IMPACT OF FINANCIAL REPORTING QUALITY ON FIRM’S FINANCIAL PERFORMANCE

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ABSTRACT

This study examines impact of FRQ on Firm’s Financial Performance, by using three different proxies of Financial Reporting Quality: (i) conservatism; (ii) accruals quality; and (iii) earnings quality. Our main objective is to analyze the outcome of a good Financial Reporting Quality on Corporate financial performance (FP) which is accessed by market to market/book ratio (MTB). To this end, proposed postulate is analyzed on a sample of cement manufacturing firms in Pakistan for the period of 2006-2017. Empirical evidences of panel data shows the positive & significant impact of FRQ on firm’s financial performance (FP). These findings are robust in accordance with three different proxies of Financial Reporting (accruals quality, earnings quality and accounting conservatism) and also for the aggregated measure of said three proxies of financial reporting. The empirical results indicate that this relation is moderated by level of firm size, the leverage (Debt) and working capital of the corporation.

Keywords: Financial Reporting Quality (FRQ); Earnings Quality (EQ), Earnings Management (EM), Accounting Conservatism, Earning Smoothness (ES) and Earning Surprise indicator (ESI)
Introduction

Due to the geographical expansion, business globalization, bigger demand for information & transparency among stakeholders, investors and society; market agents try to find their grip in the quality of financial reporting and their key source of knowledge on firm’s strategy. According to Jonas and Blanchet (2000), the information in financial reports is not merely a final outcome; the quality of financial reporting system and depends on disclosure of the firm’s dealings, information about the choice & application of accounting rules and information about the judgments made.

Financial figures issued by a firm have become a vital resource for market participant, as it gives a reduced volume of information asymmetries amongst investors, managers, society, regulatory agencies and other stakeholders. Thus, one of the key questions which arise about the quality of financial reporting is its influence on subsequent performance of the firm.

In these days reporting quality, earnings management and earning quality is very hot topic. Scandals like WorldCom, Enron, and A-hold have triggered a lot of public consideration to focus on the firm’s quality of financial reporting. Stakeholders of companies use information published in financial statements for decision making and these shames cost billions dollars. Arthur Levitt, chairman of the SEC quoted in his speech (1998), Levitt spoke about “the numbers game” in which he criticized practices where management misuses “big bath” restructuring charges, untimely revenue recognition, “cookie-jar” reserves, and unfair “write-offs” of purchased in-process “R&D” (Healy and Wahlen 1999). According to him these practices of management are threatening the integrity of financial reporting. Others followed him in stating his views point on earnings management. “We must have factual, not fictional accounting”, said Frits Bolkestein, earlier Dutch European Commissioner and in-charge of “Internal Market and Taxation”, when Bolkestein raised his apprehensions concerning earnings manipulation in his speaking in July 2002 (www.europa.eu). He also highlights the significance of firm’s accounts that are true and fair, and also stated that “… companies must not distort, hide, fabricate and present, in whole or in part, a misleading web of lies and deceit …” (Bolkestein2002)

There is an extensive agreement among practitioners, academics, investors, regulators and other agents too on the significance of regulations for the publication of financial information by public firms in order to increase the quality of financial reporting system. Though, there is a strong debate on whether financial reporting quality has been improving for last few years and also about the capability of numerous proxies to attain the quality information. A number of works examine the
statistical association among some proxies and the probable outcomes of quality information such as and information asymmetry and the cost of capital between market participants. After the adoption of IFRSs still there is a room for manipulating the earnings or accounting figures.

**Literature Review**

Accounting information system plays a vital role in firm’s active flow and also in complex economic decision because many economic decisions are based on the information obtained from accounting information system so it is important to assess, maintain and improve the financial reporting quality. Various benefits of high-quality information and FRQ have been cited: reporting quality or FRQ decreases liquidity and information risk (Lambert et al., 2007), It prevents management from using discretionary influence for their personal benefits or motives and helps them to make effective investment choices (Chen et al., 2011). Precisely, one of the key benefits of higher FRQ is help in minimization of asymmetric information glitches which arise because of conflicting agency (Rajgopal and Venkatachalam, 2011). Firms that report good quality financial information to the several markets agents enables them to perform in the market with superior conditions and upper level of information (Jo and Kim, 2007).

The outer indicators of financial reporting quality are: (i) “SEC Accounting and Auditing Enforcement Releases (AAERs)”; (ii) “Restatements”; and finally, (iii) “internal controls”. The last two indicators are more important due to they illustrate the information about the financial statements quality as a whole, not just earnings. The key results of these alternatives are; impact on the cost of investment or capital (reaction of the market toward the proclamations of restatements or AAERs is adverse). Francis et al. (2005), associate this opinion, stated that companies with a higher quality of earning have a lesser cost of debt (Ferrero, 2014).

Among the way to measure FRQ, the best employed dimensions of this theory in text are: (i) accounting conservatism; (ii); earning quality and (iii) quality of accruals. Showing this concept, Dechow et al. (2010) describe three categories of the proxies of earnings quality, base on that “higher earnings quality shows the features of the firm’s earnings process that are relevant to a specific decision made by a specific decision-maker”. These proxies are: FRQ eternal indicator, characteristic of earnings and earnings response coefficients. These researchers measured earnings quality determinants to be firm financial reporting practices, auditors, governance and controls, capital market incentives, characteristics, institutional factors and external factors too.
The next measure of FRQ is the level of conservatism accounting in accounting, which suggests a more quickly recognition of economic losses into earnings than of financial gains (Ball et al., 2000). Lastly, accruals quality is grounded on mapping past cash flows, current and upcoming cash flow processes with accruals (Garrett et al. 2012). Reporting quality FRQ has been explored in many areas, and numerous authors have mentioned to its benefits, such as its affirmative impact from the financial viewpoint, by helping to minimizing information risk and increasing liquidity (Lambertet al., 2007). Furthermore, information reported in financial statements is most essential in debt contracting (Costello and Wittenberg-Moerman, 2011).

There are various papers stating that companies enjoy more benefits under IFRS and improved quality information is associated with higher and better performance, because market approaches to those firms which are committed to provide quality information for their stakeholders and tries to reduce information asymmetries within the market participants (Martínez-Ferrero, 2014 p2-3). Financial reporting quality and earning quality is emerging topic and is in interest of many stakeholders - shareholders, employees, creditors, suppliers, stakeholders, financial analyst, and government too. Several Papers have been published relating to implementation and adaptation of IFRS or GAAPs to improve the quality of reporting.

**Firm Size (SIZE)**
Firm’s size is measured by taking logarithm of its total assets. It is common exercise to take company’s size as determinant variable of financial performance, FRQ and as well as determinant of economic. Larger companies are motivation to show the positive impact on financial performance (Prior et al., 2008; Surroca et al., 2010). Additionally, the company’s size has been used widely in numerous research projects on FRQ, but this effect of size is uncertain.

**Leverage (DEBT)**
DEBT of the company is risk or default of debt and this risk is calculated as ratio debt to equity ratio. Debt variable is also used widely in preceding. It denotes the non-compliance risk or debt (Prior et al., 2008; Mahoney et al., 2008). As with magnitude of company’s size, no consensus exists concerning the consequence of leverage level on financial reporting quality. Though, Tu (2012) concluded, debt/leverage ratios are the key determinants of earning management change.

**Operating Liquidity (WORKING CAPITAL)**
Working capital is the difference of current assets & liabilities. It reveals the liquidity of company, i.e. a firm’s capacity to endure the normal development of activities in short run. This variable is
associated to the firm’s accounting results and allows them to enjoy greater liquidity when higher financial performance.

**Methodology & Research Design**

**Measures of Financial Reporting Quality**

Taking earlier literature into consideration, the researcher used several measurements of reporting quality FRQ (Choi and Pae, 2011; Hong and Andersen, 2011; Lu et al, 2011) because there is no generally accepted mode of measurement (Dechow et al., 2010). The first measurement that is used is degree of earnings management (EM) by using accruals, whereas the second is accruals quality and the third is degree of accounting conservatism. Earning management is considered inverse to FRQ (Dechow and Dichev, 2002); a higher the level of EM or earnings management is linked with lower quality financial information and lower level of earnings quality as well (Raman et al., 2012). Therefore, the first measurement of financial reporting (FRQ) is management choice over accruals (Choi and Pae, 2011).

**Aggregated measures of FRQ**

The main goal of this study is to develop a measure of financial reporting quality FRQ, financial performance FP and then to find the influence of FRQ on FP. The variable FRQ or AFRQ is the total sum of above mentioned three variables named as “Earnings Management Earnings Management (EM), Accounting conservatism (AC) and Accruals Quality (AQ)”. Therefore AFRQ take the value 0 (lower or absence of quality information) and 3 (strong financial reporting quality or strong level of information).

AFRQ = EM + AC + AQ

**Measures of Financial Performance**

Among the several means of assessing the FP, in present study Market to Book (MTOB) is employed as market to book ratio (Seifert et al., 2003). This variable of the study classifies market measures of financial performance in accordance with the previous indication from Hillman and Keim (2001). These authors claim in their research that the accounting activities are less successful in comparison with the market actions because of fact that those actions are not capable to depict the long-term value of firm, focused on previous FP and are also subject to the likelihood of manager’s manipulation. Furthermore, these measures are also more adequate to observe if stockholders are capable of in identifying the CSR entrenchment actions. These market variables
reflect the belief that investors have not merely in the firm at present, but they are also in the past and future.

**Theoretical / Conceptual Framework**

On the basis of theoretical framework given by the financial bodies, it is most important purpose of the accounting information that this financial information should be relevant and reliable to make final decision. Must be gathered, stored, analyzed & provided timely to achieve the proper relevancy because it has greater impact on financial performance. The study is significantly important because of following objectives:

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**Empirical Evidence**

With the aim of study to examine the impact of financial reporting quality on financial performance, the researcher has created aggregate measure for FRQ. This variable aggregate financial reporting quality (AFRQ) is sum of three dummy variables; So AFRQ takes values between 3 (highest level of reporting quality) and 0 (lowest level of reporting quality). For this purpose, the researcher has created three dummies, **DEM, DAQ and DAC**; these variables are estimated usined Jones modified model, BALLSHIVAKUMAR and Basu 1997 model respectively.
1. DEM: Dummy of earning management measured by Jones modified model
2. DAQ: Dummy of accrual quality measured by BALLSHIVAKUMAR model

A Hausman was calculated to choose between Fixed Effect Model or Random Effect Model, empirical evidence clearly states that Random Effect Model is best suited for the panel data used in the study (See table #4).

Table 5. 1 Random Effect GLS Regression

<table>
<thead>
<tr>
<th></th>
<th>Coefficients</th>
<th>(b-B)</th>
<th>sqrt(diag(V_b-V_B))</th>
<th>S.E.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(b) fe</td>
<td>(B) re</td>
<td>Difference</td>
<td></td>
</tr>
<tr>
<td>AFRQ1</td>
<td>3.249354</td>
<td>3.227002</td>
<td>.0223525</td>
<td>.1179698</td>
</tr>
<tr>
<td>logTA</td>
<td>-.0928452</td>
<td>.0053713</td>
<td>-.0982165</td>
<td>.151846</td>
</tr>
<tr>
<td>Debt</td>
<td>-.0076566</td>
<td>-0.0148499</td>
<td>.0071933</td>
<td>.0080556</td>
</tr>
<tr>
<td>WorkingCap</td>
<td>-2.57e-08</td>
<td>-5.99e-08</td>
<td>3.42e-08</td>
<td>2.45e-08</td>
</tr>
</tbody>
</table>

Note: the rank of the differenced variance matrix (3) does not equal the number of coefficients being tested (4); be sure this is what you expect, or there may be problems computing the test. Examine the output of your estimators for anything unexpected and possibly consider scaling your variables so that the coefficients are on a similar scale.

Random-effects GLS regression was calculated to predict the impact of FRQ on FP, a significant regression was found (Prob > chi2 = 0.003, $R^2 = 0.55$, $β = 1.74$) (See table# 5.4, 5.5).

Overall model to examine the impact of FRQ on firm’s financial performance is significant, the adjusted ($R^2 = 0.55$) indicates that more than 55% of variability in financial performance is measured by this model.

Undoubtedly, the results show positive and significant impact on FP as the consequence of aggregated financial reporting quality (AFRQ) that is statistically significant at 95% level of confidence and even at 99% level of confidence with coefficient ($β = 1.74$).

Independent variable (FRQ) and all other control are blue variables & significant predictor for dependent variables (FP).

The results of econometric model which incorporates and examines the impact AFRQ on firm’s financial performance (FP), especially on market to book ratio (MTOB), are shown in the Table# 5.4, 5.5. The findings indicate that financial reporting quality positively and significantly
contributes to the corporate financial performance, analysis Random Effect GLS Regression revealed that the firms reporting high quality of financial information enjoy higher level of performance.

Financial reporting quality positively and significantly contributes to the corporate financial performance, analysis of linear regression revealed that the firms reporting high quality of financial information enjoy higher level of performance. Overall model to examine the impact of FRQ on firm’s financial performance is significant, ($p > 0.0003$, $R^2 = 0.55$, $\beta = 1.74$) (See table 5.4, 5.5). The adjusted ($R^2 = 0.55$) indicates that more than 55% of variability in financial performance is measured by this model.

The results for econometric model which incorporates and examines the impact AFRQ on firm’s financial performance (FP), especially on market to book ratio (MTOB), are shown in the Table 5.4, 5.5. Undoubtedly, the results show positive and significant impact on FP as the consequence of aggregated financial reporting quality (AFRQ) that is statistically significant at 95% confidence level and even at 99% level of confidence with coefficient ($\beta = 1.74$).

Thus, higher the levels of AFRQ lead to enhanced financial performance of the firms. Therefore, we can generalize that firms that report better quality of financial information enjoy higher perception and valuation from society and investors at large, allowing the companies to improve FP. These empirical findings are in accordance with hypothesis H0 and shows that the financial reporting quality has positive and significant impact on company’s financial performance.

Table 5.2 Random Effect Model

<table>
<thead>
<tr>
<th>Random-effects GLS regression</th>
<th>Number of obs</th>
<th>215</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group variable: CID</td>
<td>Number of groups</td>
<td>18</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>R-sq: within</th>
<th>0.543</th>
<th>Obs per group: mi</th>
</tr>
</thead>
<tbody>
<tr>
<td>between</td>
<td>0.53</td>
<td>avg =</td>
</tr>
<tr>
<td>Overall</td>
<td>0.715</td>
<td>max =</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>corr(u_i, X)</th>
<th>0 (assumed)</th>
<th>Wald chi2(4)</th>
<th>21.51</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Std. Err. adjusted for 18 clusters in CID)</td>
<td>Prob &gt; chi2</td>
<td>0.0003</td>
<td></td>
</tr>
</tbody>
</table>
Table 5.3 Random-effects GLS regression

| MTB1      | Coef.    | Robust Std. Err. | z     | P>|z|  | [95% Conf. Interval] |
|-----------|----------|------------------|-------|------|---------------------|
| AFRQ1     | 3.227002 | .7564208         | 4.27  | 0.000| 1.744444            |
| logTA     | .0053713 | .3036292         | 0.02  | 0.000| -.589731            |
| WorkingCapital | -5.99e-08 | 5.32e-08     | -1.12 | 0.438| -1.64e-07          |
| Debt      | -.0148499| .0163186        | -0.91 | 0.000| -.0468338           |
| _cons     | -3.330797| 4.755445        | -0.70 | 0.000| -12.6513            |
| sigma_u   | 1.1868166|                  |       |      |                     |
| sigma_e   | 3.4127255|                  |       |      |                     |
| rho       | .10789037| (fraction of variance due to \( u_i \)) |       |      |                     |

The proposed hypothesis is tested on a sample of listed companies on Pakistan stock exchange (cement sector) for the period 2006 to 2017 and empirical results of Random-effects GLS regression indicate that Financial reporting quality has positive & significant impact on firm’s financial performance, \( \beta = 174, \) Prob > chi2 0.0003

A significant regression (Prob > chi2, \( R^2 = 0.55, \beta = 1.74 \)) (See table# 5.5, 5.6). So we accept the null hypothesis.

Ho: Financial reporting quality has positive & significant impact of firm’s financial performance

**Conclusion**

The current study examines the relationship between financial reporting (FRQ) and financial performance (FP) of the company. The key objective of current research is to examine the consequence of good reporting quality on firm’s FP which is measured by market to market or book ratio (MTOB). Using a sample from Pakistan (cement sector only), the researcher analyses the proposed connection based on the FRQ and variety of control variables like: the size of the company, debt or leverage and working capital of the company.

Consciously, the proposed hypothesis is tested on a sample of listed companies in Pakistan for the period 2006 to 2017. Final findings of study are based on Random-effects GLS regression models for panel data and results highlights that financial reporting quality has positive and significant impact on firms; financial performance. The results shows that the companies with better reporting system enjoy high level of performance, good financial reporting is also linked with better earning and accrual quality and accounting conservatism as well. This also shows the trust of stakeholders on the company not only at present, but also trust level in past and future.
Limitations of the study
The researcher has tried to explore as much as possible but still the study has some limitations and these limitations should be considered before making any decisions based on the findings presented in this study. A common limitation is about the data used for this study. The data in this research is obtained from the Pakistan and sample is from cement sector only, which potentially restrict the generalizability of outcome. Other limitations of the study are directly associated with the approaches of empirical research.

Secondly, future cash flows prediction is associated to accrual quality. The accrual quality measurement was not easy, and is matter to interpretation of what accrual quality. Accrual quality is defined as amount of accruals which are converted in cash flows. Though, the model of predicting future cash flows is restricted to the prediction cash flows of subsequent period. The model of accrual quality fails to pick-up the extent of accruals that are converted into cash flows at later period. Consequently, the outcomes on the relation among AQ and future cash flows prediction can be deemed imperfect to the extent that model of AQ fails to include future cash flows. So, future study should improve the measure for long term AQ, and observe the consequence of AQ on future cash flows.

Second, performance is measured through the market to market or book ratio. so it reflects market’s expectations. Thus, subsequent study should also determine the influence of other proxies for financial performance. Furthermore, FP is estimated through market to market or book ratio MTOB, a market measure, and researcher didn’t incorporate other measures of accounting. Therefore, it is suggested for the researchers that investigation should have objective to examine whether the associations found in this research still met accounting measures (ROE or ROA) in order to ratify the results. The future research can be extended by increasing sample size at international level and time span of the data which can provide with better outcomes to generalize.

Suggestions for future research
- Subsequent researchers can make use of other variables and moderating factors to determine the relationship between FRQ and performance.
- To better understand the phenomena, the researcher makes use of data across the sectors, region and country.
- Future investigation should have objective to examine whether the associations found in this research met accounting measures like ROE or ROA in order to ratify the outcomes.
• The future research can be extended by increasing sample size at international level and time span of the data which can provide with better outcomes to generalize.
• Future study should improve the measure for long term AQ, and observe the consequence of AQ on future cash flows.
• And subsequent study should also determine the influence of other proxies for financial performance.
References
Financial Reporting Quality and Idiosyncratic Return Volatility over the Last Four Decades. (n.d.).


