

Determinants of Financial Reporting Quality of Nigerian Stock Exchange NSE Lotus Islamic Index LII

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ABSTRACT

In Nigeria regulatory authorities like SEC and FRCN takes financial reporting quality very seriously, so that end users will rely on information for their specific use. In 2012, one of such users, a fund manager called Lotus Capital collaborated with the Nigerian Stock Exchange NSE to launch an Islamic index. The Lotus Islamic Index LII comprises of fifteen companies. These companies were selected by Lotus Capital based largely on their financial performance. This implies that these companies have sound determinants of reporting quality that promoted the financial performance on which their selection was based. This study examines the determinants of financial reporting quality of Lotus Islamic Index for the period 2012-2018. A quantitative panel data approach was employed based on extracted information from the annual reports and accounts of these companies. Multiple regressions aided the analysis of the data collected; findings revealed that the internal control system's control environment, external audit independence and liquidity are not significantly related to financial reporting quality. However, Leverage and profitability does. The study recommends security and exchange commission SEC and financial reporting council of Nigeria FRCN to sustain their dedicated efforts of ensuring quality financial reporting in Nigeria.

1. INTRODUCTION

Before the global financial crisis of 2008, Security and Exchange Commission SEC issued stringent penalties on statutory auditors and directors of companies due to poor quality financial reports. This is because quality reporting portrays the value of companies to potential and existing investors (Frankzac, 2019). Eight years ago, after the crisis, Lotus Capital LC and the Nigerian Stock Exchange NSE launched the Lotus Islamic Index LII. The

index was made public to attract willing stockholders to buy stock in companies that are shari'ah compliant. LC is the name of a fund administrator who has a specific objective of meeting the investment requirement of moral individuals, business and establishments across West Africa and the world at large. LC is dully registered with the SEC as a Capital Market Operator CMO.

Eleven years ago, LC constituted the Islamic index II by excluding companies with businesses whose focus was on interest banking and insurance, gambling, alcohol, adult entertainment, and tobacco. The index was named Islamic since it comprised of companies that were already conducting businesses founded on ethical and shari'ah principles. Such principles are essentially built on ethical low-risk approach and profit-sharing procedure (Adeolu, 2014). More so, shari'ah principles are founded on intrinsic features that possibly encourage the protection of consumers and investors (Lukonga, 2015). The index was set to track the performance of shari'ah compliant stocks listed on the floor of the NSE. The index has 15 companies from NSE sectors with strong and steady consumer demand and returns. LC selection of the companies was informed by low leverage, high liquidity and capitalization. In this respect, four companies were screened and chosen from industrial goods, six from the consumer goods, and one each from agriculture, health, service, and two from oil & gas sectors of the NSE. It is important to note that the medium used by LC for the selection was the financial statements of these companies. This implied that the reliability and quality of these statements attracted the fund manager.

Studies have shown that liquidity and leverage are attributes that influence the quality of reporting financial information (Amr, 2016; Zeinali, 2015). More so, it is evidenced further that firms with high liquidity have profitability which also influences reporting quality (Al-Asiry, 2017). From another direction, internal control system ICS mechanism like the control environment is fundamentally built on governance characteristics. This is in the light of having independent non-executive directors. The study of Larcker and Tayan, (2016) revealed that increase number of independent directors attracts quality in disclosing financial information.

Furthermore, statutory audit is another characteristic that has been established to increase the reliability and integrity of financial reports especially if the independence of the auditor is not impaired (Dabor & Dabor, 2015). However, Five years after the existence of the index, 2 companies were delisted by SEC due to violations of 20% free float provision and post quotation standards violations. This ignited the objective of this study to examine whether external audit independence, leverage, liquidity,

profitability and control environment can determine financial reporting quality?

This study offers extra proof on the determinants of financial reporting quality. To the best of the researcher's knowledge, there are virtually little or no studies in Nigeria that have examined the NSE LII. (Echobu et al., 2017; Okolie et al., 2014a; Hassan & Farouk, 2014b; Okolie et al., 2013). The security and exchange commission SEC will take into account the findings of this study as evidence of their concern and support for quality financial reports. This paper is in five sections. Section one is the introduction in addition to this paragraph; section two discusses the concepts and theory; section three shows the methodology that parades study's design, variables, model specification, technique of data analysis, diagnostics and robustness tests; section four presents the findings and section five gives the conclusion, recommendation and implications.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1. Concepts

The study presents the following operational definitions:

Financial Reporting Quality (FRQ): The precision with which information disclosed in the annual financial statements of a company portrays its true functioning state and its benefit to predict prospective cash flows.

Leverage (LEV): A company's capital that is called Debt. Studies of Prihata and Rahaya (2019) and AL-Asiry (2017) established leverage is not a determinant of financial reporting quality. Contrarily, Studies have it that company with higher leverage report quality financial information to satisfy creditors' expectations. (Ilmas et al., 2018; Mahboub, 2017). Therefore, this research hypothesized that:

H₁: Leverage LEV is a determinant of Financial Reporting Quality of Nigerian Stock Exchange Lotus Islamic Index LII.

Liquidity (LQD): The position of a company to sustainably settle pressing obligations through quick conversion of inventory into cash. Amr (2016) and Hamidzadeh et al. (2015) provide evidence that liquidity is a determinant of quality financial reports. However, Izzaquny et al. (2019) established that liquidity is not a determinant. This study hypothesized that:

H₂: Liquidity LQD is not a determinant of Financial Reporting Quality of Nigerian Stock Exchange Lotus Islamic Index LII

Profitability (PRT): When expenses and claims are absorbed by a company's revenue. Mixed findings for profitability as a determinant of quality financial reports are documented. The following studies by Eyunobo et al. (2017) and Hosseinzadeh et al. (2014) revealed that it is not. While Al-Asiry (2017), Takhtaei et al. (2014), and Fathi (2013) established it that it is a determinant. Therefore, the research hypothesized that:

H₃: Profitability PRT is a determinant of Financial Reporting Quality of Nigerian Stock Exchange Lotus Islamic Index LII

Control Environment (CE): COSO, (2009 & 2013) identified CE as the first component of ICS. Roles and responsibilities relating to monitoring and oversight functions of the board of directors BOD (Governance Code, 2018) are clearly defined in the CE. According to the code, the BOD takes responsibility for its constituents direct and approves its operational activities using appropriate skills, experience and diversity.

Evidence shows that where the board has more independent directors' operational performance are guaranteed (Silalahi, 2017). Researches like Larcker and Tayan (2016) established that an independent board is a determinant of financial reporting quality. However, Luo et al. (2019) and Mahboub, (2017) revealed that it is not. This study hypothesized that:

H₄: Control environment CE is not a determinant of Financial Reporting Quality of Nigerian Stock Exchange Lotus Islamic Index LII.

External Auditor Independence (EAI): The objectivity of an auditor is not compromised as a result of unethical behavior, incompetence, long relationship, unjustifiable fees that will not allow the exposure of any misstatement, manipulations or violations what so ever. Evidence is mixed for auditor independence. Some studies posit high audit fees can guarantee financial reporting quality. From another perspective, Micheal et al. (2020) and Nirwana et al. (2018) evidenced that objectivity, competency, fees and professional ethics are determinants of financial reporting quality.

However, some findings revealed it is not a determinant for quality financial reports when the auditor's tenure is lengthy (Tepalagul & Lin, 2015). In the same vein, when audit fees are on the high side financial reports of quality cannot be guaranteed (Zayol & Kukeng, 2017; Babatolu et al., 2016). This research therefore hypothesized that:

H₅: External Auditor Independence EAI is not a determinant of Financial Reporting Quality of Nigerian Stock Exchange Lotus Islamic Index LII.

2.2. Theory

This research is underpinned by the prerequisite accounting theory. Certain conditions are required for positive accounting to possibly take place. These conditions range from the level of leverage, liquidity, profitability, external (statutory) or internal controls and so on of a company. In other words, besides the characteristics of financial reporting information like reliability, timeliness, understandability, verifiability, neutrality, and completeness, financial reporting quality can be influenced by attributes (liquidity, profitability, leverage and so on) and governance structure (internal and statutory control).

3. METHODOLOGY

3.1. Design and Population

This study extracts data from the 15 companies that constitute the NSE LII, making the design an *ex post facto* census approach to sampling for the period 2012 to 2018. The period is selected based on the year the index was constituted. However, data was not extracted for Ashaka cement in 2017 and UAC in 2018 because they were delisted. The researcher believes that it will not affect the inferential statistics of the study.

3.2. Variable and Model Specification

Table 3.1

Acronym	Nature	Measurement	<i>a priori</i> expectation
Financial Reporting Quality FRQ	Dependent Variable	Absolute value of Residuals Barth, Cram, & Nelson, 2001.	
Leverage LEV	Independent Variable	Total liabilities/Total assets*100 Echobu, Okika & Mailafiya, 2017	+
Liquidity LQD	Independent Variable	Earning after tax/Total assets Asegdew, 2016	-
Profitability PRT	Independent variable	Net income/Total assets*100 Asegdew, 2016	+
Control Environment CE	Independent variable	Number of independent directors to total number of directors on the board Htay, Said & Salman, 2013	-
External Audit Independence EAI	Independent Variable	Scores of 1 or 0 allocated / number of conditions identified for independence	-

$$FRQ_{it} = \beta_0 + \beta_1 LEV_{it} + \beta_2 LQD_{it} + \beta_3 PRT_{it} + \beta_4 CE_{it} + \beta_5 EAI_{it} + \mu_{it}$$

Source: Authors measures, 2019

Technique of Data Analysis: Unbalanced Panel Generalized Least Square regression technique of analysis was used. Hausman specification and Breusch and Pagan Lagragian Multiplier tests directed the selection of the model. Diagnostics tests multicollinearity test, normality test and heteroscedasticity were carried out to meet the classical OLS assumptions to satisfy the Best Linear Unbiased Estimation.

4. FINDINGS AND DISCUSSIONS

In table 4.1, Shapiro-wilk test showed that data are not normal p-values are significant at 1%. Multi collinearity test indicates there was none as the VIFs were > 1 but < 10 . The mean of VIF stood at 1.11; brook pagan/cook-Weisberg test indicates that chi-square significance level is at 0.002 confirming the presence of the effect of heteroscedasticity. Consequently, GLS of Fixed and Random effects were run. The Hausman specification and Breusch and Pagan Lagragian Multiplier were not significant 0.99 and 0.21 respectively. This implied we interpret our results with the robust OLS model.

Table 4.1
Descriptive and Inferential Results

<i>Variables</i>	<i>Obs-</i>	<i>Shap-</i>	<i>VIF</i>	<i>1/VIF</i>	<i>Mean</i>	<i>Std.</i>	<i>Min</i>	<i>Max</i>	<i>Coeffi-</i>	<i>P-</i>
	<i>ervations</i>	<i>iro</i>				<i>Dev</i>			<i>cient</i>	<i>Values</i>
		<i>wilk</i>								
LEV	103	0.00	1.18	0.84	0.21	0.23	0.00	0.75	0.40	0.01
LQD	103	0.01	1.21	0.82	0.60	0.61	0.01	2.60	0.01	0.66
PRT	103	0.00	1.05	0.90	3.26	1.68	0.04	9.21	-0.03	0.01
CE	103	0.00	1.06	0.94	0.27	0.21	0.01	0.85	0.02	0.68
EAI	103	0.00	1.05	0.91	0.31	0.17	0.15	0.60	0.23	0.39
<i>Tests</i>										<i>Values</i>
Mean VIF										1.11
Brook Pagan Hetttest P-Value										0.002
Breusch Pagan chi ² sig										0.21
Hausman Chi ² P-Value										0.99
R ²										0.17
F. stats										4.10
F. Sig										0.00

Extract from STATA Output listing, 2019

Descriptive statistics from the table 4.1 shows that Leverage LEV has a mean of 0.21 with a minimum and maximum value of 0.00 and 0.75. This confirms that most companies in the index were actually selected because

of low leverage level that is also below 75%. Liquidity LQD had an average value of 0.60 with a minimum and maximum value of 0.01 and 2.60. The mean value confirms that companies in the index are highly liquid and their liquidity level ranges from between less than 1% to above 26%. This also confirms why the companies were selected to make the index. Profitability PRT has a mean value of 3.26 and minimum and a maximum value of 0.04 and 9.21 respectively. This shows that on the average the sampled companies generated 33% profit from their total assets, and such generation ranges from less than 4% to 92%.

Also the statistics shows that on the average, the control environment CE has a mean of 27% with a minimum and maximum value of 0.01 and 0.85 respectively. This implies that independence of the board in controlling the activities of the index is averagely at 27% and the index has a higher number of independent directors that makes 85% of the board constitution, which is good to increase financial reporting quality. On external audit independence EAI the mean value is 0.31 and the minimum and maximum values are 0.15 and 0.60 respectively. This shows that the independence of the external auditors for the indexed companies range from 15% to 60% and this is averagely influencing financial reporting quality at only 31%.

Inferential statistics reveal that the coefficient of determination, which is the overall cumulative R^2 shows the proportion of the total variation in financial reporting quality that is explained jointly by leverage, liquidity, profitability, control environment and external audit independent to be 17%. This shows that more determinants are to be included in the model. Nonetheless, the model is adequate in selecting its explanatory variables and also fit because the F statistics probability is significant at 1%.

LEV is with a coefficient of 0.40. This implies that for every 1% increase in leverage, financial reporting quality will be increased by ₦40. The p-value of 0.01 provides evidence to accept the hypothesis. The result meets our priori expectations and it implies a leverage level of 75% attracts quality financial reporting. This finding supports Ilmas et al. (2018); and Mahboub, (2017) and is contrary to research findings reported by Moura, Zanchi et al. (2017).

LQD is with a coefficient of 0.01. This shows that for every 1% increase in liquidity, financial reporting quality will be increased by 1Kobo. The p-value of 0.65 provides evidence to accept the hypothesis that liquidity is not a determinant. The result meets our priori expectations and it implies a liquidity level of 26% cannot influence quality, as its contributing rate is only akobo. This finding is contrary to the findings reported by Echobu et al. (2017) and Amr (2016).

PRT is with a coefficient of -0.03. This reveals that for every 1% increase in profitability, financial reporting quality will be increased by 3Kobo. The p-value of 0.01 provides evidence to accept the hypothesis that it's a determinant of financial reporting quality. The result meets our priori expectations and it implies that a profitability level of 92% attracts reporting quality. This finding is contrary to Eyunobo, Mohammad, Ali; & Mahboub, (2017) but supports (Echobu, Okika, & Mailafiya, 2017).

CE is with a coefficient of 0.02. This indicates that for every 1 additional independent director, financial reporting quality will be increased by 2Kobo. The p-value of 0.68 provides evidence to accept the hypothesis that the control environment with fewer independent non-executive directors cannot determine quality financial report. The result meets our priori expectations because the Security and exchange commission governance code of 2011 required each board to have a minimum of 1 independent director. This attracted an independence mean average of 27% which is not good enough. No wonder 2 companies were delisted from the Nigerian stock exchange due to violations. With more of independent directors on the BOD, this would have been avoided. This finding does not support Larcker and Tayan (2016) but supports the findings of Abhus et al. (2019) and Mahboub (2017).

EAI is with a coefficient of 0.23. This shows that for every 1% increase in audit fees, financial reporting quality will be increased by ₦23. There are studies that have proven that increase in audit fees impairs the independence (see, Zayol & Kukeng, 2017; Babatolu et al., 2016). The p-value of 0.39 provides evidence to accept the hypothesis that external audit independence is not a determinant of financial reporting quality. The result meets our priori expectations because the mean average on independence is 31% which is not good enough. Also 2 companies were delisted from the Nigerian stock exchange due to violations and they had audited reports for the years the violations occurred. This supports the findings of (Michael, et al., 2020; Tontiset & Kaiwirit, 2018) that impaired independence and professional ethics affects financial reporting quality.

5. CONCLUSION

This study was able to determine whether or not external audit independence, leverage, liquidity, profitability and control environment can determine financial reporting quality? This study concludes that impaired external audit independence, low liquidity and a control environment that has less independent directors cannot determine financial

reporting quality but low leverage and high profitability levels can. Theoretically this study has documented that depending on each particular circumstance attributes and governance mechanism are prerequisite for positive accounting to take place and where it does not happen, financial reporting quality emerge.

The study recommends more independent nonexecutive directors on the boards of NSELII. Management of LII should resist the need of increasing audit fees as the learning curve acquired by auditors expects to attract fewer fees as the years go by. The findings of this study can be generalized because the NSELII cuts across 5 sectors (Consumer goods, industrial goods, agriculture, health service and oil and gas) out of the 12 sectors of the Nigerian stock exchange. Regulatory authorities like security and exchange commission SEC and financial reporting council of Nigeria FRCN should sustain their dedicated efforts of ensuring quality financial reporting in Nigeria.

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