MEASUREMENT OF FINANCIAL REPORTING QUALITY: EVIDENCE FROM PRIVATE COMMERCIAL BANKS IN ETHIOPIA

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Abstract

This study aims to measure the financial reporting quality of private commercial banks operating in Ethiopia. The study also attempted to assess the trend of the financial reporting quality and its components. The study used method of operationalizing the elements of qualitative characteristics of accounting information to measure the financial reporting quality. For the achievement of the study objective, both primary and secondary data have been collected from the eight sampled private commercial banks operating in Ethiopia for 15 years from 2007 – 2021. The result of the study revealed that the financial reporting quality has a mean score of 3.08775 which is close to the neutral or average value of "3". The minimum and maximum scores of FRQ are 2.24 and 3.97 respectively. From the components of FRQ, understandability is found to be the dominant one with a mean score of 3.492392. To the reverse, the least mean score is found for timeliness which is 1.975. The result of trend analysis indicated that FRQ and all components of FRQ except timeliness showed an increasing trend except some fluctuations. Finally, it is recommended for future study to incorporate verifiability which is not included in this study to make the study inclusive of all the components of FRQ.

Key words: Comparability, Faithful Representation, Financial Reporting Quality, Relevance, Timeliness, Understandability

1. INTRODUCTION

Elliott and Elliott [1] stated that financial reporting provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors when making investment and loan decisions. This information is needed to help them assess the prospects for future cash flows which, based to an extent on the review of past performance, will assist in assessing stewardship. Gibson [2] indicated that financial statements are one of the basic tools for communicating information that can faithfully portrays economic events of entities. The international accounting standards board also stated that the purpose of financial reporting is to provide financial information about the reporting entity that is useful for different users of information for making their own decisions. Gilaninia et al. [3] stated that the practice of financial reporting arise from the demand for information from the external users of financial information.

Production of high quality financial report is the foundation to communicate relevant and faithful information about the entities financial position, operation performance and cash flow prospects to different users of information [4]. Hussain et al. [5] also stated the importance of financial reports with high quality. High quality financial reports helps

users to understand the financial position, performance and cash flow prospects about the reporting entity and influence their decision positively. The usefulness of financial reporting depends on its quality.

The high quality financial reporting system is very important as it secures adequate information on the basis of which the investors are able to make the best decisions on the allocation of capital. High quality financial reporting reduces information risks which is important for the safety of all the participants on the capital market, for the stability of the financial system, and for the lowering of the financial crisis risks. In addition, it secures strengthening of confidence of the capital market players, encouraging them through their investments to contribute to the development of that market, and the financial system, and the entire national economy in general [4]. Palea [6] also indicated that high quality financial reporting plays a significant role to conform and comply with different statues and regulatory needs. The IASB [23] identified the qualitative characteristics of accounting information to identify the more useful information from the less useful information for decision making purpose. The quality indicators are grouped into fundamental qualities and enhancing qualities. The fundamental qualities of accounting information include relevance and faithful representation; whereas the enhancing qualities are comparability, verifiability, timeliness and understandability.

2. STATEMENT OF THE PROBLEM

Graham [7] investigated that financial reporting should provide useful information to different stakeholders in making various rational economic decisions. Users of accounting information require relevant and credible information that will enable them to make decisions. The usefulness of accounting information depends on the quality it has. Gainet et al. [24] stated that business enterprises have to communicate to users of information through financial reporting financial information with higher quality. Tasios and Bekiaris [8] also stated that financial reporting quality is a key requirement for the effective functioning of the economy. To provide useful information, financial reports should meet certain qualitative characteristics of accounting information.

Previous studies used different models of measuring financial reporting quality. [9], [10], [11], [12] and [13] method of operationalizing the elements of qualitative characteristics of accounting information, [14] earning measurement, [15] accrual quality, [16] degree of earning measurement using accruals, degree of accounting conservatism and accrual quality, [17] earning persistency and predictability, [18] and [19] earnings management and [20] discretionary accruals; used these different models for the measurement of financial reporting quality. Most of the models except method of operationalizing elements of qualitative characteristics of accounting information measure financial reporting quality considering only the financial aspect of financial reports [12]. Therefore, this study attempted to measure the financial reporting quality taking into account comprehensively the financial and non-financial features of financial reporting using the method of operationalizing elements of qualitative characteristics of accounting information.

3. OBJECTIVE OF THE STUDY

The objective of this study was to measure the financial reporting quality of private commercial banks operating in Ethiopia.

4. LITERATURE REVIEW

4.1 Financial Reporting

Financial reporting is the way economic entities communicate financial data to different stakeholders. Stakeholders, internal and external stakeholders, use financial reports to draw conclusions about a company's current and future financial position, operating performance and cash flow prospects; financial health in general [21]. Financial reporting is also the communication of published financial information and related information from the business organization to third parties which includes shareholders, creditors, customers, government authorities and the public. Financial reporting includes not only financial statements but also other means of communicating information that relates to the information provided by the accounting system which is information about an enterprise's resources, obligations, earnings, and the like. Management of a business enterprise may provide information to those outside an enterprise by means of financial reporting other than formal financial statements either because the information is required to be disclosed by authoritative pronouncement, regulatory rule, or custom or because management considers it useful to those outside the enterprise and discloses it voluntarily [22].

The information communicated through financial reporting to the different stakeholders is used for various purposes. To achieve the objective of financial reporting, financial reports should be prepared and presented to different users with high quality. Lekovi & Arsenovi [4] indicated the importance of financial reporting with high quality as financial reporting with higher quality provide relevant and trustworthy information about the financial affairs of a business organization. Hussain et al. [5] also stated that financial reporting with high quality will help to evaluate company's financial performance and future prospects.

The conceptual framework for financial reporting [23] identified the qualitative characteristics of accounting information that differentiate more useful information from less useful information for decision making purpose. Depending on how they affect the decision usefulness of information, the qualitative characteristics are grouped into fundamental qualities and enhancing qualities. Fundamental qualities include relevance and faithful representation; whereas enhancing qualities include comparability, verifiability, understandability and timeliness.

4.2 Measurement Models: Financial Reporting Quality

Prior researches on the determinants of financial reporting quality used different measurement models for measuring the financial reporting quality. For instance [9], [10], [11], [12] and [13] measured financial reporting quality through operationalizing the elements of qualitative characteristics of accounting information. Irwandi and

Pamungkas [14] measured financial reporting quality using real earning measurement which was combined with thee proxies; the abnormal operations cash flow, the abnormal production cost and the abnormal discretionary expenses. Soyemi and Olawale [15] measure financial reporting quality using accrual quality. Martinez-Ferrero [16] measure financial reporting quality using degree of earning measurement using accruals, degree of accounting conservatism and accrual quality. Juliani and Siregar [17] measures financial reporting quality using earning persistency and predictability. Earing persistency is determined by looking the current period earning coefficient; whereas predictability is the ability of current period profit to predict future cash flows. Eden [18] and Olowokure et al. [19] used earnings management for measurement of financial reporting quality. Abnormal loan loss provision was used as a proxy for earnings management. Echobu et al. [20] uses discretionary accruals as a proxy for measurement of financial reporting quality. Although different measurement methods have been used in the previous studies to measure the financial reporting quality, this study is based on the method of operationalizing the elements of qualitative characteristics of accounting information. This method was selected from the other methods because the other methods focus only on the financial information disclosed in the financial reports and they cannot measure the financial reporting quality comprehensively considering both the financial and non-financial information, but this method measure financial reporting quality comprehensively by considering both financial and non-financial information [12].

5. RESEARCH DATA AND METHODOLOGY

5.1 Data Sources and Collection Methods

This study is basically a descriptive type research which focuses on measuring the financial reporting quality of private commercial banks operating in Ethiopia. For the achievement of the stated objective, data have been collected from both primary and secondary sources. Secondary data in the form of annual audited financial statements have been collected from the sampled private commercial banks. Once the secondary data have been collected, content analysis was conducted to collect the primary data. For the content analysis, a questionnaire containing 33 five point likert scale type questions was used to operationalize the qualitative characteristics of accounting information. The qualitative characteristics of accounting information included in the questionnaire are relevance, faithful representation, comparability, understandability and timeliness.

5.2 Sampling Method

According to the national bank of Ethiopia, the Ethiopian financial institution consists of commercial banks, insurance companies and micro finance institutions. This study was conducted to measure the financial reporting quality of private commercial banks in Ethiopia. According to the national bank of Ethiopia report (2020/21) there are one state owned and 16 private owned commercial banks operating in Ethiopia. For sampling purpose, the researcher sets 15 consecutive years annual audited financial statements as a pre-request for selection of banks as a sample. Based on this criterion, the

researcher purposively selects eight private commercial banks as a sample. These banks are Abyssinia bank, awash bank, Cooperative bank of Oromia, Dashen bank, and Lion international bank. Nib international bank, united bank and Wegagen bank. The one state owned bank, Commercial bank of Ethiopia, was left out intentionally because it will outlier all other private commercial banks data.

5.3 Method of Data Analysis

After collection of all the required data, descriptive statistics have been employed to measure the financial reporting quality and describe the ingredients of financial reporting quality. The descriptive statistics include mean, standard deviation, minimum and maximum. As [10] indicated that, measurement of financial reporting quality involves in three steps. First, the researcher used a manual content analysis on the annual reports collected from sampled private commercial banks to score all items of the fundamental and enhancing qualitative characteristics. Secondly, a sub score was calculated for each qualitative characteristics of each individual annual report. Finally, an aggregated score for FRQ of each individual annual report was calculated.

6. RESULT AND DISCUSSION

This section presents the statistical description of the financial reporting quality and its component variables included in this study. This also presents the trend of the measure of financial reporting quality and its components. The variable of this study is the financial reporting quality to be measured using its components which are relevance, faithful representation, understandability, comparability and timeliness. The total observations for FRQ and its components were 120 which are collected from eight private commercial banks operating in Ethiopia for 15 years from 2007 - 2021. The descriptive statistics include mean, standard deviation, minimum and maximum of the FRQ and its components.

Table 1: Descriptive statistics of financial reporting quality and its components

Variables	Observations	Mean	Std. Dev.	Min	Max
FRQ	120	3.08775	.4639119	2.24	3.97
Relevance	120	2.971583	.5503307	2	4
Faithfull Rep	120	3.153917	.5404764	2.14	4.33
Understandability	120	3.492392	.4065653	2.28	4.17
Comparability	120	3.064117	.5202025	2	4.17
Timeliness	120	1.975	.1567796	1	2

Note: FRQ represents financial reporting quality and Faithful Rep. represents faithful representation

Source: Researchers' computation

Table 1 above shows the mean score of FRQ and sub scores for the components of financial reporting quality being Relevance, Faithful representation, Understandability,

Comparability and Timeliness. The mean score of the FRQ is 3.08775. In addition, its minimum and maximum scores are 2.24 and 3.97 respectively. This result indicated that the FRQ of the sampled private commercial banks tends to have a medium level since the mean value is very close to the neutral value of ''3''. From the components of FRQ, understandability of financial reports has the highest mean score of 3.492392. This indicates that, the sampled private commercial banks are more concerned with the qualitative characteristics of understandability. The result of understandability is consistent with the result of [10]. The least mean score is detected for the qualitative characteristics of timeliness which is 1.975, less than the neutral value of ''3''. This indicates that the sampled private commercial banks are less concerned with the timely production and communication of financial reports to the users of accounting information. The result of timeliness is consistent with the result of [11]. They also found the least mean score for timeliness compared to the other qualitative characteristics of accounting information. The mean scores for the other qualitative characteristics which are relevance, faithful representation and comparability are 2.971583, 3.153917 and 3.064117 respectively.

Table 2: Trend of measure of financial reporting quality and its components

Years	Financial Reporting Quality and its components					
	FRQ	Relevance	FR	Understandability	Comparability	Timeliness
2007	2.63	2.46	2.64	3.04	2.60	2.00
2008	2.69	2.50	2.66	3.19	2.73	2.00
2009	2.86	2.68	2.93	3.31	2.89	1.88
2010	2.98	2.80	3.02	3.42	3.10	2.00
2011	2.97	2.82	3.00	3.42	3.00	2.00
2012	3.05	2.88	3.14	3.52	3.08	2.00
2013	3.07	2.83	3.11	3.69	3.15	2.00
2014	2.97	2.82	3.05	3.54	2.88	2.00
2015	3.06	2.98	3.12	3.42	3.06	2.00
2016	3.04	2.86	3.20	3.50	2.96	2.00
2017	3.22	3.25	3.45	3.30	3.02	2.00
2018	3.35	3.34	3.34	3.54	3.37	2.00
2019	3.39	3.38	3.44	3.79	3.21	1.88
2020	3.35	3.24	3.50	3.83	3.17	1.88
2021	3.70	3.74	3.71	3.88	3.73	2.00

Note: FRQ represents financial reporting quality and FR represents faithful representation

Source: Researchers' computation

The above table, table 2, presents the trend of measures of financial reporting quality

and its component elements. From the above table, table 2, it is observed that for all items except timeliness, it shows an increasing trend except some fluctuations in between. The value of understandability is above the neutral or average value of ''3'' throughout the study period which indicates that, understandability is the dominant component of financial reporting quality. The value of understandability ranges between the neutral or average value of ''3'' and ''4'' from the five point likert scale. To the opposite, timeliness have the value of less than the neutral or average value of ''3'' throughout the study period. The value of FRQ, relevance, faithful representation and comparability ranges from ''2'' which indicates low to ''4'' which indicates high in a five point likert scale and shows an increasing trend except some variations.

7. CONCLUSION AND RECOMMENDATIONS

This study aims to measure the financial reporting quality and assess the trend of FRQ and its components. The components of FRQ include Relevance, Faithful Representation, Understandability, Comparability and Timeliness. For the achievement of the stated objectives, the study was based on the data collected from the eight sampled private commercial banks for 15 years. First, secondary data in the form of annual audited financial statements have been collected from the sampled private commercial banks. Then, a content analysis have been conducted on the annual audited financial statements to collect data on the components of qualitative characteristics of accounting information using a five point liket scale prepared questionnaire. The result of descriptive statistics indicated that FRQ has a mean score of 3.08775 which is almost equal to the neutral or average value of ''3''. The minimum and maximum values of the FRQ are 2.24 and 3.97 respectively. From the components of FRQ, understandability is the dominant component which has the highest mean score of 3.492392. Timeliness has the least mean score of 1.975 from all the components of FRQ. The trend of the measure of FRQ and its components, except timeliness, show an increasing trend except some variations.

The result of descriptive statistics showed that timeliness has the least mean score from the other components of FRQ which is 1.975 below the neutral or average value of ''3''. This indicated that the sample private commercial banks give less attention to the timely preparation and communication of financial reports to the users. Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Having relevant information available earlier than later can improve its capacity to influence decisions and a lack of timeliness can reduce information of its potential usefulness. Therefore, banks should give great attention for the timely preparation and communication of financial reports to the users.

8. DIRECTION FOR FURTHER STUDY

According to [23], the qualitative characteristics of accounting information includes two fundamental qualities namely relevance and faithful representation; and four enhancing qualities including comparability, verifiability, timeliness and understandability. This study attempted to measure the FRQ using only the five components excluding

verifiability. Therefore, it is recommended to conduct a study to measure the FRQ by incorporating the remaining component of FRQ which is verifiability.

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