality institutions can be an important factor in the development of stock markets. Other institutional factors as well, such as law and order, democratic accountability and bureaucratic quality are important determinants of stock market development.

Chami et al. (2009) argue that financial markets will develop if borrowers and lenders are willing and able to enter into contracts, and liquidity providers find conditions conducive to trading created financial instruments. They also emphasize the importance of regulatory structure in supporting this process by removing obstacles that render potential borrowers, lenders and liquidity providers unwilling or unable to play their roles and by creating an appropriate incentive for each agent to fulfill their end of the bargain.

The key insight of the strand of research that emphasizes the role of institutional framework in the development of stock markets identifies the following factors: political stability, quality of legal institutions (particularly with respect to investor protection), law

enforcement, disclosure of reliable information and a diversified investor base. It is worth highlighting that while the literature has examined a variety of macroeconomic and institutional factors, the marginal impact of each individual factor is difficult to isolate as they are, of necessity, interrelated, and the causality relationship between them and stock market development is a complex process to unravel.

## **2.2. EMPIRICAL REVIEW**

### **2.2.1 Economic Growth and Stock Market Developments**

The importance of stock markets in both developed and developing economies of the world has shifted the research focus to identify the cause and effect relationship between stock market development and economic growth over the last few decades. Since late 1980s there has been significant development in emerging stock markets particularly; in terms of market capitalization, listed companies and shareholders. El Wassal (2005) notes that the emerging stock markets capitalization has increased 32 times and developed stock market's capitalization has increased only 11 times between 1980 and 2000. This shows the expansion of emerging stock markets capitalization is almost three times larger than expansion of developed stock market's capitalization. It is often debated that if stock market can predict the economy growth or vice versa. Economists (e.g., Jefferis and Okeahalam, 2000; Shirai, 2004; Adajaski and Biekpe, 2006; Mun et al., 2008) believe that larger increase in stock prices is reflective of future economic growth, and large decrease in stock prices is an indication of future economic recession.

Levine and Zervos (1996) examined whether there is a strong empirical connection between stock market development and long run growth for forty-one countries by using data from 1976 to 1993 on real per capital average growth and stock index. Results of cross country growth regression suggest that a pre condition of stock market development is positively and strongly associated with long run economic growth.

Mun et al. (2008) tested the causal relationship between stock market and economic activity in Malaysia for the period of 1977 to 2006. Their study used annual data on real GDP and Kuala Lumpur Composite index (KLCI), results from Granger causality test indicated that causality runs from stock market to economic activity and not the other way around. Pearce (1983) study showed that stock prices could lead the direction of the economy. His study was carried out for the time span of 1956 to 1983 for the U.S. and discovered that stock market is as an indicator of economic growth.

Empirical studies of Atje and Jovanovich (1993); Demirgüçüç Kunt and Levine (1996); Korajczyk (1996); Levine and Zervos (1996 & 1998) showed that there exists a strong positive relationship between stock market development and economic growth. Alam and Hasan (2003) find that the stock market development has a sizeable positive impact on economic growth in the case of US. In a similar study by Agarwal (2001) investigated the relationship between stock market development and economic growth for nine African countries with cross sectioned data for the period of 1992 to 1997. His study documents a positive relationship between several indicators of the stock market performance and economic growth. Atje and Jovanovic (1993), Caporale et al. (2004), Adajaski and Biekpe (2006) also show that financial intermediaries usually have less information as compared to stock markets and these markets efficiently allocate the resources and enhance economic growth. Likewise, Filer et al. (1999) find that an active equity market plays an important role in promoting economic growth in developing countries.

Dailami and Aktin (1990) find that a well developed stock market can enhance savings and provide investment capital at lower costs by offering financial instruments to savers to diversify their portfolios. In doing so, these markets efficiently allocate capital resources to productive investments, which would eventually promote economic growth. The causal nexus between stock market development and economic growth was examined by Vazakidis and Adamopoulos (2009) for France for the period of 1965 to

2007. This study employed co-integration, Granger causality test and Vector error correction model; results indicate that there is a positive association from economic growth to stock market development and at the same time interest rate has a negative effect on stock market development. Similarly, Brasoveanu et al. (2008) have studied the correlation between capital market development and economic growth in Romania for the period 2000 to 2006. Results indicate that capital market development is positively correlated with economic growth by way of feed-back effect. However, the strongest link is from economic growth to capital market, signifying that financial development follows economic growth. Likewise, El-Wassal (2005) study also supports demand following hypothesis in 40 emerging economies, where emerging stock markets development is determined by economic growth, financial liberalization policies and foreign portfolio investment.

Arestis et al. (2001) have investigated the relationship between stock market development and economic growth, controlling the effects of banking system and stock market volatility by utilizing time varying quarterly data from five developed economies (France, Germany, Japan, United Kingdom and United States) for the time span of 1968 to 1998. Results addresses that both stock markets and banks seems to play an important role in promotion of output growth in France, Germany and Japan but in case of United Kingdom and United States the link between financial development and growth found to be statistically weak. Study concluded that bank-based financial systems may able to promote long-term growth than capital market based ones. Oskooe (2010) also systematically investigated the relationship between stock market performance and economic growth in Iran by using real GDP and stock price indices for the period of 1997 to 2008. Results of the study indicated that stock price movements are influenced by the level of real economic activity in the long-run and in the short run stock market plays an important role as a leading economic indicator of future economic growth in Iran.

There are some other studies addressing about diversification of risk and economic growth, for instance; Pagano, (1993) study stated that a sound performing and liquid stock market that ultimately allows investors to diversify away unsystematic risk, which eventually turn to encourage the marginal productivity of capital. Obstfeld (1994) has pointed out that international risk sharing by way of internationally integrated stock markets can advance the allocation of resources and accelerates the process of economic development. In the same way, Korajczyk (1996) study finds that internationally integrated stock markets tend to amplify capital accumulation and have positive association between stock markets integration and economic growth. Gupta and Donleavy (2009) also investigated the benefits of diversifying investments into emerging markets. Results show that despite increasing correlations, there are still potential benefits for Australian investors who diversify their investments into emerging markets. Contrary, studies of Shleifer and Summers (1988); Morck et al., (1990a) showed that stock market development would lead to harm the economic growth by easing counterproductive corporate takeovers. In a similar fashion, Devereux and Smith (1994) study also specified that greater risk sharing through internationally integrated stock markets can minimize saving rates and that would decelerate the economic growth. Some other empirical studies (Bencivenga and Smith, 1991; Naceur and Ghazouani, 2007; Adajaski and Biekpe, 2006) who could not determine any significant relationship between stock market development and economic growth, particularly in developing countries. Likewise, Barro, (1989) study also found evidence that stock market development doesn't support as a leading indicator of economy. Tuncer and Alovast (2010) as well examined stock market growth and found that a positive correlation between stock market development and economic activities. According to Agarwal (2001) the study of stock market development and economic growth in African countries revealed a positive relationship between different indicators of the stock market performance and economic activities.

### **2.2.2. Stock market Overview in Africa**

Over a decade, Africa has been receiving a growing attention and investment opportunity from foreign investors to invest in Africa but still there are challenges which hinder sustainable economic growth and development (Senbet L., Otchere I., 2008). Some of the challenges may be one of the factors which affect also the sustainable growth of capital markets as well as stock exchange markets in Africa. However, the increase in the number of stock exchange in Africa has been derived from the expansion and reformation of financial sector undertaken by African countries to improve the economic environment. This process of reformation has been undergone different measures on restructuring and privatization of state owned banks, promotion and development of capital markets, interest rate liberalization and credit ceilings. In addition, globalization has been part of the process which accompanied and stimulated by technology and innovation as a result of the integration between Africa and the rest of the globe.

According to Levine (1997), the past two decades, stock exchange market liquidity has been a catalyst for long run growth in developing countries. He further argued that without a liquid stock market, many profitable long term investments would not be undertaken because savers would be reluctant to tie up their investments for long periods of time. In contrast, a liquid equity market allows savers to sell their shares easily, thereby permitting firms to raise equity capital on favorable terms. By facilitating longer-term, more profitable investments, liquid market improves the allocation of capital and enhances prospects for long-term economic growth. However, the increase in the number of stock exchange markets in Africa has been derived from the expansion and reformation of financial sector undertaken by African countries to improve economic environment and stimulate economic growth. This process of reformation has been undergone different measures on restructuring and privatization of state owned banks, promotion and development of capital markets, interest rate liberalization and credit ceilings. In addition, globalization has been part of the process which accompanied and

stimulated by technology and innovation as a result of the integration between Africa and the rest of the globe. Despite that Africa has been receiving a growing attention and investment opportunity from foreign investors to invest in Africa but still there are challenges which hinder sustainable economic growth and development (Senbet L., Otchere I., 2008).

The research paper conducted by Ziorklui, (2001) on capital market development and growth in Sub-Saharan Africa on the case of Tanzania which is funded by United States Agency for International Development Bureau for Africa office of sustainable development with the objective of examining the various problems that constrain the development of functioning capital markets in Sub-Saharan Africa countries in general and Tanzania in particular. That study shows as there is the linkage between capital market development and the real sector growth, regional integration and globalization of the capital market with policy implications and as the change in policy have an impact on equity and poverty alleviation in Tanzania. To this end, Tanzania achieved her capital market development with the establishment of the Dares Salaam Stock Exchange (DSE) in 1998 for the purpose of deployment and distribution of long-term capital to the private sector and hence, both the policy changes and various relevant reform laws have had positive influence and challenges on the capital market development in Tanzania. To that extent, with establishing her capital market, Tanzania benefited largely because even after one year of its establishment, four companies were listed on DSE and three of them have raised a combined equity capital of US \$35.71 million in the primary capital market and the remained company which is the East African Development Bank has raised an amount of US \$12.5 million by issuing a four-year corporate bond. According to that study however, though this country have largely benefited from the capital market development, this is not without some difficulties because there were different side effects such as decline of credit to the private sector that can be emanated on the reduction in growth potential and poverty alleviation due to slow stride of rearranging the

misshapen banking sector, shortage of rivalry among the financial segment, infancy of the capital market structure which can be expressed on the illiquidity, infrequent trading, and fewer listings of private companies, the devaluations of country's currency and sneaking inflation were the common problems among Tanzania.

Another study conducted by Wilson, (2012) on the current status and future potential of capital market development in North Africa considering the stock exchanges in Cairo, Casablanca, Tunis and Tripoli and analyzing the trading volumes and price trends reveals as capital market development in North Africa have a long history though the limited breadth and depth are the common but they have been marginal to the region's development. Hence, according to this study, there is under-development of both sovereign and corporate bonds in North Africa nevertheless they complement equity financing since raising equity finance plays a crucial role for the expanding and flourishing the private sector. The study also shows there were adequate legal and regulatory provisions, but both domestic and foreign investors lack confidence on such market and there is adverse influence of the global financial crisis and the Arab Spring on the North African capital markets.

The book chapter published from the national, regional and international challenges of Africa in the World economy by Kitabire, (2005) with the title of capital market development for Uganda's experience shows that the greatest trouble challenged by the governments of developing countries was their inability to borrow abroad in domestic currency and borrowing at home with long term maturity periods in order to finance their fiscal deficits. To that extent, the development of bond market enables them to close such wide gap and smoothies the well-functioning of capital infrastructure development. But the author recommends that for the priorities of the Uganda's development of capital market, bond market development should not be considered as urgency, so long as long-term bonds are not needed to finance the fiscal deficit. So, such primacies for capital

market development would be given to pension sector reform and expansion of micro finance provision.

The African Economic Policy discussion paper conducted by Ziorklui, (2001), on the development of capital markets and growth in Sub-Saharan Africa with special reference to Ghana reveals as the establishment of the Ghana Stock Exchange (GSE) has provided an opportunity for corporations to raise long-term capital of \$125.8 million from 1991 to December 1998 and given opportunities for investor diversification since the number of listed companies from 11 in 1989 increased to 21 during the same period though both the financial institutions and the capital markets were underdeveloped due to institutional, and structural weaknesses and the challenges of regionalizing and globalizing capital markets itself. However, from the period of 1997-2000, the lack of sustained capital investment becomes the major obstacle to sustainable growth in Ghana. Hence, the development of capital market supported by policy environment enables and helps the Ghana's government to finance their fiscal deficits. Therefore, the paper recommends that the value-added tax (VAT) exemption from stock transaction applications since that period's tax regime favors short-term investments in Ghana.

The article published on spyghana by Anzagra, (2014) entitled emerging opportunities for Africa's development financing through the capital market reveals as the development of capital market becomes a vital and feasible substitute to that of traditional financing sources of Africa's development and it is also the most energetic means of nourishing its present growth thrust by yielding better returns. In addition to that, market intelligence provides as much more countries of the world have commissioned to the international capital markets especially after the recent world financial crises of 2007/08 and superfluous countries has shown their interest and some are planned to join such market. The study of Gup, (2005) and some other recent economic research shows as large, efficient capital markets promote rapid economic growth and they have documented a direct link between capital market development and economic growth. Due to the context

of globalizations, launching of multinational corporations or companies and the effort of technological advancement in the future, the existence of international capital market becomes the reason for the existences of the world countries as a whole without the favor of their development level. This can be reasoned out that the economy of both developing and that of developed country can be highly influenced by such large multinational companies no matter where their continent or country was. For instance, by 1990 which means only two and half decades ago, the combined sales of multinational corporations these ranked above 200 from the world's corporations have largely influenced and shaped the world economy by yielding about 28.3% of the world GDP. Hence, for the matter of their presence, to generate capital and maintain their own sustainable growth, more developing countries especially these of African countries will need to enter into such international capital markets.

### **2.2.3. Stock Market in Ethiopia**

In the Ethiopian context, the historical development of stock market traces its roots back to the Imperial period. In 1897 Emperor Menelik II sold share in France to raise part of the 40 million francs needed to build the Ethio - Djibouti railways line. In 1906 the first bank in Ethiopia, Abyssinia Bank, floated its share in Addis Ababa, New York, Paris, London and Vienna.

From 1960 to 1974 share companies were flourishing and share were traded by the National Bank of Ethiopia through the Addis Ababa share Dealing Group. Addis Ababa Bank, Ethiopia abattoirs, Bottling Company of Ethiopia, Indo – Ethiopian Textiles, HVA Ethiopia, and Tendaho plantations were some of the share companies whose share were publicly traded during that time. All the companies were nationalized in the 1974/75 socialist revolution that shattered the private sector led economy.

After the change of the socialist government in 1991, attempts were made to re-establish stock exchange market in Ethiopia by interested parties like the Addis Ababa Chamber of Commerce and Sectoral Associations. According to Ruecker (2011), in 1995, the

National Bank of Ethiopia undertook a study on the Feasibility of Establishing of Securities Exchange Market in Ethiopia and also prepared a draft securities and exchange proclamation which are awaiting government endorsement.

Different seminars and studies were undertaken by different scholars which emphasized on the necessity of having capital market in Ethiopia. In 1995, a group of entrepreneurs organized as the Ethiopian Share Dealing Group under the Addis Ababa Chamber of Commerce and Sectoral Associations initiated a share dealing group similar to the former Addis Ababa Share Dealing Group of 1974. The group initiated the development of a Stock Exchange rules and regulations as well as bylaws of a share dealing group, and commissioned Ernst & Young to develop an international standard rules and regulations manual. (Ruecker 2011)

In 2008, the NBE launched a capital market infrastructural development study by international consultants under the Financial Sector Capacity Building Project. The study included capital market infrastructure development in Ethiopia. This initiative was financed by the World Bank (WB) based on the potential interest of the government of Ethiopia. According to the WB Ethiopia Office and the Project Unit at NBE, the study is under review by the concerned government body. (Ruecker, 2011) Despite the attempts described in the previous paragraphs, Ethiopia does not have a stock exchange market nor does it allow companies to be listed in foreign countries until now. Due to this, share trading has been carried out through various means like part-time brokers or through the invested companies or the seller has to find buyers by him, exposing the seller to unfair prices and delays. This is not because of the lack of buyers and sellers in the market; rather, it is because of the lack of the proper institutions that could facilitate the trade. (Tsegaye, 2007)

#### **2.2.4. Prospects and challenges of Share markets in Ethiopia**

While reviewing the literatures in relation to the prospects and challenges for establishment of stock exchange in Ethiopia, the study made by Tessema (2003)

indicated that many prospects (opportunities) for developing securities markets exist in Ethiopia. The prospects mentioned include: Ethiopia has considerable unexploited resources and is considered as one of the largest potential markets in Africa; Ethiopia's process of transition from a centrally planned to a market oriented economic system and the process of economic liberalization underway is encouraging; the privatization efforts going on would help with the supply problems, particularly if a public offering of shares is used as the method of privatization; the existence of many profitable companies, which can potentially benefit from floating shares to the public; the existence of institutions like the country's pension fund, insurance companies, credit unions, etc., with large sums of money. If allowed to invest, they would boost the demand for securities; the gradual improvements of the incentive packages in the successive investment proclamations help attract new investors including Ethiopians with foreign passports. Similarly, Teklay (2011) stated prospects as including the current scenario in share buying is a testimony of the existence of demand and supply sufficient to begin the long journey: the government has consistently maintained that the macroeconomic situation is reasonably stable and there are already some legal pronouncements, which can be reinforced a little more for a start.

Further on the issue of opportunities, Reucker (2011) has identified the following in his study:-

- ❖ The agenda of poverty eradication turned into a national growth and transformation plan
- ❖ Macro-economic development is positive
- ❖ Economic growth and human development is increasing consistently
- ❖ Capital market provides services to the economy that are crucial for long-term economic development.
- ❖ Ongoing and future privatizations stipulate additional capital needs
- ❖ Efficient stock pricing through competition and market

- ❖ Capital market promotes Private Sector Development, which is seen to be crucial for the economic development.
- ❖ De-concentration of ownership could be seen as a democratic measure by the Government of Ethiopia
- ❖ Accession to World Trade Organization
- ❖ Capital market increases liquidity by supporting the placement of government bonds
- ❖ Capital market mobilizes local savings
- ❖ Capital market could increase remittances as an additional capital to FDI
- ❖ Capital market leads to transparency

Additionally, Teklehaimanot (2014), after studying the potential beddings and constraints in the establishment of stock exchange markets in Ethiopia, has indicated economic growth, privatization scale-up, increasing capital inflow, negative real interest rate, inclination to incorporated enterprises, the establishment of Ethiopian Commodity Exchange (ECX) and energy expansion as some of the motivating matters for the establishment of stock exchanges in Ethiopia.

Challenges are also highlighted by different writers. Solomon (2011) stated Ethiopia currently faces the following problems and the creation of securities market is justified by its potential to solve these problems.

- Bank loans are usually given on short term basis and most private companies suffer from high leverage, less access to finance as banks usually require huge collaterals due to high NPLs of banks. The securities market can fill the gap by allowing direct formation of equity and debt capital.
- The country has limited share of foreign capital investment which forces the utilization of domestic resources to finance investments. The securities market can facilitate the mobilization of domestic resources to meet the need.

- Both the government and a large number of private companies have already issued securities to the public and these have lacked market for secondary trading. The issuance, transferability, liquidity and proprietary value of all these securities has, however, become severely weak due to absence of securities market.
- Excess liquidity and reserve of banks are kept idle which could have been invested in securities markets. The securities market can help the banks and the NBE to mop up and manage their idle fund during this situation.
- The country's financial market is limited being dominated by banks, MFIs and insurance (Edir and equib). It lacks investment banks, mutual funds, private pension companies, and venture capital companies that can pool and share risk and offer alternative channels for saving and investment as institutional savers and investors which remained to be informal and piecemeal.
- Most of the business organizations in the country suffer from narrow ownership base and inability or lack of motivation to go public. The majority of the business organizations have also suffered from non-separation of ownership and management as a result of their narrow ownership base and inability or lack of motivation to go public. Creation of the market can curb the problem by encouraging the business organizations to go public and stimulating competition.
- The flow of information and corporate management, accounting and control is severely limited. Most business firms do not keep operational reports and formal books of accounts. Creation of the securities market can change the situation by stimulating competition and increasing the need for enhancement of corporate governance by at least those which want to raise finance through it.
- Individuals and businesses have limited source of income and investment options. The securities market can assist the country to curb the problem by serving as alternative investment channel. Solving the problem will also be in line with the poverty reduction goal of the country.

- Although the country has privatized several state owned enterprises, the privatization has been made through direct sales to individual buyers. Creation of the market is necessary to facilitate future privatization. However, lessons learnt from many countries as a late comer and the current economic and social development in Ethiopia will prove the betterment of opportunities than the effect of threats.

Similarly, Tessema (2003) identifies different challenges for establishment of stock exchange including: low level of public awareness about securities markets; Lack of public confidence in share investment; Lack of institutional capacity to facilitate securities trading; The underdeveloped state of the bond (debt) market; A low level of private sector development and a low level of market orientation in the economy; Easy access to loans by wealthy and financially sophisticated Ethiopians, and probably those with a strong link to the party ruling the country; Problems with the supply and demand for securities at least initially and absence of input by the business community in the formulation of economic policy by the government.

In addition to this, Teklay (2011) states that the current state of affairs does not make the country ready for a full-fledged stock market. Besides, Reucker (2011) made market potential assessment for successful establishment of stock exchange market in Ethiopia, The study evaluated the country's situation from different angles; such as, government commitment, macroeconomic conditions, corruption and transparency, the business environment, foreign investment, legal and regulatory infrastructure, accounting and auditing practices and market conditions. The study examined the internal and external environments and puts the threats in the establishment of stock markets in Ethiopia. These are, high level of poverty, volatile macroeconomic and political environments; legal, regulatory, accounting, tax, and supervisory systems influence stock market liquidity; lack of awareness and willingness among Ethiopian policymakers; oligopoly position of Ethiopian banks in the financial system, Ethiopian banks are highly reliant on

loan income, poor savings culture, no access for foreign investors and financial institutions, and therefore less flow and international awareness, African stock markets are generally small, illiquid, with infrastructural bottlenecks and weak regulatory institutions, lack of liberalization of the financial sector, low implementation capacity on the part of the government serious demand in knowledge, training and education, some of the potential market participants see the private sector as weak, disorganized, short-term oriented, emotional and non-systematic.

Further, Teklehaimanot (2014) states that many challenges for establishment of stock market in Ethiopia. The challenges are government's reluctance; the underdeveloped infrastructure, like the legal and regulatory frameworks, media, ICT; immature financial sector, uninformed and small base investors and shortage of professionals. To conclude, from review of literatures, for an efficiently operating stock market to exist in a country, the factors that need to get the necessary attention are government commitment, policies and laws; availability of market participants; the legal and regulatory framework that protects the rights and interests of shareholders; macroeconomic` policymakers; oligopoly position of Ethiopian banks in the financial system, Ethiopian banks are highly reliant on loan income, poor savings culture, no access for foreign investors and financial institutions, and therefore less flow and international awareness, weak regulatory institutions, lack of liberalization of the financial sector, low implementation capacity on the part of the government serious demand in knowledge, training and education, some of the potential market participants see the private sector as weak, disorganized, short-term oriented, emotional and nonsystematic.

# CHAPTER TREE

## Research Design and Methodology

In this chapter, I discuss the research design, research method, sample design, source data, data collection method, and instrument for data collection, validation of the questionnaire, method of data analysis and ethical consideration.

### 3.1 Research Design

The researcher used quantitative type research approach with descriptive research method. This is because the main purpose of the study is to describe the prospects and challenges of stock market establishment in Ethiopia. Furthermore, sample survey research method was used because the population to be studied is large.

### 3.2 Research Approach

The quantitative aspect of the research method aimed to obtain data needed to describe the prospects and challenges in Ethiopia. Hence, survey design (questionnaire and interview) were applied for this study. A survey design provides a quantitative or numeric description of trends, attitudes, or opinions of a population by studying a sample of that population. From sample results, the research generalizes or makes claims about the population.

### 3.3. Sample Design

The sampling frame of the organizations for this study was selected systematically, based on the list of specific functions expected to generate information. For this purpose, respondents were drawn from different level, Addis Ababa Chamber of commerce and Sectoral Association, Ministry of finance and economic Commission, National Bank of Ethiopia, Private Banks, Insurance Companies, and other credible sources through interview, questionnaires and also refer secondary data at large.

### **3.4. Source Data**

For the study, both primary and secondary data source were used. Primary data collected from the employees and managers of Addis Ababa Chamber of commerce and Sectoral Association, Ministry of finance and economic commission, National Bank of Ethiopia, Private Banks, Insurance Companies, audit firms, accounting institutions, share holders and other credible sources through interview, questioner and also refer secondary data at large. Whereas, secondary data also collected from books, reports, websites and Manuals.

#### **3.4.1 Data Collection Method**

In the study the researcher uses both primary and secondary data collection tools.

##### **3.4.1.1 Primary Data Collection Method (Tools)**

- **Questionnaires:** For shareholders (120), share company managers (10), academicians (10), Accounting and Auditing firms (10) and other stakeholders (10) a total of 160 both closed ended and open ended questionnaires were distributed to the selected respondents.
- **Interview:** unstructured and semi-structured interviews were conducted with Promoters of share companies, share company managers, accounting and auditing firms and other stakeholders.

##### **3.4.1.2 Secondary Data Collection Method**

The secondary data were collected through reviewing of materials, reports of the World Bank development indicators, CIA fact book, National Bank of Ethiopia reports and various government institutions like MOT, MOFEC, IMF database and various journals and literatures.

#### **3.4.2. Method of Data Analysis**

Descriptive analysis method is used in the study to analyze data. In order to arrive at certain conclusion and recommendation the data are tabulated. In each table the actual number and percentage, mean and standard deviation of the responses for each question

included. After each table, there is a discussion as to what quantifies data mean to the reader.

### **3.5 Measures for reliability and validity**

Reliability and validity are central issues in research (Neuman 2004). They represent the yardsticks by which the qualities of all kinds of research quantitative, qualitative or participatory are evaluated. The following sections explain how this was done, especially using the questionnaire surveys.

#### **1. Reliability**

The reliability of the results of this study materialized through a particular question relevant for the survey research that gave the same results when applied to different groups or samples.

#### **2. Validity**

The validity of the results of this study was ensured not only by the consistency of results but also by the quality of the questionnaire that was developed to measure all areas relevant to the research issue.

### **3.6 Ethical Consideration**

The information which was collected from the respondents was confidential and used only for academic purpose. In-addition, the researcher was not mention the name of the respondents, be neutral and not undermines the political, religious, and social attitudes of the respondents.

## **CHAPTER FOUR**

### **DATA PRESENTATION AND ANALYSIS**

The results from the analysis of data obtained from the survey are presented in this chapter. The data collected through survey questionnaire and interview was analyzed using descriptive statistics. Thus, percentage, mean and standard deviation are used in the analysis. Accordingly, the percentages show the frequency distribution of the variables, the composite mean value shows the average of all respondents' perceptions on a certain questions. While, standard deviation shows how diverse are the perceptions of respondents for a given questions.

For instance, deviation means that the data are wide spread, which implies respondents give variety of opinion while, low standard deviation implies respondent's close opinion whether positively or negatively. Based on these, the result mean score value and standard deviation of the study determined using rule of thumb that pertaining to the intervals for breaking the range in measuring variables that are captured with five point scale (that ranges from strongly disagree to strongly agree) is 0.8, which is actually found by dividing the difference between the maximum and minimum scores to the maximum score (Thumb, 2012). Hence, a calculated composite mean value that ranges from 1 to 1.80 implies strong disagreement, whereas the remaining ranges of 1.81 to 2.6, 2.61 to 3.40, 3.41 to 4.2 and 4.21 to 5.00 representing respondents perceptions of disagreement, neutrality, agreement and strong agreement respectively.

#### **Result of the survey**

In this study, the population comprises the management of share companies (10), academicians (10), Accounting and Auditing firms (10), other stake holders (10) and share holders (120) summing up to a total of 160 respondents as represented by the Table 1 below.

**Table4.1. The Selection of the Sample**

<b>Classification of sample</b>	<b>Sample size</b>	<b>Response received</b>	<b>Response rate</b>
Share company managers	10	7	70
Academicians	10	8	80
Accounting and audit firms	10	7	70
Other stake holders	10	6	60
Share holders	120	94	79.17
Total	160	122	76.25

Source Questioner, 2018

From Table 1, Share company managers questionnaires were 10 but 7 questionnaires were received given a response rate of 70%, in the case of the Academician 10 questionnaires were given out and 8 were received representing 80 % response rate, Accounting and Auditing firm were 10 of which 7 responses were received indicating a response rate of 70%,incase of other stake holders 10 questionnaires were given and 6 with response rate of 60% were received and share holders questionnaires were 120 of which 94 questioners were received given a response rate of 79.17%. A total of 160 questionnaires were distributed and 122(76.25%) questionnaires were received.

#### **4.1. General information of the respondent**

In this section the researcher tries to include age, sex, and educational level of the respondents. Table2. Depict the age, sex and educational level.

**Table 4.2. General information of the respondents**

Description		No of respondent	Percentage
Age	Below 25 Years	-	0%
	26-30 years old	22	18.033%
	31-40 years old	53	43.443%
	More than 40 years old	47	38.525%
sex	Male	96	87.23%
	Female	26	12.77%
Educational levelback ground	Illiterate	0	0%
	High school	16	13.11%
	Diploma	30	24.59%
	Bachelor degree	45	36.89%
	Masters or higher	31	25.41%

Source Questioner, 2018

As we can see from the above table there is no respondent in the age category below 25 years, 18.033%(22)of the respondents are between 26 and 30years old,43.443%(53) between 31 and 40years old and the remaining 38.525%(47)respondents are above 40 years old. In terms of sex of shareholders, 87.23% are male while 12.77% are female. In terms of educational back ground, there are no respondents who are illiterate, 13.11% of the respondents are high school complete, 24.59% have diploma, 36.89%hold bachelor degree and 25.41% have masters or higher qualification.

## 4.2 Benefits of establishing stock exchange to Ethiopia

To analyzed respondents view on the benefit of stock market, the study provide 12 related questions using five types of likert scale the scale indicated 1 for strong disagreement, and 5 for strong agreement ) the rest 2, 3, and 4 at the middle, agreement, neutrality and disagreement the responses are summarized in the following table.

**Table 4.3. Respondents view on benefits of establishing Stock market**

Potential Advantages	N	Strongly Agree	N	Agree	N	Neutral	N	Disagree	N	Strongly Disagree
It provides a ready market for investors to buy and sell their shares	35	28.69%	67	54.92%	20	16.39%	0	-	0	-
It serve as an alternate source of finance	38	31.15%	55	45.08%	22	18.03%	7	5.74%	0	-
It builds public trust/confidence to invest in share companies	27	22.13%	64	52.46%	26	21.31%	5	4.10%	0	-
It provides protection for investors which stems from sets of rules of regulators	26	21.31%	61	50%	35	28.69%	0	-	0	-
It contributes to country's economic development	40	32.79%	68	55.74%	14	11.47%	0	-	0	-
It necessitates the determination of true/fair price of shares of companies	37	30.33%	42	34.43%	28	22.91%	15	12.3%	0	-
It helps to attract more domestic and foreign investors	33	27.05%	49	40.16%	40	32.79%	0	-	0	-
Promote efficient financial system	42	34.43%	48	39.34%	32	26.23%	0	-	0	-
Allow de concentration of ownership	46	37.71%	51	41.80%	25	20.49%	0	-	0	-
Improve accounting and auditing standards	42	34.43%	62	50.82%	18	14.75%	0	-	0	-
provide effective tools for monetary and fiscal policy	28	22.95%	54	44.26%	31	25.41%	9	7.38%	0	-
Help privatization efforts by the government	32	26.23%	42	34.43%	28	22.95%	20	16.39%	0	-

Source Questioner, 2018

From those respondents 83.61% (102) respond that it provides a ready market for investors to buy and sell their shares;76.23%(93) of them said it serve as an alternate source of finance;74.59%(91) select it builds public trust/confidence to invest in share companies; 71.31%(87) reflect that it provides protection for investors which stems from sets of rules of regulators; 88.5%(108) of them said it contributes to the economic growth of the country; 64.76% (79) select it necessitates the determination of true/fair price of shares of companies; 67.21% (82) reflects that it helps to attract more domestic and foreign investors; 73.77% (90) respond that promote efficient financial system; 79.51% (97) respondent selects allow de-concentration of ownership; 85.25% (104) select improve accounting and auditing standards; 66.67% (81) respond provide effective tools for monetary and fiscal policy and 60.65%(74) selects help privatization efforts by the government. This implies that most of the respective respondents believe that establishment of stock exchange in our country at this time helps to easily sell and buy shares and it contributes to the economic growth of the country. And also in terms of building public trust, determining true/fair price of shares, providing protection for investors, attracting more domestic and foreign investors, providing effective tools for monetary and fiscal policy, promoting efficient financial system, improving accounting and auditing standards and helping privatization efforts by the government significant level of agreement was obtained from respondents as the benefit of stock exchange markets.

### **4.3. Assessment of Prerequisites to establish Stock Market**

For the successful establishment of a stock market in Ethiopia, it is essential that specific preconditions are in place. These are sufficient government commitment to stock market development, macroeconomic conditions that permit development and operation of such a market, and a reliable market environment which supports the operation of a fair, transparent and well regulated stock market in which investors will be willing to place their confidence.

Regarding the prerequisites to establish a stock market the study assessed respondents using structured questioner and the result of the respondents view and other relevant literatures on the area were discussed below

**Table 4.4. Respondents view on the Prerequisites to Establish Stock market**

<b>Factor Affecting Stock market Establishment</b>	<b>N</b>	<b>Mean</b>	<b>Standard Deviation</b>
Inadequate legal and regulatory institution	122	4.188525	.764198
Lack of efficient and independent judicial system	122	3.631148	.899088
Lack of financial literacy	122	3.606557	1.152391
Macro-economic situation of the country	122	3.45082	1.114165
Corruption and lack of good governance	122	4.434426	.842936
Low level of corporate governance	122	3.803279	1.088173
Lack of technology	122	3.877049	.755999
Low awareness level of the society about stock exchange	122	3.45082	1.54806
Prevalence of family – owned companies	122	3.852459	.789101
The Government lack of commitment	122	4.172131	1.083463

Source Questioner, 2017

### **In adequacy of the Legal and Regulatory Institution**

Strong institutions and a well-functioning legal system are critical for the development of stock markets because they provide the basis for the protection of investor rights, including minority interests, to attract widespread interest from investors and ensure that creditors are repaid in an orderly fashion.

Regardless of the legal basis of potential tradability of shares in Ethiopia, the Commercial Code and the subsequent proclamations fail to provide legal and institutional frameworks

for the prudent regulation of subsequent transactions of shares in an open market. There is no rule that sets the standard and requirements for listing and delisting of companies stock in the market. Thus, share issuing companies are operating traditionally under unregulated market. According to a capital market consultant, Ruediger Rucker, “the current situation of share issuing may threaten the prospect of capital market formation in Ethiopia. It may erode public credibility towards capital market in case of default.”

Thus, the pertinent question is how could Ethiopia harvest any perceived economic advantage from the stock exchange in the absence of legal and institutional frameworks that regulate stock market? Particularly, in the absence of mandatory disclosure requirements, shareholders could be deprived of the right to be informed and get relevant and timely information regarding the selling and buying of shares. Hence, inadequate rules on the supervision and regulation of stock trading may engender fraudulent brokerage in the process thereby affecting public confidence.

As confirmed by respondents in the above table with the highest mean score 4.188525 there is no an independent regulatory institutions that could facilitate stock market in Ethiopia. To establish a fair, orderly, transparent, and well-regulated capital market in which investors will be willing to place confidence, it is absolutely necessary establishing regulatory authority.

### **Lack of efficient and independent judicial system**

One of the major criticisms leveled against the justice system in Ethiopia is its lack of credibility in the eyes of the public. The distrust is by and large attributed to the non existence of impartiality and transparency within the system.

In a constitutional order the justice system is obliged to perform its duties independently and within its purview yet in a manner which respects the powers of the legislative and the executive branches of the government. If it is to carry out its functions free from executive interference it should be able to have the necessary human resource, budget, the latest technology and an environment which allows judges, prosecutors, attorneys and

other support staff to discharge their duties in compliance with the ethical standards of their respective professions.

Regarding the Ethiopian judiciary system, Ruecker (2011) stated that the most important provision regarding share issuing and trading is the 1960 Commercial Code of Ethiopia which is outdated and needs significant revision. Addis Ababa Stock Exchange Rules and Regulations Manual (Volumes I and II) were prepared in 1999. However, it is at a working draft level and not up-to-date. There is no system of civil courts where securities cases can be prosecuted by a dedicated governmental authority. There are no specific training programs to educate prosecutors and judges on capital market regulation, including corporate governance. There are commercial courts that specialize in hearing commercial cases, but there are no courts that specialize in hearing only securities law and company law cases. There are provisions in the jurisdiction's laws that may be used to prosecute securities violations. An independent judiciary works free from the interference of the political forces through proper enforcement of law. If the government officials twist the judiciary system to their advantage, one can say that the judiciary system is partial - both in the sense of being biased and in the sense of encompassing less than the whole. Hence, adequate and independent judiciary system fosters the economic, social and political development of the nation. The fact was supported by majority of the respondents of this study also as implied by 3.631148 mean value respondents.

### **Lack of financial literacy**

Financial literacy constitutes financial knowledge, financial attitude, confidence and ability in applying knowledge in the managing finance. It refers to the set of skills and knowledge that allows an individual to make informed and effective decisions through the understanding of finance. According to Asrat, "stock markets work most efficiently when brokers, dealers and the like are knowledgeable, professional, skillful, honest, and have sufficient training and resources to perform these functions". He further added that lack of a skilled labor force has been cited as one of the reasons why foreign investors are

not attracted to developing countries like Ethiopia. Lack of such trained human resources as accountants, lawyers, financial analysts, economists, etc could be a serious obstacle for running and managing securities markets, and security market activities in particular. This fact is also supported by majority of the respondents at average mean value of 3.606557.

### **Macro-economic situation of the country**

Macroeconomic stability is also a significant factor for the stock market development. With a higher macroeconomic stability, it is expected that more firms and investors can take part in the stock market. A corporate profitability can be influenced by changes in monetary, fiscal and exchange rate policies. Therefore, we assumed that countries which have a stable macroeconomic environment should experience stronger developments in their stock markets.

In line with the literature (Garcia & Liu, 1999), the effect of macroeconomic stability on market capitalization is measured by the real interest rate and current inflation.

Ethiopia is facing inflation, currency depreciation over dollar, unemployment, population increase and poverty. These factors may affect either indirect or direct economic stability of the country. For instance the inflation rate in Ethiopia was recorded at 14 percent in July of 2018 and averaged 16.09 percent from 2006 until 2018, reaching an all time high of 64.20 percent in July of 2008 and a record low of -4.10 percent in September of 2009. This inflation sometimes affects the purchasing power of the currency since the value of birr depreciates and hence affects trading in Ethiopia by increasing cost of trading. The currency depreciation over dollar also affects macro-economic stability of the country which leads to inflation. Basically, sustainable macro-economic stability may accelerate growth and performance of stock exchange by motivating investors to invest with positive expectation; also vice versa is true under "*Ceteris Peribus*". On the economic aspect of the country, respondent implied their agreement at a mean score 3.45082.

### **Corruption and lack of good governance**

Accordingly respondent agreed on the lack of good governance and the existence of corruption at a mean value of 4.434426, and also supported by scholars.

Myint (2000) defines corruption as the use of public office for private gain, or in other words, use of official position, rank or status by an office bearer for his/her own personal benefit. Examples of corrupt practices include bribery, extortion, fraud, embezzlement, nepotism, cronyism, appropriation of public assets and property for private use, and influence peddling. Despite countless policy diagnoses, public campaigns to raise awareness, and institutional and legal reforms to improve public administration, research shows that corruption continues to flourish and remained as a global challenge. A wide ranging prevalence of corruption is considered as one of the direct challenges against nations overall growth. In the case of Ethiopia, the survey conducted by Alemayehu (2008) clearly indicates that a number of firms pay bribes either in kind or in cash to run their businesses. The degree of corruption is relatively lower in Ethiopia compared with both regional countries and the total sample average. But much more needs to be done to make the business environment free from corruption because a significant number of firms perceive corruption as a major constraint. In relative terms, Ethiopia is an attractive place for domestic and foreign investors who are presumed to be active players in the financial market if established in Ethiopia. As a result it is possible to deduce that the threat of corruption is less compared to the regional countries but a lot shall be done to improve the situation.

### **Low level of corporate governance**

Good corporate governance is an important pillar of the market economy and it enhances investor confidence. A strong and balanced board of directors is necessary as a supervising body for the executive management of a company with dispersed ownership. The Ethiopian company law does not have adequate legislative provisions on governance issues related to the separation of supervision and management responsibilities, and on

the composition, independence and remuneration of board of directors in share companies. Besides, the draft Commercial Code has not yet been finalized.

There are a number of companies that are being formed by sale of shares to the wider public unlike most share companies in the past which were formed among founders. The emergence of publicly held share companies in Ethiopia gives rise to a multitude of issues on corporate governance. Typically, ownership separates from the control of dispersed shareholders and goes into the hands of few managers, which in turn creates the principal-agent relationship. In such situations, agents (managers) may misappropriate the principals' (shareholders') investments as they have more information and knowledge than the shareholders. Where there exist few block holders in share companies, minority shareholders could be exploited in the hands of such block holders. The agency problems that could occur between dispersed shareholders and managers and/or block holders of share companies in Ethiopia, therefore, necessitate good corporate governance laws and institutions.

Some scholarly works have been published recently on company law in general and corporate governance in particular by Ethiopian academics. Minga Negash (2008) observes that the status of corporate governance in Ethiopia is disappointing and notes that “the Commercial Code of 1960 does not provide adequate legislative response to complex governance issues of the day, and the new draft corporate law has not yet been finalized;” and he further states that “key international conventions, codes and standards are not ratified or adequately incorporated in the Proclamations” and that “the Decrees and Directives lack coherence and foresights, and at times suffer from poor drafting.”

Tewodros Meheret (2011) discusses the legal regime applicable to governance of share companies in Ethiopia. He explores the theoretical background and legal framework of corporate governance and examines the rules of governance in light of available standards. In particular, he discusses the structural choice, appointment and removal, powers, duties and responsibilities, remuneration, and the working methods and

mechanism for controlling the boards of directors. Tewodros states that “a share company is managed by its board which is composed of directors appointed by the general meeting of shareholders.”

The study conducted by the Addis Ababa and Ethiopia Chambers of Commerce and Sectoral Associations on corporate governance in Ethiopia suggests the introduction of a voluntary code of corporate governance in the country. It recommends that “corporate governance law reform should consider key development policy aspects which match with the country’s plans for poverty reduction and wealth creation.” The fact is also supported by the result of the research with a mean value of 3.803279 response rate.

### **Lack of technology**

As indicated in the table the respondent’s agree with lack of technology to establish the stock market in Ethiopia with a mean value of 3.877049. Currently use of state of the art technology is becoming a must to do efficient business in the world. However, a survey conducted by Alemayehu (2008) clearly shows that Ethiopian firms technology usage is poor compared to regional countries. To be specific Ethiopian firms seem less inclined to use the World Wide Web, and are very limited in the use of licensed technology, both by regional and the total sample standards. The World Bank survey indicates that only about 4 percent of the firms have both ISO certification and employ licensed technology which is about threefold less than the sample and the region’s average. This shows how weak Ethiopian firms are when it comes to use of technology and signify that it is one of the potential challenges of establishing financial markets.

### **Low awareness level of the society about stock exchange**

Most of the Ethiopian public is not familiar with negotiable instruments and also they do not know enough about the stock market. Generally, there is lack of information on the roles, functions and operations of the stock exchange. The lack of public awareness with stock markets is the major barrier to corporate participation in many African stock exchanges. The public should be sensitized about benefits associated with the securities

market and encouraged to participate in individual and collective investments. The government should also promote public education on investment.

On the level of public awareness of stock markets, 53.28% with mean value of 3.54082 and standard deviation 1.54806 agreed on the idea that the public awareness is low.

### **Prevalence of family – owned companies**

The structure of companies that are family owned is also an obstacle to the creation of a stock market in Ethiopia. Ethiopia has a large number of businesses that are family owned and which are likely to have enough resources to issue shares but whose managers may fear losing control by opening up their businesses to public ownership. Generally, the main factors limiting the supply of equities include the unwillingness of small, family-owned businesses to reduce ownership and the perception by many companies that the risks associated with additional disclosure are not adequately compensated by additional returns. Since banks do not require public disclosure like the stock market does, many firms would prefer to remain private limited company and source their capital from banks. As a result, these firms cannot be for any use to the stock market. Regarding this issue respondents agree with a mean value of 3.852459 and Standard deviation 0.789101.

### **The Government lack of commitment**

Regarding the level of interest or support the Government of Ethiopia has been showing towards the development of stock market, respondents have recognized the lack of government's interest as one reason which impacts the successful establishment of stock market in Ethiopia at the mean value of 4.172131.

#### 4.4. Supply and Demand Prospects for Securities Market Establishment In Ethiopia

The Ethiopian finance sector is dominated by the commercial banks (private and public) whose focus is on mobilizing short-term liabilities and extending short term loans. These banks have limited capacity and are less reliable to support Project Financing. The banks, expected to extend loans for projects with long-term pay back have limited resources of their own to sustainably support long-term credit supply to the economy. This clearly shows that a securities market is a missing element in the financial structure of the country (Yishak, 2000).

Regarding the demand of stock market the study assessed respondents using structured questioner and the result of the respondents view and other relevant literatures on the area were discussed below

**Table5. Respondents View on the Demand of Stock market in Ethiopia.**

Potential Demand of Stock market	N	Mean	Standard Deviation
The Institutional and individuals savers who put their money in the bank and buying a treasury bill with less interest rate imply the demand for stock market.	122	4.393443	.828794
The traditional form of asset holdings practice in Ethiopia is the implication of lack of Stock market computation on the country.	122	4.139344	.816317
To cop up with challenges of inflation savers need to invest on an opportunity investment like stock market.	122	3.418033	1.011015
The mismatch between the low interest rate for saving and high interest rate for loan is the implication of lack of Stock market computation on the country.	122	3.639344	1.004663

Source Questioner, 2017

#### Individuals and institutional savers

The study assessed the demand implication of stock market on the need of savers choice where to invest their money to get good return. Accordingly, the study invited respondents to give their view on institutional and individuals savers who put their money in the bank and buying a treasury bill with less interest rate due to lack of

opportunity, Accordingly respondent agreed on the idea at a mean value of 4.393443, they explained that, under the current legal and policy environment, small savers have limited choice how to hold their savings. The main avenue for them is to put in the banks in the forms of saving and time deposits. The size of private companies and individual saving in the banking sector is surpassing the ongoing liberalization process. What does this imply? The savers are either motivated by the rate of return offered by the banks or the protection motive. If a well functioning and rewarding stock market is established, both of the motives will be satisfied with the stock market.

### **Asset portfolio adjustment**

Thus far Ethiopians used to hold their assets in the form of cash, bank deposits, physical assets in the form of land, buildings, livestock, precious metals (like gold, silver), vehicles, and hard currency. These are the traditional forms of asset holdings available to Ethiopians. Establishment of stock market will create another form of asset holding and incentives to diversify asset portfolio for individuals and companies. Investors can buy stocks of listed companies and diversify their investment. Besides to portfolio adjustment, the stock market transforms resources from passive forms of asset holding to more active and productive activities and long-term investments. In this regard the respondents agree with a mean value of 4.139344.

### **Importance of Stock Market to cop up with Inflation**

The study also assessed the demand implication of stock market of the country to minimize inflation problem. Accordingly, the study invited respondents to give their view for the provided question such as, to cop up with challenges of inflation, investors or individuals need to invest on an opportunity shareholder investment. Accordingly respondent agreed on the idea at a mean value of 3.418033, they explained that, high rates of inflation in the country increase the cost of living and causes a shift in resources from investments to consumption. This leads to a fall in the demand for market instruments and subsequently leads to a reduction in the volume of stock traded. Also the

monetary policy responds to the increase in the rate of inflation with economic tightening policies, which in turn increases the nominal risk free rate and hence raises the discount rate in the valuation model.

### **The mismatch between the low return interest from saving and high interest rate for loan**

The study assessed the arguments that the mismatch between the low return interest from saving and high interest rate for loan is the implication lack of Stock market computation in the country. Accordingly, respondents of the study implied their agreement at the highest mean value of 3.639344 with a few respondents which implied their disagreement represented at Std. deviation 1.004663. The responses show that the competition among financial institutions/banks in providing balance saves and loan interest is weak in Ethiopia. According to this Idea a Study Alemneh (2016) implied that, there is large gap between deposit rates for savers (which tend to be very low) and interest rates for borrowers (which tend to be very high). Establishing stock markets cultivates channels for firms to issue various debt instruments and raise equity, while simultaneously providing more long-term options for saving and asset management for investors that will benefit enlarging economies by increasing market efficiency.

### **Assessment on Supply side (issuer base) of Stock market**

Issuer base refers to the potential number of issuers of securities and the amount of capital to be raised. In Ethiopia there are several types of Implication of stock market establishment potential suppliers (issuers" base), the study assessed respondent and potential implication of the need to establish financial market in Ethiopia. Below in the table implied respondent view on the potential implication of stock market potential suppliers.

**Table 6. Respondents View on the supply of Stock market in Ethiopia.**

<b>Potential supply of Stock market Analysis</b>	<b>N</b>	<b>Mean</b>	<b>Standard Deviation</b>
Privatization	122	4.016393	.852644
Existing share companies	122	4.213115	.632841
Growing economy of the country	122	3.639344	1.29271

Source Questioner, 2017

### **Privatization**

The Government announced state-owned enterprises, including the railway and the sugar corporation, will be partially privatized while Ethiopian state-owned monopolies in the sectors of aviation, telecommunications, and logistics will be opened to the private sector through the sale of minority shares.

Previously different scholars criticized the privatization scheme of the government. Because it didn't contribute to the formation of private corporations/share companies as Government of Ethiopia transfers the public enterprises only via the open bid/tender to selected investors not to the general public on share basis. Therefore, the government stand is good opportunity to the potential investors to participate in this investment. The respondents also agree with this idea with a mean value of 4.016393 and standard deviation of 0.852644.

### **Existing share companies**

The private sector involvement in the economy may take the form of share companies. It is undisputed that share companies play a significant role in today's economic world. A share company is a form of business organization where, in most instances, a large group of people invest cash or in-kind contributions in a company (administered by strangers) in return for units of ownership representing a proportion of the company's capital in the form of shares (Bahakal and Micael, 2013). Despite the vital role share companies play in the economy, the peculiar nature of shares in Ethiopia is their illiquidity. Rather than

being an instrument frequently traded in the market, Ethiopian shares are mostly locked in the drawers praying for dividends which may or may not come and later inherited to successors if the company does not die earlier than the owner of the share. Where, to whom and at what price would a shareholder sell his/her shares? Some possibilities of disposing shares exist under the law, but the implementation is lacking. The present understanding of share companies in a global scale acknowledges the importance of such business structure for a nation's economy. It is believed that share companies could be a strong arm of the nations economy if properly regulated in order to attract shareholders, protect their interest and boost their confidence. The results of the survey also support this idea with the mean value of 4.213115.

### **Growing Economy of the country**

Ethiopia has been registering an enticing economic growth and it is one of the fastest growing in the world notwithstanding the global economic shock and financial crisis. According to the government official reports, the country has been growing at about 10.8% between 2005 and 2013, where the country has been enjoying sustained economic growth in the past years (African Economic Outlook, 2014). Comparing the average yearly GDP growth of Rwanda, Kenya and Uganda for the same period of 8.2%, 4.8% and 6.7%, respectively (African Economic Outlook, 2014), Ethiopia's yearly economic growth is the highest in the Sub Sahara African countries. This stimulates foreign investors and the Ethiopian Diaspora to invest in diverse investment potentials including agriculture, manufacturing, tourism and others investment opportunities open for foreign investors. This increasing trend of investors prefer to establish large scale companies through issuing shares in an initial public offering to take the advantages of corporations. Based on the survey, these entrepreneurial and forward looking investors of the Ethiopia Diaspora are perpetually putting a pressure on the government to establish a stock market. The issue is supported by the respondent by a mean value of 3.639344 and standard deviation of 1.29271.

#### **4.5. The role of Accounting and Auditing in the Development of Stock Market**

The development of stock markets requires a careful and effective monitoring and financial control. Accounting and auditing are important controlling tools in developed economics. As an example, accountability of managers and response requesting of investors and creditors is carried out through accounting information and reports. Accounting and auditing society has well passed these tests of applying financial controls. Development of capital market depends on not manipulated prices system, not pretermitted transparency and reliable information in an efficient market. That is impossible without accounting and auditing profession in the heart of the market.

In fact, accounting information presented with the aim of providing the necessary data to investors and creditors in making investment decisions. Information that extracted from financial statements apart from its importance to creditors and competitors, widely used in anticipation of future cash flows in capital market. Thus helps investors and other interested people in assessment of future risk and return.

On the one hand, investors search for maximum profit and return with minimum risk and for that investors be encouraged to invest in an asset, return of the asset must be greater than the other options. And in the other hand, an entity`s value depends on its profitability. So managers with the aim of maximizing investor`s wealth, must interact between efficient investment opportunities and investor`s expectations. The interaction can be well established by reliable accounting information such as net future flows.

In Ethiopia there is a lack of appreciation of the role of quality financial reporting by the business community. Most people in the business community are not aware of the importance of good quality financial reporting and for what purpose it would serve. The reason behind would be previously Ethiopia as a nation does not have its own national accounting standards; the accounting and auditing practices are fragmented and are inconsistent among organizations (ROSC, 2007).

## **The Accounting Auditing and Reporting Standard in Ethiopia**

Respondent stressed that reliable and relevant accounting information is critical for making investment decisions. It was confirmed that the accounting and auditing standards are improving in Ethiopia but still they are not yet at an internationally accepted level where as stock market required international financial reporting standards.

Accounting and auditing standards in Ethiopia are not of a high and international acceptable quality. Share companies are not required to include audited financial statements. As there is no public offering and listing, there are no requirements regarding publicly available annual reports and their preparation and presentation in accordance with a comprehensive body of accounting standards. (Ruecker and Shiferaw, 2011). Even without reporting requirement, there is general unwillingness among Ethiopian businessmen to provide financial information of any nature to the needy. As a result, the data compiled for private businesses do not reflect the true picture in most situations. Such data shortages and inaccuracies significantly affect researches made in accounting and finance areas and lead to errors policy making. Unlike other countries, information is not made available on the websites too, except for public and government undertakings. Often in many cases, the information provided is too outdated to be useful for any meaningful conclusion. Laws and institutions governing corporations, securities and investors are insufficient according to international best practices and standards. The 1960 Commercial Code of Ethiopia is not up to date and has many grey areas. The registration of patents and trademarks are non-existent. The judiciary is poorly staffed and inexperienced in commercial cases. (Ruecker and Shiferaw, 2011)

The respondent also confirmed that even if the country has agreed to adopt international financial reporting standards it is on its infancy stage. Absence of sophisticated internal and external users of financial statements precluded the investment flow towards the country. In addition, there is no ethical and professional code that directs accountants and

auditors responsible and accountable for standardization of report and reflection of predetermined related material weakness.

Respondents' further stated that banks demanded audited financial statements for loans request of more than Br. Five million to assess the borrowing capacity of the applicant. As a result of sub standardization and ethics concern, no supervisory authority in charge to supervise, monitor and evaluate accountants' and auditors' report towards taking any remedial actions in time. Thus, defaults in the preparation and presentation of financial reports standards were observed and substantiated. Respondents also stated that NBE had issued many directives on financial reporting standards for banks, insurances and micro-finance institutions to monitor and evaluate the performances to assure compliance to the rules and regulations. Recently, the Ethiopian Government has issued a Regulation No.332/2014, Federal Negarit Gazette No.22, January 14, 2015 to regulate the Establishment and Determination of procedures of Accounting and Auditing Board of Ethiopia. Now a day's AABE is undertaking an important work to standardize the accounting and auditing practices in the country.

### **Accounting and Auditing Profession and legal requirement in Ethiopia**

Respondent stressed that the number of professional accountants in Ethiopia is relatively low in relation to the size of the economy. There are an estimated 200 professional accountants in the country. In comparison, Uganda and Ghana, with economies less than Ethiopia, each have more than 1,000 professional accountants. Kenya, whose economy is roughly 1.5 times that of Ethiopia, had 3,000 professional accountants in 2001. Having a shortage of professional accountants means that there are positions in the private and public sector that are filled by persons with lower qualifications.

The respondent also confirmed that Ethiopia does not have a quality assurance program for auditors. A quality assurance program checks the auditors' work at both partner and firm level, and ensures that auditors conduct their duties with outmost professional diligence. The program also identifies areas that become a source of designing training

programs to improve the capacity of auditors. Establishing a country-level quality assurance program is an international good practice. Under this program, the professional accountancy body develops quality control standards and relevant guidance, requiring audit firms to establish the quality control policies and procedures necessary to provide reasonable assurance of conforming to professional standards in performing services. To ensure that audit firms have effective quality control arrangements, a mechanism of independent review must be in place. Such a review mechanism does not exist in Ethiopia at the present time.

Respondents' further stated that no legal requirement exists for auditors to have professional indemnity insurance. Professional indemnity insurance is the means by which assurance is provided that auditors would be able to meet liabilities in the event there are valid claims regarding their professional conduct. Usually, the regulation will make it a condition for granting a license and for license renewal every year. At present, there is no requirement for auditors to have the insurance in order to get a practicing license. This is also an important area to be considered in strengthening the country's financial reporting infrastructure.

## CHAPTER FIVE

### Conclusion and Recommendation

Based on the results obtained from the respondents the following conclusions and recommendations are drawn.

#### 5.1. Conclusion

- The current realities of the Ethiopian economy have many favorable conditions (opportunities) that can pave the way for stock market development. This includes favorable macroeconomic and social conditions, increased interest of foreign investors, the growth and transformation Plan (GTP), financial sector development, increased private sector participation and high enthusiasm among stakeholders.
- Though it is highly laudable, the launch of stock market is not without challenges. Some of the major challenges include: inadequate institutional and legal framework, Low Quality and Quantity of Financial Services, scarcity in Communication Network, Policy Measures Impetus, Gaps in Accounting, Auditing and Legal Infrastructure, Low level of saving and financial literacy, Inadequacies in skilled manpower, and Forms of Business Organizations.
- Establishing stock market, among other things, allows the “de-concentration of ownership, improve accounting and auditing standards, provide effective tools for monetary and fiscal policy and help privatization efforts”. In addition the finding also implied that, the establishment of stock market in Ethiopia could contribute to economic growth, since it encourages investment by helping traders buy and sell stocks quickly and efficiently. Beside, Existence of the financial markets help to mobilize local savings, enhance competition among financial institutions, increases remittances, lead to improved corporate governance, provide for sources of project financing on short and long term bases. Hence, absence of stock market

in Ethiopia may cause illiquidity of assets as holders of stocks may find it difficult to sell same at a fair market price.

- Despite the acclaimed benefits, a well-functioning financial system requires strong institutions and a sound legal framework. Among others consumer and property rights protection, contract enforcement laws and corporate governance can be considered as the key elements for creating deep and vibrant financial markets and creating an enabling business environment. Establishing Stock market in Ethiopia is not a task that can be achieved over-night. Since, it is affected by several environmental factors emanating from different sources, and some of these pre requisites are not currently in place in the country.

For instance:-

- There is no institutional, legal and policy framework for any secondary financial market activity in the country.
- Pertaining to the adequacy of the judiciary system, the 1960 commercial code is outdated and there is no system of civil courts where securities cases can be prosecuted by a dedicated governmental authority.
- Corporate governance is not fully developed and the governing laws on corporate governance are not up-to-date. However, the recent activity of revising the commercial code of Ethiopia is on progress.
- Technological infrastructure of the country is in its development stage, which needs to be further improved to facilitate smooth transaction settlement and flow of information.
- Even if the country has agreed to adopt international financial reporting standards in the country it is on its infancy stage.
- The awareness level of the public is not high as there is no stock market in the country.

- Regarding the demand of stock market the finding implied that individuals and institutional savers have limited choice how to hold their savings. Therefore, the establishment of a well functioning stock market will satisfy their rate of return need and protection of their asset, avoid the traditional forms of asset holding practice, cope up with challenges of inflation and reduce the mismatch between low interest rate for deposit and high interest rate for borrowing.
- Currently there is high rate of Shareholding Company's establishment. Without any capital market for share trading in Ethiopia there are more than 60,000 shareholders this implies that there is high share illiquidity. If this illiquidity persists, the existing shareholders tend to frustrate and new shareholders will be discouraged to get into share company business which in effect hinders the growth of investment and private sector involvement in the Economy. This is one of the implications of high demand of stock market establishment is needed in the country.
- The government stand is good opportunity to the potential investors to participate in the privatization of government owned companies.

## **5.2. Recommendation**

According to the information from the prime Minister office the government was planning to establish a capital market by 2020. However the formation and evolution of stock markets and its institutions is certainly a process, influenced by a large number of factors and complex relationships between these. It is not an easy task to the government since, the fact that the stock market provision most importantly required appropriate studies and lay-down legal foundation to promoting, regulating and facilitating the participation of the players. However, the following essential recommendations to fulfill in establishment of stock market are forwarded to the Government of Ethiopia as prerequisites:

- ✓ Before establishment of the market finalizing the revision of the Country's Commercial Code related to Accounting and Auditing Registrations and develop a Corporate Governance Code, the revision and registration should be comprehensive leading towards the development of stock market in the country.
- ✓ Improving the legal framework by enacting a stock market law, embodying the basic principles and policies in clear and unequivocal standard.
- ✓ Developing stock market Standard operating procedures (SOPs) which clearly outline the stock market system. To enforce, SOPs will require routine and consistent supervision at all levels. IT-controlled stock market management systems are required move closer to players that will eventually be optimized information networks and decisions in the ongoing operations. The IT development requires huge investments to improve the capacity of stock market management. Suitable training programs directed towards different user groups accompanied by hands-on manual to ensure compatibility and commitment critically fundamental.
- ✓ Establishing Stock market and other related institutions with the technical assistance (training, manuals, expertise service, etc) of International Finance Corporation and World Bank.
- ✓ The role the media plays in promoting the stock exchange market is highly recognized. Therefore, the country's media should do more in giving more coverage for business and financial matters.

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