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# DETERMINANTS OF FINANCIAL REPORTING QUALITY: EVIDENCE FROM LISTED MANUFACTURING FIRMS IN NIGERIA

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## ABSTRACT

*This paper investigates the determinants of financial reporting quality in Quoted manufacturing firms in Nigeria. In order to achieve the objectives of the study, a total of fifty-two (52) firms were selected based on a purposive sampling technique. The firms included in the sample had to meet two key criteria: first, they have electronic websites; and second, they had published annual reports in their websites for a period of seven successive years from 2012 to 2018. The study adopted the ex-post facto research design and used longitudinal data from secondary sources. The hypotheses were validated with the use of multiple regressions as a tool for data analysis. The results showed a positive significant relationship between firm age, firm size, Board size, Ownership structure and financial reporting quality, measured using residuals from the modified Jones model. It is recommended among others that firms may increase their size and leverage levels, which apart from enjoying the benefits of leverage; it provides an incentive to quality earnings reporting as seen in major research. A good corporate governance practices (code) should be maintained as it has been found not only to preserve the going concern of the firm but also a strong feature for enhancing the quality of financial reporting. The board size of between 5 and 11 is recommended as it has been found that this size is adequate to check earnings manipulation and other related financial statement fraud in the sectors. Emphasis should not be placed on the age of the firm, but on their capital tangibility and ability to checkmate management tendencies to manipulate financials reports or statement.*

**Keywords:** Earnings Management, Financial Reporting Quality, Firm Characteristics, Corporate Governance.

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## 1. Introduction

The outright failures of governance systems, financial disclosures and presentations have been argued to be major contributors to the collapse of many of the well-celebrated organizations that have littered the world's corporate landscape. These failures, which translate into inability of organizations to meet the expectations of their various stakeholders, have often been traced to weaknesses in the internal controls infrastructures and operating environments, and a lack of commitment to high ethical standards (Ezelibe, Nwosu, & Orazulike, 2017). These Extensive failures in the financial disclosures have generated the demand by investors, regulators, and other stakeholders to improve the financial information quality and to reinforce the control of managers by putting up adequate governance structures (Klai & Omri, 2011). This will allow boards of directors to assess management's effectiveness and to take timely correctional actions, when essential, to tackle failures in the financial condition of firms (Fung, 2014).

According to Akeju and Babatunde (2017), many accounting scandals and financial crises which happened lately in numerous reputable firms, have undermined investors 'trust concerning the financial reports and have introduced several criticisms about financial reporting quality (FRQ). Hence, Firms are expected to prepare its financial Report with high quality, transparency and timely. Quality of financial reporting, especially over the last decade, has been of considerable concern to accounting researchers; however, one of the key problems is how to measure the so-called FRQ (Scaltrito, 2015). The quality of the information, however, is not always simple and instantly comprehended: diverse methods had been applied in the previous studies in measuring FRQ (Lang & Lundholm, 2000). A thorough overview of previous studies have demonstrated that numerous studies have been carried out on the determinants of FRQ in developed countries such as United States of America, United Kingdom, Canada and some developing countries like Nigeria. Most of these researches were conducted using the qualitative characteristics and features of financial reporting such as timeliness and FRQ index (Mahboub, 2017).

Earnings management is a fundamental aspect of financial reporting quality. How earnings are recognized and measured is essential to the quality of financial reporting. Corporations, through their managers, are duty bound to report business activities for the benefit of shareholders, potential investors, regulators/policy makers, suppliers of finance and other stakeholders (Echobu, Okika & Mailafia, 2017). This is usually done through the production of annual reports covering their economic, financial, environmental and social activities. These reports are expected to be of high quality information, portraying a true and fair view of transactions. However, the practice of earnings management flaws this process of producing quality financial reports and questions the credibility of the quality of reported earnings (Shehu & Abubakar, 2012).

Some of the determinants affecting FRQ which relate to specific characteristics of the company include leverage, firm size, profitability, size of audit firm, and the status of listing. The other classification of determinants that have impact on FRQ incorporates the features of corporate governance such as board composition, board size, and ownership structure (Fathi, 2013; Chakroun & Hussainey, 2014). In spite of its popularity in the foreign and developed countries, FRQ research is still in its infancy in developing countries like Nigeria (Monday & Nancy, 2016). The dearth of research in this area is even more evident in the manufacturing sector of Nigeria where little or no research works can be found.

Therefore, the main objective of this study is to investigate the determinants of financial reporting quality of quoted manufacturing firms in Nigeria. The specific objectives are to determine the relationship and the effect that firm age, firm size, board size and ownership structure have on financial reporting quality of quoted manufacturing firms. These determinants precisely pertain to firms' specific characteristics, structural characteristics and corporate governance related characteristics. Based on these, the study formulates the following hypotheses in the null form as follows:

$H_1$: There is no significant relationship between firm age and financial reporting quality of quoted manufacturing firms in Nigeria.

$H_2$: There is no significant relationship between firm size and financial reporting quality of quoted manufacturing firms in Nigeria.

$H_3$: There is no significant relationship between board size and financial reporting quality of quoted manufacturing firms in Nigeria.

$H_4$: There is no significant relationship between ownership structure and financial reporting quality of quoted manufacturing firms in Nigeria.

## 2. Review of Related Literature

### 2.1 Conceptual Framework

#### 2.1.1 Financial Reporting Quality

According to AICPA (1970) the purpose of financial statements is "the provision of quantitative financial information about a business enterprise useful to the statement users". Financial reporting is broad and aims at providing financial and other information, together with information from other sources facilitates the efficient functioning of capital markets and assists the efficient allocation of the scarce resources in the economy (FASB, 1978). The concept includes financial information and non-financial information disclosures useful for decision making. As the subject of financial reporting quality is broad, several definitions of the term have been expressed. Verdi (2006) defines financial reporting quality as "the precision with which financial reports convey information about the firm's operations, in particular its cash flows, in order to inform equity investors". Jonas and Blanchet (2000), state that "…quality financial reporting is full and transparent financial information that is not designed to obfuscate or mislead users".

According to the IASB and FASB in their conceptual framework high quality is achieved by adherence to the objective and the qualitative characteristics of financial reporting information (IASB, 2008). Thus, financial reports should meet certain qualitative criteria in order to avoid poor quality and accomplish their purpose. Qualitative characteristics are "the attributes that make the financial information useful and are distinguished as fundamental or enhancing depending on the way they affect the usefulness of the information" (IASB, 2008). IASB (2006, 2008), states that "the objective of financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers".

#### 2.1.2 Firm Age and Financial Reporting Quality

The age of a firm is considered as one of the essential element of specific firm characteristics which is also a cardinal determinant of financial reporting quality. The internal control system of a firm gets stronger with age, and a strong and well-structured internal control system guarantees quality financial reporting process (Huang, Ena, & Lee, 2012). As firms advance in age, they also improve in their governance mechanisms, and as a result, become more closely monitored by government regulatory agencies. This is expected to produce a corresponding improved financial reporting practice (Chalaki, Didar, & Riahnezhad, 2012). Researchers use different measures of age to compute the age of firm. While some use the date of incorporation to the year of reporting (Olowokure, Tanko, & Nyor, 2016); others, use no of listing years, which is the number of years the firm has been on the stock exchange (Haniffa & Cook, 2002; Ojeka, Mukoro, & Kanu, 2015).

Several studies have investigated the nexus of firm age and financial reporting quality. Echobu, Okika, and Mailafia (2017), conducted a research on the determinant of financial reporting quality with evidence from Agricultural and Natural Resources firms in Nigeria, The result shows that firm age is positive but not significantly related to financial reporting quality. This implies that the higher the listing years of Agriculture and Natural Resources firms in the NSE, the higher the financial reporting quality. However, the result shows that listing age does not improve their financial reporting quality. Chalaki, Didar, and Riahnezhad (2012) used age as a control variable and found that age is not statistically significant with financial reporting quality. Studies by Huang, Ena, and Lee (2012), Hossain (2008) reported insignificant relationship. The result of the study of non-financials firms in Nigeria by Kibiya, Ahmad, and Amran (2016) used firm age as a control variable, and found a significant association between age and financial reporting quality.

### 2.1.3 Firm Size and Financial Reporting Quality

Many researchers have studied the relation between firm size and FRQ and the results were mixed. Haji and Ghazali (2013), Agyei-Mensah (2013), Ebrahimabadi and Asadi (2016) and Monday and Nancy (2016) found a significant positive relation between firm size and FRQ. This result demonstrated that big companies have more propensities to disclose more high quality information because they are more under scrutiny. Conversely, Abdul Majid and Ismail (2008) as well as Takhtaei and Mousavi (2012) found a negative relation between firm size and FRQ. This finding indicated that small-sized companies have revealed their readiness to disclose more might point that they incline to put themselves for competitive advantages and public visibility (Abdul Majid & Ismail, 2008). However, Al-Asiry (2017) found an insignificant relation between size and FRQ.

### 2.1.4 Board Size and Financial Reporting Quality

Empirical Studies like Asegdew (2016), Egbunike, Ezelibe, and Aroh (2015), Uwuigbe, Erin, Uwuigbe, Igbinoba, and Jafaru (2017), and Akeju and Babatunde (2017) found a positive relation between board size and FRQ. Obigbemi, Omolehinwa, Mukoro, Ben-Caleb and Olusanmi (2016), Shehu (2013) and Swastika (2013) also reported positive relationship in their studies. These results implied that better disclosure quality of the annual reports could be achieved by having greater board size (Htay, Said, & Salman, 2013). Larger board size could provide more competence and knowledge to the firm and may have the capability to monitor excellently, which could consequently lead to higher quality of financial reporting (Haji & Ghazali, 2013).

Conversely, Yoshikawa and Phan (2003), Byard, Li, and Weintrop (2006) and Ostadhashemi, Shafati, and Aliei (2017) found a negative relation between board size and FRQ. This finding demonstrated that the lesser the board size, the better communication and coordination is which in turn will result in better disclosure quality of accounting information (Yoshikawa & Phan, 2003). However, Nugroho and Eko (2011); Navarro and Urquiza (2015) demonstrated that FRQ is not significantly associated with board size. This result could be justified by the fact that board size may not convey board quality if it does not work proficiently.

### 2.1.5 Ownership Structure and Financial Reporting Quality

Only few researches considered the association between ownership structure and FRQ. Fan and Wong (2002), Ben-Ali (2008) and Htay, Said, and Salman (2013) found a negative relation between ownership concentration and FRQ. This reveals that FRQ is weak in companies with both high ownership and control concentration (Ben-Ali, 2014). Haji and Ghazali (2013) and Fathi (2013) found an insignificant relation between ownership concentration and FRQ. The results show that the ownership structure does not affect the quality of financial reporting.

## 2.2 Theoretical Framework

This paper adopts the agency theory as the theoretical underpinning for this research work. Agency theory is a neoclassical economic theory (Ping & Wing 2011); and, has been widely applied in corporate governance research. The agency theory defines the principal-agent relationship. The principal here are shareholders while agents refer to the managers. These parties have divergent interests, thus giving rise to agency costs (Shehata, 2014). The theory is based on the idea of separation of ownership (principal) and management (agent). It states that "in the presence of information asymmetry the agent is likely to pursue interest that may hurt the principal" (Sanda, Mikailu, & Garba 2005). It is earmarked on the assumptions that: parties who enter into a contract will act to maximize their own self-interest and that all actors have the freedom to enter into a contract or to contract elsewhere. Furthermore, it is concerned with ensuring that agents act in the best interest of the principals. Disclosures by way of financial reporting and regulation help to mitigate the agency problem as it requires that management of corporations report both mandatory and voluntary information for the benefit of shareholders and other interest parties.

## 3. Design and Methodology

The study utilizes the ex-post facto research design. The ex-post factor design helps to investigate possible cause and effect relationships among variables. The population of the study comprises manufacturing companies listed on the Nigerian Stock Exchange (NSE) as at 1st January 2019. The companies are classified under 11 sectors, such as: Agriculture; Conglomerates; Construction/Real Estate; Consumer Goods; Financial Services; Healthcare; Information & Communications Technology(ICT); Industrial Goods; Natural Resources; Oil & Gas; and, Services (NSE, 2019). The sample size is fifty-two (52) firms; selected based on a purposive sampling technique. The firms included in the sample had to meet two key criteria: first, they have electronic websites; and second, they had published annual reports in their websites for a period of seven successive years from 2012 to 2018. The study used longitudinal balanced panel data from secondary sources because it is a quantitative study with positivism paradigm. Longitudinal panel data is used to account for individual diversity of the sample companies. The data were extracted from the audited financial reports of the selected firms within the period of the study.

### 3.1 Methods of Data Analysis

The study made use of multiple regression technique in testing the formulated hypotheses. Multiple regression is a viable technique to examine the effect of several independent variables on a dependent variable.

### 3.2 Model Specification

The modified Jones Model by Dechow, Sloan, and Sweeny (1995) which represent the discretionary portion of accruals is used to derive values for financial reporting quality, which is the dependent variable of the study. The modified Jones model by Dechow, Sloan, and Sweeny (1995) adjusted to separate the discretionary accruals (DA) portion from the non-discretionary portion of total accruals is given as:

$$DA = TA/A_{i,t-1} - \beta\,(1/A_{i,t-1}) + \beta\,((\Delta \text{ in Rev} - \Delta \text{ in Rec})/A_{i,t-1}) + \beta\,(PPE/A_{i,t-1})$$

The values so derived for financial reporting quality are substituted as values for FRQ in the model of the study which is given as:

$$FRQ = \beta_0 + \beta_1 FAGE + \beta_2 FSZE + \beta_3 BOSIZE + \beta_4 OWNST + \epsilon_{it}$$

Where:
FRQ is financial reporting quality;
FAGE is firm age;
FSZE is Firm size;
BOSIZE is board size;
OWNST is Ownership Structure;
$\beta_0$ is the Intercept;
$\beta_{1-5}$ are the coefficients of the independent variables;
$\epsilon$ is the error term; and,
*i* is firm and *t* is year.

## 4. Data Analysis and Results

### 4.1 Test of Hypotheses

**Table 1: Ordinary Least Squares output**

Dependent Variable: FRQ
Method: Panel Least Squares

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| FAGE | -1.013317 | 0.510560 | -2.366711 | 0.0045 |
| FSIZE | 0.045621 | 0.043974 | 3.248548 | 0.0005 |
| BOSIZE | 0.031634 | 0.071160 | 3.405420 | 0.0006 |
| OWNSTU | 0.122257 | 0.185440 | 0.559380 | 0.4108 |
| **Model Summary** | | | | |
| R-squared | 0.643650 | Mean dependent var | | 7.100577 |
| Adjusted R-squared | 0.517875 | S.D. dependent var | | 7.456093 |
| Log likelihood | -371.7250 | Hannan-Quinn criter. | | 6.887596 |
| F-statistic | 9.549874 | Durbin-Watson stat | | 1.010528 |
| Prob(F-statistic) | 0.000152 | | | |

Source: E-Views 9

The table above shows the multiple regression output conducted to test the influence of the predictor variables. The Adjusted R squared is coefficient of determination which tells us the variation in the dependent variable due to changes in the independent variable. From the findings in the table above, the value of adjusted R squared was 0.51.7, an indication that there was variation of 51.7% on the Financial Reporting Quality (FRQ) due to changes in the explanatory variables.

#### 4.1.1 Test of Hypothesis One

$H_1$: There is a significant relationship between firm age and financial reporting quality of quoted manufacturing firms in Nigeria.

Based on the result, the p value of FAGE is 0.0045; this is less than the critical value of 5% significance level. Thus, leading to the conclusion that there is a significant negative relationship between firm age and FRQ, hence, $H_1$ is accepted. The result is in arrangement with previous study like Olowokure, Tanko, and Nyor (2016) and Echobu, Okika, and Mailafia (2017).

#### 4.1.2 Test of Hypothesis Two

$H_1$: There is a significant relationship between firm size and financial reporting quality of quoted manufacturing firms in Nigeria.

Based on the result, the p value of FSIZE is 0.0005; this is less than the critical value of 5% significance level. Thus, leading to the conclusion that there is a significant positive relationship between firm size and FRQ, hence, $H_1$ is accepted. This study is in consonant with studies by Haji and Ghazali (2013), Agyei-Mensah (2013), Ebrahimabadi and Asadi (2016) and Monday and Nancy (2016) found a significant positive relation between firm size and FRQ. This result demonstrated that big companies have more propensities to disclose more high quality information because they are more under scrutiny.

### 4.1.3 Test of Hypothesis Three

$H_1$: There is a significant relationship between board size and financial reporting quality of quoted manufacturing firms in Nigeria.

Based on the result, the p value of BOSIZE is 0.0006; this is less than the critical value of 5% significance level. Thus, leading to the conclusion that there is a significant positive relationship between board size and FRQ, hence, $H_1$ is accepted. This research is in arrangement with previous works like Asegdew (2016), Egbunike, Ezelibe, and Aroh (2015), Uwuigbe, Erin, Uwuigbe, Igbinoba, and Jafaru (2017) and Akeju and Babatunde (2017) who found a positive relation between board size and FRQ. In addition to that, Obigbemi, Omolehinwa, Mukoro, Ben-Caleb and Olusanmi (2016), Shehu (2013) and Swastika (2013) also reported positive relationship in their studies.

### 4.1.4 Test of Hypothesis Four

$H_1$: There is a significant relationship between ownership structure and financial reporting quality of quoted manufacturing firms in Nigeria.

Based on the result, the p value of OWNSTU is 0.4108; this is greater than the critical value of 5% significance level. Thus, leading to the conclusion that there is a non-significant positive relationship between ownership structure and FRQ, hence, $H_1$ is rejected. This work is in arrangement with studies like Fan and Wong (2002), Ben -Ali (2008) and Htay, Said, and Salman (2013) who found a negative relation between ownership concentration and FRQ. This reveals that FRQ is weak in companies with both high ownership and control concentration. Furthermore, Haji and Ghazali (2013) and Fathi (2013) found an insignificant relation between ownership concentration and FRQ.

## 5. Conclusion and Recommendations

This study assessed the major determinants of financial reporting quality of quoted manufacturing firms in Nigeria. In addition, the effects of specific firm variables, that is, firm age, firm size, board size and ownership structure were assessed. The results of the multiple regression analysis revealed that firm characteristics, specifically, firm size and board size have a statistically significant positive effect on financial reporting quality. The variable of firm age was negative and statistically significant; while, ownership structure was positive but not statistically significant.

The study therefore recommends that firms may increase their size and leverage levels, which, apart from enjoying the benefits of leverage, provides an incentive to quality earnings reporting as seen in major researches. A good corporate governance practice (code) should be maintained as it has been found, not only to preserve the going concern of the firm but also a strong feature for enhancing the quality of financial reporting. The board size of between 5 and 11 is recommended as it has been found that this size is adequate to check earnings manipulation and other related financial statement fraud in the sectors. Emphasis should not be placed on the age of the firm, but on their capital tangibility and ability to checkmate management tendencies to manipulate financials reports or statement. Furthermore, adequate monitoring should not be placed on the perception of ownership structure as it has been found that it does not significantly affect the quality of financial reporting. The NSE should review its monitoring rules to ensure definite rules for the prevention of window dressing behavior of management in financial reporting

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