Print ISSN: 2234-3040 / Online ISSN 2234-3059
doi:10.13106/eajbm.2019.vol9.no1.13

Determinants of Quality of Financial Information: Empirical Evidence from Cement Sector of Bangladesh

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Received: February 24, 2018. Revised: November 4, 2018. Accepted: January 05, 2019.

Abstract

Purpose - The purpose of this paper is to find out the determinants of the quality of financial information in the financial environment of the cement companies of Bangladesh.
Research design, data and methodology - This study considers a total of fifty-eight firm years as the sample from the seven listed cement companies of Bangladesh during the period of 2007 to 2015. This study applies the multivariate regression analysis including the pooled OLS, panel and controlling time.
Results - This study finds that profitability and external financing are the two major explanatory variables in determining the quality of financial information. This study also finds that firm size and accrual quality don't have any significant influence on quality of financial information.
Conclusion - This study observed that profitability of this sector which is much volatile and prone to be manipulated. Thus, this paper suggests that higher profitability needs more scrutiny while assessing quality of financial information. Finally, this study provides some indications for future research such as considering the listed firms of other sectors of Bangladesh or cross country comparison in different country setting.

Keywords: Quality, Financial Information, Profitability, Leverage, Manipulation.

JEL Classifications: L11, M410, M480.

1. Introduction

Several financial scandals, fraud and manipulation in different business entities has been observed in recent years. These sorts of financial scandals are mainly committed by the directors or chief executives belonging to the large companies. To commit these sorts of misdeeds, they have used different types of financial information manipulation and provided misleading information. Because of such practices, financial information quality has become such a crucial issue. There were many sequential events of accounting scandals during the period of of 19th and the 20th century, and various scandals questioned the quality of accounting information (Agrawal & Chadha, 2005). These scandals also indicate the weakness of corporate governance system which gradually ends up as agency problem. A better financial information system is to be developed to ensure the high quality of reporting. The financial statements should disclose relevant, reliable, comparable and understandable information (IASB, 2008). These are also considered as the primary qualities of financial information. The qualities of financial information are very important because of external users use this financial information for investment and financing decision. The world has seen a number of illustrations such as Enron, Marconi, and WorldCom that have resulted from lack of qualities. Decision from the management using financial information, therefore, lost credibility. Moreover, financial information can be manipulated by the firms even though there is the presence of high quality accounting standard. Basically, accounting quality is molded by many factors like firm size, companies' indebtedness, market competition, firm's

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compensation, regulation of the capital market and the taxation system (Susanto, 2015).

The objectives of this research paper are to observe financial information quality and firm-specific characteristics of the cement sector in Bangladesh. This research will also try to find out the relationship between financial information quality and firm's performance. Moreover, this study investigates the applicability of the Beneish M-score in finding out earning quality in the context of cement sector of Bangladesh.

In 1989, Cement Company first enlisted in the stock market of Bangladesh but became operational in the 1990s. Since then, there are now seven enlisted companies. So this sector is being influential for stock market in Bangladesh, but it is still a big challenge for these firms to cope with various internal handicaps like earning management quality. Moreover, the major beneficiary of this paper is the Bangladeshi cement industry, which is the 40th largest industry in the world. The country has been experiencing a huge portion of cement consumption for the last decade. But surprisingly, there is a dearth of research about the quality of financial information in the cement sector of Bangladesh. Therefore, this research study will contribute to fill in the gap and serves as the motivation of this research study.

This paper, hence, deals with two research questions:

RQ 1: Is there any relationship between quality of Financial Information and firm-specific characteristics?

RQ 2: Is the overall performance scenario good enough for this sector?

Quality of financial information is influenced by the firm specific characteristics. One of the major firm specific characteristics is the profitability of the firms. This study has been conducted in the context of the Cement companies of Bangladesh. Manipulation of financial information is mostly done through profitability. The study also found that information related to use of external financing is also misleading.

This paper has been designed with six sections. Apart from introduction, rest of the parts includes theoretical framework in section 2, literature review and hypothesis development in section 3, methodology in section 4, empirical results in section 5, and additional analysis, discussion and conclusion in the last section 6.

2. Theoretical Framework

Two major theories (transaction cost theory and agency cost theory) are directly associated with the content of this paper. The paper involves assessing determinants of financial information quality. The theories are described below:

2.1. Transaction Cost Theory

When internal control is weak, there is a need for transaction cost that is associated with strong system designing. However, a relationship exists between weak internal control and lower accrual quality which ultimately leads to poor disclosure quality of financial information (Doyle, Ge, & McVa, 2007). They also found that reported material weakness is prone to be lower accrual quality. Such internal weakness may arise from some external factors like change in currency (Dimitropoulos, Asteriou, & Syriopoulos, 2011). In the meantime, technology gifted something more valuable and trust worthy solution. Enterprise Resource Planning (ERP) system is one contemporary issue which is considered to be a product of transaction cost theory. However, this ERP system has influential effect on the quality of financial reporting (Shafakheibari & Oladi, 2015). The researchers depicted the insight of fair financial information. They also described that fair information is possible when there is a good governance system. On the other hand, governance system breaks apart for want of proper internal control.

Another important product of transaction cost theory is Accounting Information Systems (AIS). This is a set of tools to ensure certifiably better data which comprises the Financial Statements (Kaplan, Krishnan, Padman, & Peters, 1998). The assessors of this certification are the auditors who are highly paid in terms of the professional category. This is also a process of establishing outstanding internal control. In the context of Uganda, highly skilled professionals are badly desirable for public sector firms (Bukenya, 2014). This empirical study was based on audited financial data that showed statistically consistent data. Now-a-days, literature of earning quality is being extended to internal control at a great extent (Doyle, Ge, & McVa, 2007). In the developed countries, financial data is so authentic that even a share price is important enough to make a decision. Capital market analysts or researchers always focus on nature of financial data and their relationship with various financial fundamentals as well as their role on determining stock price (Shafakheibari & Oladi, 2015). Therefore, at the firm level, strong and efficient ERP system is a matter of fact in case of determining quality of financial data and other financial reporting.

2.2. Agency theory

In financial based literature, agency theory is concerned with profit maximization and wealth maximization. But in broader sense, it is a relational fact. Owners (principal) and management (agent) are the only two key players in the context of this theory. In the study of Kholeif (2008), dual part of management (CEO duality) is considered to be drastic for the shareholders. When management tries to endeavor the interest of the shareholders, it fails and hence cannot achieve the ultimate goal of the whole organization (Kholeif, 2008). Such events were witnessed by the example of ENRON, WorldCom etc.

To decrease the extent of financial fraud, a number of measures were taken to improve principal-agent relationship. One strong step is to strengthen internal control (Luo, 2017). After the commencement of Sarbanes-Oxley, internal control got significant notice and has been regarded as an outcome of agency theory. In the study of Luo (2017), a significant positive relationship was found between agency problems and the quality of financial information. A phrase, reliable decision making, is directly associated with quality of financial information. Investors in developing and in emerging economies simply rely on the information provided in the financial statements of the companies. Again, higher level management gets facilitated irrationally when governance loses its quality (Rahman, 2016). Hunt and Hogler (1990) argued that "free market determined" contracts are suitable enough to minimize organizational conflict. Such an environment is possible if there are sound and fair systems of information and legal theories, and agency-based accounting can be converged (Hunt & Hogler, 1990). This has also been concluded in the study of Rahman and Khatun (2017a) by specifying the importance of tax and risk management issues and board independency and incentive issues that can contribute to the quality corporate governance and, hence, to the mean of mitigating conflict of interest.

3. Literature Review and Hypothesis Development

Cement industry is one of the most growing sectors in Bangladesh, but most of the companies of this sector disclose very little amount of information. In this study, quality of financial information has been analyzed. Outcome of the operational activities is expressed to the stakeholders of an organization through financial reporting which can also be considered as a mean of communication (Hasan & Hosain, 2015). The major purpose of financial reporting is to provide reliable, fair and quality information about the business entities for economic decision making (IASB, 2008).

Auditors provide assurance on the company's financial statements, and users of financial statements rely on the auditor's report. Moreover, high quality financial reporting is essential because it will influence the decision of the capital providers and other stakeholders in making decision about investment, credit, and similar resource allocation enhancing overall market efficiency (IASB, 2008).

Several studies provide evidence on the distinctiveness of firms applying IFRS voluntarily. Al-Basteki (1995) demonstrates that audit firm and the line of business are explanatory variables that influence Bahrain firms of voluntary adoption of IFRS. It is very common that the quality of IFRS is higher than most domestic financial standards (Barth, Landsman, & Lang, 2008). It is also anticipated that financial quality would be higher after the adoption of IFRS, but in Bangladesh, the financial quality of cement sector is not up to mark.

Prior studies found that financial disclosures have been failing to provide reliable information, and as a result, the demand of quality of financial information is increased through structured governance (Brown & Caylor, 2006; Karamanou & Vafeas, 2005). In this study, the factors that influence the financial information quality were strived to investigate in the context of Cement Sector of Bangladesh. Here, the attributes considered were firm size, external financing, profitability and accrual quality of seven listed cement companies of Bangladesh (Hoque, Mia, & Anwar, 2015; Ahmed & Azim, 2015; Michäilesco, No reference 2010). Athanasakou and Olsson (2012) study find a significant positive relationship between corporate governance factors and the quality of earnings revealed in the financial statements. They also found that business fundamental and managerial incentives are two major factors to assess the quality of financial information. Ownership diffusion and audit quality are considered as the proxies of corporate governance which also affect the quality of financial information (Fathi, 2013; Michäilesco, 2010).

Reduced amount of corporate disclosure and transparency became a vital issue in Asian countries following the financial crisis of 1997-98. Rather, subsequent regulatory attempts to enlarge corporate disclosure in many Asian countries, concerns remain about not so strapping level of disclosure in the region.

In Bangladesh, public sector needs better financial quality to implement public financial management. Hasan and Hosain (2015) study stated that better financial quality information ensures more transparency. Rahman and Khatun (2017b) study suggested for a strong regulatory framework with improved monitoring system in the governance. The quality of financial information is also not adequate in the Cement sector of Bangladesh. ROA and Interest coverage ratio are the major indicators of profitability of the firms (Devi & Sabarinathan, 2015), and profitability is also affected in this sector (Ahmed & Azim, 2015).

The following hypothesis are developed to find out the determinants of quality of financial information:

3.1. Firm Size

In many studies, firm size (FS) has been considered as proxy for profitability (Mistry, 2012; Hoque et al., 2015). In this study, it is used as an independent attribute following the study of Swastika (2013). This study found a significant relationship between firm size and financial information quality (originally referred as quality of earning). Larger firms are responsible and stakeholder-oriented. So, they are prone to disclose more quality information. The result is also supported by Llukani (2013), where financial data manipulation is found through earning management. But the extent of manipulation differs from small size firm to large size firm (Llukani, 2013). Thus, the hypothesis is developed as:

H1: There is an association between quality of financial information and firm size.

3.2. Profitability

Quality of financial information can also be termed as financial reporting quality. Quality of financial information plays a very important role in investment decision or any other managerial decision (Yoo, Lim, & Chang, 2013). They also stated that earnings can be manipulated by changing the ROA, ROE, and EPS for friendly investment decision. Bushman, et al., (2011) study stated that investment efficiency is highly influenced due to lack of timely recognition of economic loss. They also stated that financial information quality is associated with profitability at a large scale, and ROA is the good indicator of profitability. Besides investment decision, many companies are involved in earning manipulation through highly volatile revenue and income from operation (Ahmed & Azim, 2015). Hence, from previous discussion, it can be concluded that financial information quality can be manipulated through return on asset. Therefore, it is assumed that there is a negative relationship between quality of financial information revealed in the financial statements and the firms' profitability.

H2: There is a negative relationship between financial quality and ROA.

3.3. External Financing

Use of external financing is considered another determinant of earning quality or quality of financial information (Michäilesco, 2010). He found a positive relationship between financial information quality and use of external financing. He also stated that firms always try to show appreciable financial condition to get loan benefit. It may lead to financial data manipulation, but situation might be different. External financing may create stretch and may lead to good governance (Sharma, 2014). This will ultimately improve the quality of financial information (Karamanou & Vafeas, 2005). Thus, the hypothesis is developed in the following way:

H3: Leverage or use of external financing has impact on quality of financial information.

3.4. Accrual Quality

Accrual quality is a good indicator of earning quality. Hence, there is a parallel relation between accrual quality and accounting earning quality (Chen, 2016; Doyle et al., 2007), which represents quality of financial information. To measure the quality of earning related information, the users should not consider only one measures of earning quality (Lyimo, 2014). Besides, Doyel et al. (2007) study found that weak accrual quality results in weak disclosure quality. Thus, on the basis of the above discussion, the hypothesis is developed as the following:

H4: There is a positive relationship between financial information quality and accrual quality

4. Methodology

The research paper is designed as an empirical study. Variables were calculated from the financial data of the annual reports. Beneish M-score was used to detect the quality of financial information (QFI).

4.1. Data collection and sample observation

The research study is developed in the context of the cement sector of Bangladesh. To collect financial data, annual reports were initially used of the seven listed cement companies of Bangladesh during the period of 2007 to 2015. But there were two reasons for which total observation set is incomplete as per initial planning. Firstly, during the research work, only a few firms published audited financial statements of 2016. Hence, firm year of 2016 is excluded. Secondly, annual reports of two of the firms were not available during research work. However, some financial data were collected from the database of Lanka Bangla Finance's website. As a whole, there are seven firms and 63 firm years. Observation size is given below:

Table 1: Number of Observation

Number of observation initially taken	70
Excluding firm year	7
Unavailable financial data	5
Number of observation examined	58

4.2. Research model

In this study, pooled OLS (Ordinary Least Square) and panel methods were used to find the determinants of quality of financial information. The research model is presented below:

$$QFI = \beta_0 + \beta_1 FS + \beta_2 ROA + \beta_3 LEV + \beta_4 AccQ + \dot{e}$$

Some additional analysis was conducted to check the robustness of the model. To resolve the problem of heteroskadasticity, the regression results are presented using OLS.

Table 2 shows the definition of the variables:

Table 2: List of Variables

Dependent Variable (QFI)	Formula		References
DSRI	$(net\ Acc.\ Receivables_t / Sales_t) \div (net\ Acc.\ Receivables_{t-1} / Sales_{t-1})$		Ahmed and Azim, 2015
GMI	$Gross\ Margin\ Ratio_{t-1} \div Gross\ Margin\ Ratio_t$		
AQI	$(1-(\frac{Current\ Asset + Net\ PPE}{Total\ Asset}))t \div (1-(\frac{Current\ Asset + Net\ PPE}{Total\ Asset}))t-1$		
SGI	$Sales_t / Sales_{t-1}$		
DEPI	$(\frac{DepExpense}{DepExpense + Net\ PPE})t-1 \div (\frac{DepExpense}{DepExpense + Net\ PPE})t$		
SGAI	$(\frac{SGA\ Expense}{Sales})t \div (\frac{SGA\ Expense}{Sales})t-1$		
LVGI	$(\frac{Long\ Term\ Debt + Current\ liability}{Total\ Asset})t \div (\frac{Long\ Term\ Debt + Current\ liability}{Total\ Asset})t-1$		
TATA	$(\frac{(Income\ from\ continuing\ Operations\ -\ Operating\ Cash\ Flow)}{Total\ Asset})$		
Independent Variables	Formula	Expected Sign	
Firm Size (FS)	$In\ Sales$	+/-	Llukani, 2013
Profitability (ROA)	$\frac{Net\ Income}{Total\ Asset}$	-	Yoo, Lim, & Chang, 2013
External Financing (Lev)	$\frac{Long\ Term\ Debt}{Total\ Asset}$	+/-	Karamanou & Vafeas, 2005
Accrual Quality (Accq)	$\frac{Operating\ Cash\ Flows}{Operating\ Profit}$	+	Chen, 2016

Overall equation for dependent variable calculation:
Dependent Variable*

$$QFI = -4.84 + 0.920*DSRI + 0.528*GMI + 0.404*AQI + 0.892*SGI + 0.115*DEPI - 0.172*SGAI - 0.327*LVGI + 4.679*TATA$$

5. Empirical Results

5.1. Descriptive Statistics

From 70 observations, 58 observations were available. Table 3 presents the descriptive statistics. The descriptive result shows that the average mean value of the quality of financial information is 1.257, and standard deviation is 16.9844. In case of firm size, average natural logarithm of sales is 20.57 with SD of 2.49. Average firm size is close to the median value. The average mean value of the profitability is 5.7%, which indicates that the firms in the Cement sector of Bangladesh are getting 5.7% return from their total reported assets. Leverage shows 15.51% mean value that indicates firms are holding almost 16% debt in comparison with total asset. A high standard deviation exists in the accrual quality of the firms.

Table 3: Descriptive Statistics

Variable	Observation	Mean	Std. Dev.
QFI	58	1.2573	16.9844
(FS) ln Sales	58	20.5694	2.4941
(LEV) Leverage	58	0.1551	0.1688
(ROA) Profitability	58	0.0570	0.0481
(ACCQ) Accrual Quality	58	-14.0095	111.3393

5.2. Correlation analysis

Table 4 presents the correlation matrix which shows that quality of financial information is positively associated with firm size (0.083) and accrual quality (0.037) and negatively associated with profitability (-0.280) and leverage (-0.134).

Table 4: Correlation Matrix

	QFI	Ln Sales	Lev	ROA	AccQ
QFI	1.000				
FS	0.083	1.000			
LEV	-0.134	0.113	1.000		
ROA	-0.280	-0.527	-0.263	1.000	
ACCQ	0.037	-0.025	0.120	0.154	1.000

* Beneish M-score of measuring earning quality; Score less than -2.22 means Good earning quality; Score more than -2.22 means Bad earning quality.

Table 5 presents the checking of multicollinearity test and the results show that the average mean VIF is 1.27, which is less than 10. It can be inferred that there is no multicolinearity problem in this research study.

Table 5: Checking of Multicollinearity Test

Variables	VIF	1/VIF
ROA	1.53	0.6529
lnSales	1.39	0.7182
Lev	1.11	0.9029
ACCQ	1.06	0.9435
Mean VIF	1.27	

5.3 Multivariate analysis

Table 6 shows the multivariate analysis of the quality of financial information. In this study, initially pooled OLS regression analysis (Michäilesco, 2010) and panel analysis (Waweru, 2014) were done. Though initial firm years were 70, final 58 firm years were analyzed because of low awareness of the disclosure in the financial statement or unawareness of the annual report publication. However, the regression results show consistent results using both pooled analysis and panel analysis. From both the analysis, regression equation fits to the same extent. Profitability and leverage show significant relationship with quality of financial information consistent in both the analysis. Hence, it indicates that profitability and leverage are influential factors to determine quality of financial information, and this result is consistent with the study of Ahmed & Azim, 2015. The result shows that leverage (external financing) and ROA are significant at 10% and 1% level respectively. This study also finds that firm size and accrual quality have no significant association with the quality of financial information.

Table 6: Regression Results of the Quality of Financial Information

	Pooled OLS Analysis	Panel Analysis with random effect
FS (Firm Size)	-0.7395 (0.4710)	-0.7465 (0.4680)
LEV (Ext. Financing)	-24.4248* (0.0698)	-24.9548* (0.0630)
ROA (Profitability)	-149.3331*** (0.0090)	-149.3741*** (0.007)
AccQ (Accrual Quality)	0.0198 (0.214)	0.0195 (0.3210)

In the first row, the table shows the coefficient and the second row shows the probability; * denotes significant at 1% level, *** denotes significant at 10% level.

6. Additional analysis

Table 7 presents the additional analysis, which considers the time dummy to check the robustness of the results. In this analysis, time dummy is controlled in the pooled OLS regression. The regression results show that the results are consistent with the main analysis. This result implies that profitability and leverage are the significant explanatory variables for determining the quality of financial information, but accrual quality and firm size have no significant association with the quality of financial information.

Table 7: Regression Results of Pooled analysis (with and without considering time dummy)

	Pooled OLS with Time dummy	Pooled OLS analysis
FS (Firm Size)	-0.3747 (0.741)	-0.7395 (0.471)
LEV (Ext. Financing)	-24.0250* (0.0980)	-24.4248* (0.0698)
ROA (Profitability)	-123.7283* (0.075)	-149.3331*** (0.009)
AccQ (Accrual Quality)	0.0130 (0.57)	0.0198 (0.214)

In the first row, the table shows the coefficient and the second row shows the probability; * denotes significant at 1% level, *** denotes significant at 10% level.

7. Discussion and Conclusion

This study finds that there is an association between profitability of the firms and the quality of financial information, which implies that profitability is a good indicator of quality of financial information in the context of Cement sector of Bangladesh. This finding is consistent with the study of Ahmed and Azim (2015). This study also finds that condition of overall performance is not up to the mark. This performance can be seen from two different perspectives: disclosure scenario and financial reporting. Low disclosure status communicates the lower performance in terms of quality financial information. Profitability status is very poor in the cement sector as a whole. Earnings are more volatile and, thus, profitability should be more focused to enhance the quality of financial performance without daunting the quality of disclosed financial information.

In short, this study finds that profitability and external financing are the two major explanatory variables in determining the quality of financial information. This study also finds that firm size and accrual quality don't have any significant influence on quality of financial information. This research has some limitations such as limited sample size, unavailability of sufficient dataset, no affiliation with BIG 4 audit firm of the listed cement firms of Bangladesh. But this study provides some indications for future research such as considering the listed firms of other sectors of Bangladesh. Moreover, a cross country comparison can also be considered to check the variation of results in different country setting.

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