



**DETERMINANTS OF FINANCIAL REPORTING QUALITY IN CASE  
OF INSURANCE COMPANY IN THIOPIA**

**MSc. THESIS**

**BY**

**SEYOUM YILMA**

**MAY, 2024**

**WOLKITE, ETHIOPIA**

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OF INSURANCE COMPANY IN ETHIOPIAN**

**BY**

**SEYOUM YILMA**

**ADVISOR NAME**

**MITIKU MELESE (ASS.PROF)**

**A THESIS SUBMITTED TO**

**DEPARTMENT OF ACCOUNTING AND FINANCE, COLLEGE OF  
BUSINESS AND ECONOMICS, SCHOOL OF GRADUATE STUDIES,  
WOLKITE UNIVERSITY**

**IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE  
DEGREE OF MASTER OF SCIENCE IN ACCOUNTING AND  
FINANCE**

**MAY, 2024**

**WOLKITE, ETHIOPIA**

**SCHOOL OF GRADUATE STUDIES**

**WOLKITE UNIVERSITY**

**EXAMINERS' APPROVAL SHEET**

We, the undersigned, members of the Board of Examiners of the final open defense by **Seyoum Yilma** have read and evaluated his/her thesis entitled "Determinants of Financial Reporting Quality in Case of Insurance Company in Ethiopia", and examined the candidate. This is, therefore, to certify that the thesis has been accepted in partial fulfillment of the requirements for the degree of Masters of Science in Accounting and Finance.

<u>Berhanu Dereja</u>	_____	_____
Name of the Chairperson	Signature	Date
<u>Mitiku Melese (Ass.prof)</u>	_____	_____
Name of Major Advisor	Signature	Date
<u>Chernet Bereda (Dr)</u>	_____	_____
Name of Internal Examiner	Signature	Date
<u>Kassahun wolde (Dr)</u>	_____	_____
Name of External examiner	Signature	Date
_____	_____	_____
SGS Approval	Signature	Date

Final approval and acceptance of the thesis is contingent upon the submission of the final copy of the thesis to the School of Graduate Studies (SGS) through the Department/School Graduate Committee (DGC/SGC) of the candidate's department.

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## **ACKNOWLEDGMENT**

First and foremost, I want to thank the Almighty Lord for giving me the perseverance and fortitude to persevere throughout my life. Next to Almighty God, I would like to express my gratitude to my major adviser, Mr. Mitiku Melese (Asst. Prof.), for his direction, counsel, and comments on the thesis. Next, I would want to thank the board secretaries, management, and staff of Ethiopian private insurance businesses for taking the time to provide the necessary information and statistics. Sincere gratitude is also sent to Wolkite University, friends, students, and others for their aid. Finally, I'd want to thank my family and parents for their encouragement, continued understanding, and unwavering support throughout my life.



## STATEMENT OF DECLARATION

By signing below, I swear that my thesis named "Determinants of Financial Reporting Quality In Case Of Insurance Company in Ethiopia." and the material provided in it are my own and was created as a result of my own original research. The study acknowledges all of the materials utilized. I created it on my own, with the exception of the thesis Advisor's advice and suggestions. To the best of my knowledge, this work has not been submitted for a degree at this or any other university. It is provided as a partial completion of Wolkite University's Masters of Science in Accounting and Finance concentration.

Seyoum Yilma

\_\_\_\_\_

\_\_\_\_\_

Student name

signature

date

Mitiku Melesw(Asst.Prof)

\_\_\_\_\_

\_\_\_\_\_

Main advisor

signature

date

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Co- advisor

signature

date

## **ACCRONYMS AND ABBREVIATION**

ARL	Audit Report Lag
FASB	Financial Accounting Standard Board
FRQ	Financial Reporting Quality
FS	Firm Size
IASB	International Accounting Standard Board
LV	Leverage Size
MRL	Management Report Lag
PR	Profitability
SFAC	Statement of Financial Accounting Concept
TA	Types of Auditors
US	United State

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## Abstract

*This study intends to assess the determinants of financial reporting quality in case of insurance company in Ethiopia over a period of 2014-2022. Consequently, the study used document review of insurances' audited financial statements. The explanatory variables used in this study were Leverage (LE), Profitability (ROA), Liquidity (LQ), Auditor Change(AC), Firm Age (FA) and Firm Size(FS).In this study sixteen Insurance companies were selected from a total population of sixteen insurances companies to accomplish a study for the period of nine years (2014-2022) with the total of 144 observations. Moreover, The secondary data were analyzed using descriptive statistics, correlation analysis and panel data analysis and data from document reviews were interpreted quantitatively. The study used panel data and random regression model to analyze the Determinants of Financial Reporting quality of Ethiopian insurance companies. The study found that profitability ratio has positive and insignificant effect on financial reporting quality. While, auditor changes and firm ages had significant effect on financial reporting quality, leverage and liquidity were found to be insignificant effect on financial reporting quality of Ethiopian insurance companies.*

**Keywords:** Financial Reporting Quality, Insurances Company, Earning Management, Abnormal Accrual.

## CHAPTER ONE

### 1. INTRODUCTION

This chapter introduces briefly about background of the study, statement of the problem, research objectives & hypothesis development. Apart from this, this chapter also identifies the significance of the study, scope and limitation of the study and organization of the paper.

#### 1.1. Backgrounds of the Study

Financial institutions play a significant role in the socio-economic growth and development of a nation. Insurance companies, in particular, facilitate a nation's innumerable economic transactions through efficient and effective savings mobilization, risk transfer, indemnification, and financial intermediation processes (Salvatore, 2013; Mishkin, 2010). Today, the necessity for producing quality financial report has received great attention over the world. Providing high quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit and similar resource allocation decisions enhancing overall market efficiency (IASB, 2013).

Financial institutions, channel funds and transfers risks from one economic unit to other economic units so as to facilitate trade and resources arrangement. Recent research, as surveyed by Naveedet all (2011), shows that the efficiency of financial intermediation and transfer of risk can affect economic growth while at the same time institutional insolvencies can result in systemic crises which have unfavorable consequences for the economy as a whole. Hence, Part of the immune and repair system of the economy is the significant role that financial institutions, like insurance companies, continue to play in financing and guaranteeing economic activity as well as contributing to the stability of the financial system in particular and the stability of the economy of the concerned country in general.

Numerous accounting researchers have deep-rooted on the benefits and role of the quality of financial reporting and they also showed that insufficient quality of financial reporting might negatively influence the business performance and economic decisions of the companies (Jaballah *et al.*, 2014; Jane and Jung, 2015). This means that the financial reporting quality might determine managers' willingness for engaging in activities that are not valuable.

Although, the financial reporting quality may facilitate better contracts to avoid investment efficiency. Furthermore, it can increase investors' ability to control the investment decisions. Therefore, it is expected that high-quality financial reporting reduces excessive and wasting investments (Biddle *et al.*, 2009).

The main intention of financial reporting is to provide high-quality financial reporting information concerning economic entities, primarily financial in nature, useful for economic decision-making (IASB, 2008). According to IASB (2008), providing high quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit, and similar resource allocation decisions enhancing overall market efficiency.

In fact, the determinants of financial reporting quality were overlooked in many empirical studies. However, financial reporting quality cannot easily be measured directly and it is very complicated issues. Assessing the quality of financial reporting requires a broad range of measurements using models, proxies, qualitative characteristics, and other elements of financial reports. In the literature, three different dimensions of financial reporting quality are frequently used: Accrual-Based Models, Accounting Conservatism, and Earnings Managements (Yimenu, 2016).

Many approaches have been used to measure and assess financial reporting quality and new approaches are still being developed. For this study the accrual-based model developed by Dechow and Dichev (2002) will be used to measures the financial reporting qualities of Ethiopian insurance companies.

As Jember (2014) report, the Ethiopian financial reporting status has been a remarkably increasing. Based on the recommendations of studies (Observance of Standards and Codes (ROSC), 2007; Ministry of Trade and Industry, 2005), the government has established Steering committees, passed financial reporting Proclamation and drafted the establishment of a professional body.

Several studies have been conducted on financial reporting quality in many parts of the world including Ethiopia. However, the contemporary literatures show conflicting in their findings.

Furthermore, the literature in the context of Ethiopia, (Kirubel, 2016 and Eden, 2017) assessed the determinants of financial reporting quality from manufacturing companies and private banks cannot in Addis Ababa Ethiopia. In very recent year, the study conducted by Eden (2017) assessed the Determinants of Financial Reporting Quality: Evidence from Ethiopian Private Banks. These studies limit their scopes only on manufacturing share companies and Ethiopian private banks. However, these researchers cannot fill the gap. This study, therefore, has come to assess the determinants of financial reporting quality in Ethiopian insurance companies.

### **1.2.Statement of the Problem**

The results of different studies showed that one of the many challenges the financial world is facing currently is lacking quality financial reports. This might decrease the economic environments of the companies, if not assure the quality of financial reporting properly and timely. Today, the insurance sector plays important role in the financial services industry of developed and developing countries, contributing to economic growth, efficient resource allocation, reduction of transaction costs, creation of liquidity, facilitation of economics of scale in investment, and spread of financial losses(Haiss and Sümegi, 2008).

As noted by different empirical evidence that the quality of accounting information can influence the cost of capital, both directly, by affecting market participants' perceptions about the distribution of future cash flows, and indirectly, by affecting real decisions that alter the distribution of future cash flows Lambert, Leuz and Verrecchia (2007).

Other literature found that FRQ positively affects private firm's investment efficiency in emerging markets and that this effect enhances bank financing and decreases incentives to minimize earnings for tax avoidance purposes. It has been noted in different literatures that firms tend to manipulate financial information to meet investor's expectation or to reduce other financial burdens from authorities Chen *et al.* (2011).

Hassan and Bello (2013) stated that when operating performance is poor, managers tend to increase earnings; however, if operating performance is extremely poor, some firms may decrease income further, which is so called "taking bath" strategy. The empirical Studies

implied that firm's quality of financial statement will most likely be influenced by the capital structure choice they make (Hassan *et.al.*2006).

Many researches were conducted on the determinants of Quality of Financial Reporting: measuring qualitative characteristics(Ferdy*et.al.*, 2009;Ahmed *et.al.*, 2018). In Ethiopia a plenty of studies were conducted on determinants of financial reporting qualities and much of them focused on manufacturing companies, private and government owner banks of Ethiopia (Eden, 2017;Yimenu, 2016). Moreover, very few studies were conducted on insurance companies in Ethiopia on the Determinants of Insurance Companies Profitability in Ethiopia(Tariku, 2019). Hence, apart from this conducted research works the researcher found gap on determinants financial reporting quality on Ethiopian insurance companies. The studies locally have not been assessed in the relationship between financial reporting quality and factors determining financial reporting quality.

### **1.3.Objectives of the Study**

#### **1.3.1. General Objective**

The general objective of the study is to examine Determinants of Financial Reporting Quality Evidence from Insurance Company in Ethiopia.

#### **1.3.2. Specific Objective**

Based on the above general objective, the researcher has the following specific objectives:-

- Asses financial reporting quality of Insurance companies in Ethiopia
- To identify the effect of leverageon financial reporting quality of Insurance companies in Ethiopia.
- To identify the effect of liquidityon financial reporting quality of Insurance companies in Ethiopia.
- To identify the effect of profitability on financial reporting quality of Insurance companies in Ethiopia.
- To identify the effect of firm sizeon financial reporting quality of Insurance companies in Ethiopia.
- To identify the effect of insurance ageon financial reporting quality of Insurance companies in Ethiopia.

- To identify the effect of Auditor change on financial reporting quality of Insurance companies in Ethiopia.

#### **1.4. Research Hypotheses**

##### **Firm Leverage**

In large part, agency theory has also been employed to explain the connection between corporate leverage and the accuracy of financial reporting. According to the agency theory (Jensen and Meckling, 1976), a company with a higher debt ratio has an incentive to disclose more information. Empirical evidence appears to be inconclusive for some cases. While Hossain, tan and Adams (1994), Naser, Al-Khatib and Karbhari (2002), Hassan, Percy and Stewart (2006) and Adelopo (2010) have all found a positive relationship between leverage and financial reporting quality, many researchers have not found the positive relationship (Camfferman and Cooke, 2002; Ali, Ahmed & Henry 2004; AlSaeed, 2006). On the other hand, Zarzeski (1996) and Ahmed (2012) found a negative relationship between leverage and disclosure, suggesting that highly leveraged companies tend to disclose private information to their creditors which may not be reflected in their annual reports. These conflicting results provide genuine incentives for further investigation of this relationship. From the above theoretical explanations, we anticipate that the relationship between the quality of financial reporting and leverage is positive.

*H1: Firm Leverage has a positive and significant effect on quality of financial reporting.*

##### **Liquidity**

According to economic theory, disclosures made voluntarily and better information quality ought to reduce information asymmetries. This reduction in information asymmetries increases the firm's liquidity (Hassan and Bello, 2013; Easley and O'Hara, 2004). Overall, the empirical evidence suggests that disclosures and accounting information of higher quality are related to improved liquidity.

*H2: liquidity has a positive and significant effect on quality of financial reporting.*

##### **Profitability**

According to the signaling theory, a profitable corporation may release additional information to support the accuracy of its claimed profitability, to increase its reputation and to avoid

undervaluation of its equity (Inchausti 1997). Firms' profitability has also been argued to have an influence on the quality of financial reporting. Alsaeed (2006) argued that a profitable firm may feel proud of its achievements and therefore would wish to disclose more information to the public in order to promote positive impressions of its performance. However, even though studies by Raffournier (1995) and Patton & Zelenka (1997) did find a significant positive relationship, a study by Alsaeed (2006) on the other hand, had found insignificant relationships. The above arguments lead us to predict a positive relationship between profitability and financial disclosure.

*H<sub>3</sub>: Firm profitability has a positive and significant effect on quality of financial reporting.*

### **Firm Size**

Positive accounting theory gives arguments on entity size and its importance for financial statement disclosures. According to Leftwich, Watts, and Zimmerman (1981), the political costs of large corporations are larger, revealing additional information in order to boost their confidence in their business. Large corporations better information systems that provide them with more information there is no charge. Verrecchia (1983) and his colleagues created a unique cost theory. Dye (1985) quantifies the costs and advantages of revealing.

If the costs outweigh the advantages, the information is withheld. Larger corporations are motivated to improve reporting quality (Prior, Surroca, and Tribó, 2010). Surroca, Tribó, and Waddock, 2010)

*H<sub>4</sub>: Firm size has a positive and significant effect on quality of financial reporting.*

### **Insurance age**

A firm's internal control strength is significantly influenced by its insurance age, and good internal control is linked to high-quality financial reporting. It is believed that the internal control system of a firm becomes better structured as years pass by and a well-structured internal control should naturally guarantee the integrity of the financial report (Huang, Rose-Green & Lee, 2012). Moreover, with the passage of time, firms are more likely to improve their governance and are more likely to be exposed to political risk. This is because government may not pay attention to new firms while firms that have been around for some time are always on the radar of government agencies. These factors are likely to affect their reporting practices

(Chalaki, Didar&Riahnezhad, 2012). Eden, 2017, found significant positive effect of bank age on FRQ. Therefore the study forecast the hypothesis as follow.

*H<sub>5</sub>: Insurance age has a positive and significant effect on quality of financial reporting.*

### **Auditor change**

Documented evidence indicates that IAF has a significant impact on FRQ in terms of detecting and preventing fraud (Church *et al.*, 2001; Coram *et al.*, 2008) and reducing the level of earnings management (Prawitt *et al.*, 2009). Also, investors who have access to IAF reports are more confident of financial statements reliability than those who do not have access to the reports (Archambeault *et al.*, 2008; Holt and DeZoort, 2009; James, 2003). Other evidence indicates that IAF plays an important role in completing the financial statements audit (Felix *et al.*, 2001; Zainet *al.*, 2006), implying that IAF has an effective role in improving the audit quality and, in turn, FRQ. Although, the evidence indicates the importance of IAF quality in influencing the quality of financial reporting, there has been little research on the link between IAF and FRQ. In a recent study, Coram *et al.* (2008) investigated whether organizations with IAF were more capable of detecting and preventing fraud than those without IAF. The study conducted by (Dabor and Ibadin, 2013) found a positive relationship between auditor change and earnings management. This study supports the finding that auditor change brings earnings management. Carcello and Nagy (2004) found that duplicitous financial reporting occurs early in an auditor-client relationship.

*H<sub>6</sub>: Auditor change has a positive and significant effect on quality of financial reporting.*

### **Scope of the study**

The scope of this study was limited to the relationship between FRQ and determinants of FRQ of insurance company in Ethiopia. The study covered all insurance companies that were in full applicable in study period. The scope of study was also limited to the study the all-insurance companies with nine-year annual audited reports.

### **1.5. Significance of the Study**

The primary motivation for this study is the fact that prior research on the determinants of financial reporting quality evidence primarily examined banks rather than insurance companies, and some studies only examined the determinants of financial reporting quality without considering other variables that could affect financial performance. As a result, it is anticipated that this study would present actual data on the reporting quality of insurance companies in Ethiopia. Furthermore, the outcomes of the study would be advantageous to a wide range of stakeholders.

- The administration is interested in identifying success and failure indicators so that it may take the required steps to enhance the company's performance and make the best judgments.
- The government is interested in learning which businesses run successfully or failed to take the required precautions to prevent financial failures in these businesses.
- Investors who want to protect their capital and allocate it to the best investments are interested in such studies.
- Customers are interested in learning about the insurance businesses' financial stability and their capacity to meet their obligations. This research could potentially provide as a foundation for future studies in the field.

### **1.6. Structure of the Study**

The remaining parts of the study are organized as follows. The second chapter of the study contains the literature review portion. The review of the literature contains a theoretical analysis as its first section, which is followed by an analysis of prior research in the field, conclusions, and knowledge gaps as its last sections. The research design and methodology are presented in the third chapter. The fourth chapter of the paper then presents an analysis of the findings and the discussion section. The fifth chapter concludes by outlining the conclusions and suggestions.

## **CHAPTER TWO : LITERATURE REVIEW**

### **2. 1. Introduction**

The study's objective, research hypothesis, and problem were all introduced in the first chapter. The next sections of this chapter give the theoretical review and gap identification in order to set the study within the context of the body of existing literature.

### **2.2.Theoretical Review**

The theoretical review seeks to explain fundamental terminology and theoretical concepts and develop an extensive theoretical framework for the subject. The concept of financial reporting quality, the goals of financial reporting, and a discussion of the theories that aid in understanding and identifying the drivers of financial reporting quality are presented in the subsequent subsections.

#### **2.2.1.Definition of Financial Reporting Quality**

According to Gaynor (2016), financial reporting is a process of reporting financial activities of business on a formal way. It has been considered as an essential resource for any market participant. It also reduces the mystery and the conflict in opinion between all interested users such as managers, investors, regulatory agencies, society and other stakeholders. Every one participates in this process ( In financial reporting quality process), even each operation related to this process should be submitted carefully, especially the disclosure process, all transactions, the accounting policies and all judgments and opinions made by the staff involved in this process.

There is no one, generally acknowledged definition for the concept of financial reporting quality. There are numerous definitions that differ greatly across people, projects, businesses, and organizations, as well as depending on the use to be made of the financial information.

According to IASB (2010), the two primary qualitative characteristics of information in financial statements are relevance and faithful representation. When information in financial statements has the potential to affect how a user of those statements makes decisions, that information is relevant. Information that is relevant has confirmatory or prescriptive value. The

information must accurately represent the economic phenomena that it claims to describe in the real world. Financial statements are helpful to the reader when they are relevant and accurately represented. Along with the fundamental qualities, there are other boosting qualitative qualities that are complementary to them: comparability, verifiability, timeliness, and understandability. More valuable information can be distinguished from less useful information by improving qualitative features. They improve how valuable and accurate financial reporting information is for making decisions.

Financial reporting quality (FRQ) is defined as the faithfulness of the information conveyed by the financial reporting process (Martinez-Ferrero, 2014). The characteristic of the word faithfulness is relevance, reliability, transparency and clarity (Jonas and Blanchet, 2000).

According to FASB & IASB the FRQ is a financial reporting that produce useful information to users, complete, transparent and not misleading, and meets the characteristics of financial information quality that is relevant, reliable, comparable and understandable: FASB and IASB (2008) is explicitly explained his desire to build a comprehensive assessment tool for assessing the quality of financial reporting related to all qualitative characteristics decision because these characteristics determine the usefulness of financial reporting information (IASB, 2008). Usefulness decision paradigm explains the relationship between users of accounting information, accounting information relevance, understanding decision-makers regarding accounting information, and others that affect the use of information in decision making.

### **2.2.2. The Objectives of Financial Reporting**

FASB on its Statement of Financial Accounting Concepts (2008) have stated the objectives of financial reporting. Evaluations of the qualities of financial information are based on the goals of financial reporting since only after these goals have been identified can an effort be made to define the qualities of the information required to achieve those goals. Financial statement content was not the only information that was covered by that statement. "Financial reporting," according to the Statement, "includes not only financial statements but also other means of communicating information that relates, directly or indirectly, to the information provided by the accounting system that is, information about an enterprise's resources, obligations, earnings, etc."

The objectives of financial reporting are summarized in the following excerpts from the Statement:

- ✓ Financial reporting ought to offer details to assist current and potential investors, creditors, and other users in determining the amounts, timing, and uncertainty of upcoming cash receipts from dividends or interest, as well as the earnings from the sale, resale or maturity of securities or loans. The likelihood that an enterprise will be able to generate enough cash to pay its obligations on time, cover its other cash operating needs, reinvest in operations, and pay cash dividends is a factor in the prospects for those cash receipts. This factor may also be influenced by how investors and creditors understand the enterprise's ability, which has an impact on market prices for the enterprise's securities. In order to help investors, creditors, and others evaluate the amounts, timing, and uncertainty of potential net income, financial reporting should give information.
- ✓ Financial reporting should contain details on an organization's economic resources, claims against those resources (such as equity held by owners and obligations to transfer resources to other entities), and the results of any transactions, occurrences, or other circumstances that might alter those resources or claims.
- ✓ Information concerning an organization's financial performance during a specific time period should be included in financial reporting. Investors and creditors frequently consult historical data when evaluating an enterprise's potential. Therefore, even if creditors' and investors' expectations regarding future business success are reflected in investment and credit decisions, those expectations are frequently at least partially based on assessments of previous business performance.
- ✓ Information regarding an enterprise's performance provided through measures of earnings and its components is the main emphasis of financial reporting.
- ✓ Financial reporting describes how a company raises and spends cash, borrows and repays capital transactions, including cash dividends and other distributions of company resources to owners, and how a company's liquidity affects its solvency. Information about other factors that may have an impact should be provided.
- ✓ Financial reporting should offer information on how an enterprise's management has discharged its stewardship responsibility to its owners (stockholders) for the use of company resources entrusted to it.

### **2.2.3. Elements of Quality**

The main principle of evaluating financial reporting quality, according to the IASB, is related to the faithfulness of the objectives and the quality of revealed information in a company's financial reports. These qualitative features facilitate evaluating the value of financial reports, resulting in a high level of quality. Financial reports must be honestly presented, comparable, verifiable, timely, and clear in order to achieve this level. Thus, the emphasis is on having transparent financial reports, and not having misleading financial reports to users; not to mention the importance of preciseness and predictability as indicators of a high financial reporting quality (Gajevszky, 2015).

There are agreed upon elements of good quality financial reporting, as described in the FASB and IASB Conceptual Framework for Financial Reporting. Relevance, faithful representation, understandability, comparability, verifiability, and timeliness are among the qualitative qualities of financial reporting quality. They are classified as basic qualitative features and increasing qualitative characteristics. A theoretical explanation for each of these phrases underlines their significance as qualitative features while also indicating which attributes are regarded as fundamental by certain frameworks.

#### **2.2.3.1. Relevance**

Relevance is strongly related to the concepts of utility and materiality. Relevance demonstrates consumers' capacity to make judgments. When information in financial reports impacts consumers' economic actions, it is unfortunate when this information lacks relevancy. It is also valuable when this knowledge supports users in evaluating, correcting, and confirming present and prior occurrences. The usefulness of making a decision an important part of relevance is consistent with the conceptual framework (Cheung & Wright, 2010). Fair value is considered one of the highly significant indicators of relevance. Using Fair Value in an entity, as a basis for measurement, is an indicator of a high level of relevance in financial reporting information (Beest et al., 2009). Annual reports have a crucial role in determining the level of relevance by disclosing forward-looking information, disclosing information about business opportunities and risks, and providing feedback on how major market events and significant transactions affected entities (Beest et al., 2009).

#### **2.2.3.2. Reliability**

Another important aspect of financial reporting quality is reliability. To be relevant in financial reporting, information must be of high reliability. This level of quality is attained when the information on which consumers rely is free of bias and material errors. Reliability is analyzed based on the qualities of faithful, verifiable, and neutral information (Cheung & Wright, 2010).

#### **2.2.3.3. Comparability**

Comparability refers to the notion of allowing consumers to compare financial statements in order to assess an entity's financial situation, cash flow, and performance. This comparison enables users to compare across time and across other firms operating during the same time period. As Cheung & Wright (2010) remarked: Comparability demands that identical events in the two situations will be reflected by identical accounting facts and figures different events will be reflected by different accounting facts and figures in a way which quantitatively reflects those differences in a comparable and easily interpretable manner. To emphasize this point, financial report notes should disclose and explain all changes in accounting rules as well as the impacts of these changes, not to mention the necessity of consistency in implementing accounting policies and principles. In addition, the results of the present accounting period can be compared to those of earlier periods. Finally, displaying financial index figures and ratios aids in comparison with other firms (Beest et al., 2009).

#### **2.2.3.4. Understandability**

One of the most important characteristics of information in financial reports is its understandability. Effective communication is the key to achieving understandability. Thus, the greater the quality attained, the better the understanding of the information from consumers (Cheung & Wright, 2010). It is one of the improving qualitative features that will rise when information is clearly and appropriately given and categorized. Users can understand their demands when yearly reports are adequately arranged (Beest et al., 2009). The use of graphs and tables aids in the presentation of information, and the use of terminology and technical jargon is readily followed.

#### **2.2.3.5. Timeliness**

Another improving qualitative characteristic is timeliness. Timeliness demonstrates the need of making information available to decision makers before it loses its strong and positive impacts. When evaluating the quality of reporting in an annual report, the period between the end of the

fiscal year and the date the auditor's report is issued is used. The number of days it took for the auditor to sign the report following the conclusion of the fiscal year (Beest et al., 2009).

#### **2.2.3.6. Faithful Representation**

The term of faithful representation refers to reflecting and expressing the true economic situation of the financial information that has been reported. This idea is valuable in that it explains how well responsibilities and economic resources, including transactions and events, are adequately reflected in financial reporting. Furthermore, this trait includes the sub-concept of neutrality, which is concerned with objectivity and balance.

#### **2.2.4. Related Theories**

This section presents theories that help in understanding determinants of financial reporting. The existence of a theory requires us also to use our reasonable expectations about objects. Hendriksen (1970) defines theory as a coherent set of theoretical, conceptual and pragmatic principles forming the general framework of reference for a field of inquiry. Theory is not considered just a simple 'hunch' and it is not a ready concept to be used on demand or when exceptional scenarios exist. A review of the literature indicates that five main theoretical frameworks have been used to explain and analysis the association between financial reporting quality and its determinants. These are Agency theory, Signaling theory, Legitimacy theory, Proprietary costs theory and Positive Accounting Theory: Political Costs. Thus, each of the aforementioned theories related to financial reporting quality and its determinants are discussed in detail in this particular section in an orderly.

##### **2.2.4.1. Agency Theory**

According to agency theory, there is a contract between shareholders (principals) and external auditors to supervise the activity of other agents (management). Shareholders (principals) delegates duties to management (agents). Tasks primarily include running the firm on behalf of shareholders to achieve their goals. The key principle of agency theory is that managers are often driven by their own personal profits and activity to exploit their own personal interests rather than considering shareholders' interests and maximizing shareholder value whereas stakeholders act in a relational way to maximize their personal utility (Toukabri, Ben and Julani, 2014).

The agency relationship leads to the information asymmetry problem due to the fact that managers can access information more than shareholders (Nermeen, 2014). This will allow pursuit of self-interest which increases costs to the firm, which could include the costs of the formation of contracts, loss due to decisions being taken by the agents and the costs of observing and controlling the actions of the agents. Leuz, Nanda and Wysocki (2003) assert that the effects of such behavior ultimately reflect in the company earnings.

As a result, management has an incentive to manage the company's reported profitability in order to achieve or exceed earnings objectives and, as a result, collect any incentives attached to the company's earnings (performance-related compensation). This generates an information asymmetry in that managers can use their accrual discretion, reducing the relevance and reliability of reported earnings and the entire financial statement. 2015 (Leilina) According to Davidson, Goodwin, and Kent (2005), when management gives erroneous financial reporting information, earnings management is introduced as a sort of agency cost. Managers, as a result, cannot be completely trusted. Most of researchers that examine the determinants between financial reporting quality relied upon agency theory (Ahmed, 2012; Hassan and Bello, 2013; Michailesco, 2010; Fathi, 2012; Dechow, Ge and Schrand, 2010) Disclosure literature theoretically hypothesizes and empirically examines agency cost. Some authors apply firm size as a proxy for agency costs and assume a positive association between disclosure and firm size. The ownership structure variable is also examined widely in the literature as a proxy for agency cost. The literature hypothesizes there is a positive association between the ownership diffusion pattern and agency cost. They assume that shareholders will put more pressure on the managers in order to disclose more information. Another proxy for agency cost is audit type. Some authors argue that the monitoring role is fulfilled by the auditing role. They assume that the better the quality of auditor, the more adequate and increased the information will be. A company's financial leverage is also applied as a proxy for agency cost in the disclosure literature. Some authors argue that leverage represents the agency cost between debt holders and managers or shareholders and therefore such association will be reflected in disclosure practice (Abdulla, 2011).

#### **2.2.4.2. Signaling Theory**

The signaling theory argues that the existence of information asymmetry can also be taken as a reason for good companies to use financial information to send signals to the market (Ross1977).

Information disclosed by managers to the market reduces information asymmetry and is interpreted as a good signal by the market (Teixeira and Lima). Although the signaling theory was originally developed to clarify the information asymmetry in the labor market (Spence, 1973), it has been used to explain voluntary disclosure in corporate reporting (Ross, 1977).

Empirically, several studies have studied signaling influence on disclosure: Watson, Shrives and Marston (2002) and Haniffa and Cooke (2002).Several indicators, including profitability, liquidity, and leverage, are identified in the disclosure literature as proxies for signaling theory. According to the hypothesis, directors who feel their firm can outperform others would wish to convey this to shareholders in order to attract more investments. Directors may do so as part of a broader disclosure that goes beyond what is required by law.

According to signaling theory, when a corporation's performance is good, management will communicate such to their investors, stakeholders, and the market by making disclosures that inferior firms cannot make. By enhancing disclosures, directors wish to receive more benefits: a better reputation and the firm's value will increase (Abdulla, 2011). In contrast, firms with poor performance may choose to keep silent rather than reveal unflavored performance. However, investors may misinterpret this silence as withholding the worst possible information (Verrecchia, 1983).

#### **2.2.4.3. Legitimacy Theory**

According to Toukabri, Ben and Julani (2014) the theory of legitimacy is based on two fundamental ideas; companies need to legitimize their activities, and the process of legitimacy that confers benefits to businesses. Thus, the first aspect is consistent with the assumption that social disclosure is connected to social pressure. In this context, we say that the requirement for legitimacy varies depending on the degree of societal pressure to which the corporation is subjected and the amount of responsiveness to that pressure. A variety of variables influence the level of societal pressure on businesses and their responses to that pressure. These variables have the ability to influence corporate social disclosure. The second component is based on the premise that firms may expect to gain from lawful social responsibility conduct.Since the

objective of accounting is providing users with information that help in decision making, i.e., satisfy social interests, the theory has been integrated in accounting studies as a “means of explaining what, why, when and how certain items are addressed by corporate management in their communication with outside audiences” (Magness, 2006). Those external perceptions about companies could be ways by the management of corporate disclosure policies (Deegan, 2002). Then the companies could have a strategy legitimacy and choice and change their legitimacy status and consequently the external perceptions (Aerts and Cormier, 2009). Normally the legitimacy theory is used to explain social and environmental reports disclosure. But the legitimacy theory can be used in corporate report, suggested by Woodward, Edwards and Birkin (1996), as one possible legitimacy/accountability reporting framework, to communicate with the shareholders and clarify the importance of this relationship. Damaso and Lourenco (2011), has concluded that the organizational legitimacy is a useful concept to explain corporate report behavior.

#### **2.2.4.4. Proprietary Costs Theory**

Teixeira and Lima (2007), stated that proprietary costs theory considers the costs of disclosures as well as its benefits. Managers take into account the costs of disclosing information and do not disclose when costs outweigh the benefits. These costs include not only those of preparing and disseminating the information, but also costs of appropriation of the information by competitors. Investors know this and do not apply adverse selection. Proprietary cost theory applied to disclosure is analytically developed by Verrecchia (1983), Dye (1985), Darrough and Stoughton (1990) and Wagenhofer (1990).

#### **2.2.4.5. Positive Accounting Theory**

PAT is focused with anticipating behaviors such as accounting policy decisions made by business management and how managers will react to proposed new accounting standards.

“Positive” refers to a theory that attempts to make good predictions of real world events (Scott, 2003). Watts and Zimmerman (1978) develop a positive theory of the determination of accounting standards. This theory was established through a deductive and normative interaction, and it holds that the choice of accounting systems by businesses reflects agency connections inside the organization as well as potential political consequences. Watts and Zimmerman's major findings demonstrated that accounting disclosures provided by corporations include relevant substance for financial markets. As a result, unexpected market

results yield unusual earnings in the same direction and with fluctuations. However, Watts and Zimmerman argue that financial and extra financial disclosure has little informative meaning unless they convey information about a company's cash flows. According to Hassan (2008), PAT can assist explain how a conflict of interest among management, shareholders, and debt holders effects the corporation's accounting processes.

Highly leveraged corporations, according to politico-contractual theory, use accounting procedures to increase their profits. Toukabri, Ben, and Julani (2014) argue in the same vein that corporations that undertake special expenditures demonstrating their commitment to social duties have a major goal of changing accounting period results and contract debt terms.

### **2.3. Empirical review**

The existing literature is sated with studies undertaken internationally and locally on this phenomenon and the researcher attempt to review some of this study in line with the context of this study.

Yimenu(2016) investigated the Determinants of Financial Reporting Quality: Evidence from Large Manufacturing Share Companies of Addis Ababa. The finding of the study showed that liquidity, leverage and board composition has no any statistically significant impact on large manufacturing share company's financial reporting quality. The data were collected from a two-year period of 2011 and 2012 and the multiple regression analysis was used to test the hypotheses. The findings of the study support the agency theory; hence the results of the relationships between the corporate governance mechanisms, finding that the audit report lag (ARL) and management report lag (MRL) were generally significant. Consequently, the results of the studies revealed that corporate governance mechanisms affect the timeliness generation of financial reports .

Adebiyiet.al (2015) appraised the relationship between corporate ownership structure and financial reporting quality among Deposit Money Banks in Nigeria. The study analyzed whether a firm's ownership structure (measured with three variables: managerial ownership, foreign ownership and institutional ownership) improves the quality of the financial reporting or not. Whereas financial reporting quality is measured by modified Jones model, the researchers used discretionary accruals as a proxy for financial reporting quality. The data are extracted from a sample of all Deposit Money Banks listed on Nigerian

Stock Exchange for nine years between 2005 and 2013, using Ordinary Least Square Regression technique as a tool of analysis for the study. The result showed that financial reporting quality is positively related to managerial ownership and relates negatively to institutional and foreign ownership. This result is consistent with the alignment of interest hypothesis that suggests that managers who own a significant portion of the equity in a firm have less incentive to manipulate reported accounting information. The study's result suggests that managerial ownership improves the quality of annual earnings by reducing the levels of financial reporting manipulation.

The study conducted by Eden S. (2017) on Determinants of Financial Reporting Quality: Evidence from Ethiopian Private Banks shows that; profitability, liquidity, non-performing loan and bank age has significant impact on the financial reporting quality of Ethiopian private banks. Moreover, Al Daoud et al, (2015) the author in her study revealed that liquidity has statistically significant and positive effect on financial reporting quality of Ethiopian private banks. While, in this the author find that financial leverage as measured by ratio of total liabilities to total assets has no statistically significant positive impact on financial reporting quality of private banks in Ethiopia.

#### **2.4. Conclusions and Knowledge Gap**

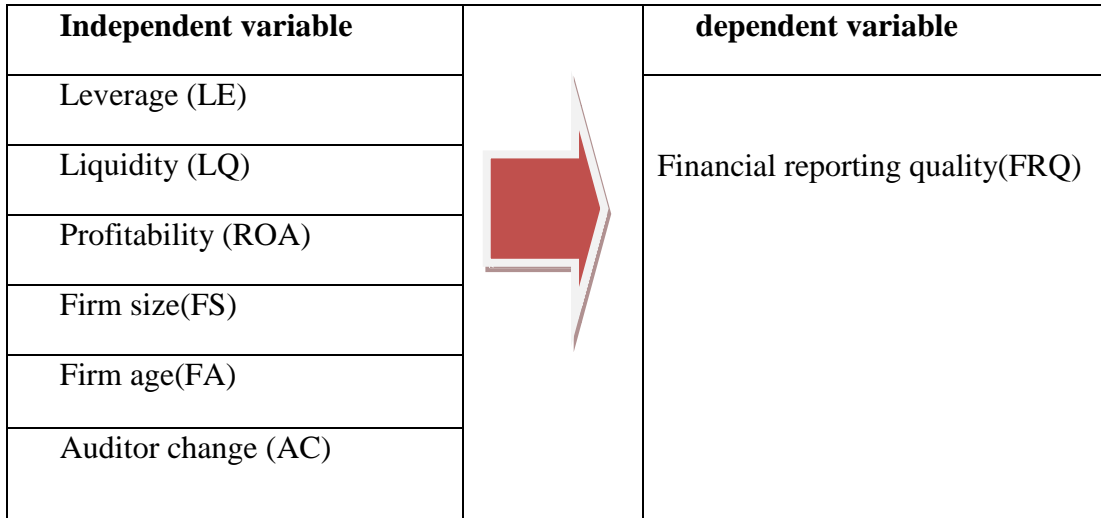
A few literatures on financial reporting quality have been reviewed from previous studies and these literatures focused determinants of financial reporting qualities from different economic sectors of the world. More over the studies on the issue varies from countries to countries and as the researcher in these reviews restricted in developing countries in different time. As far as the knowledge of the researcher, the studies conducted in Ghana, Nigeria and our country Ethiopia.

#### **2.5. Conceptual frame work**

To achieve the research objective and to test the research hypotheses, the research developed this conceptual framework. Since the insurance financial reporting quality is determined by various factors, these insurance companies need to recognize what influences their FRQ to reach optimal level of financial reporting. Financial Reporting Quality (FRQ), which is the

dependent variable, on the other hand, the independent variables are, leverage (LE), liquidity (LQ), profitability (ROA), firm size (FS), firm age (FA) and auditor change (AC).

Figure 1: Conceptual frame work: Relation between Financial Reporting Quality (FRQ) and its determinants.



## CHAPTER THREE

### 3. METHODOLOGY

#### **Introduction**

This chapter discusses the research methodology used in the study. The chapter is organized in following sections. The first section presents the research approach. The second section presents research design of the study. The next section presents sources and type of data and data collection instrument methods of the study. The fourth section focus on data analysis method and finally, model specification and model validity are presented in the study.

#### **3.1. Research Approaches**

When evaluating the factors that influence the quality of financial reporting in the context of Ethiopian insurance businesses, the research problem is often explanatory in nature. Consequently, the quantitative research technique is used, which is a way to evaluate objective ideas by looking at how variables relate to one another (Creswell, 2009). Quantitative research is predicated on measuring quantity or amount, claims Kothari (2004). It works with phenomena that have a quantitative expression.

#### **3.1. Research Design**

The researcher employed an explanatory research design in order to meet the study's goals. A descriptive research aims to paint a picture of a circumstance, person, or event, or to demonstrate the relationships between various elements and the state in which they naturally occur. Descriptive studies, on the other hand, are best suited for a relatively unexplored or relatively new study subject because they are unable to explain why an event occurred. The study's secondary data came from audited financial records of Ethiopian insurance companies between 2014 and 2022. Ethiopian insurance businesses with audited financial reports from 2014 to 2022 made up the study's population. As a result, there are 16 insurance firms in Ethiopia, with a small number having been founded recently (Buna insurance was founded in 2013; Zemen insurance) and weren't taken into account for the research. Since the research include the firms' annual reports for the years 2014 through 2022. As a result, the research included organizations having nine years of audited financial reports.

### **3.2. Data Types and source**

Yugi (2006) asserts that secondary data offers benefits of its own. Secondary data typically provide a source of data that is both permanent and available in a form that can be reviewed reasonably simply by others. Secondary data also offers greater quality data than primary data, the ability to perform longitudinal research, and the permanence of data. As a result, the researcher employed secondary data, which is based on the insurance firms' easily accessible audited yearly financial statements on their website, to increase the reliability of the data (2014–2022).

### **3.3. Data Collection Instruments**

Various data gathering equipment might be employed throughout the data collection process. As per the data collection requirements for the study, the researchers examined the yearly audited financial statements of insurance businesses in Ethiopia from 2014 to 2022 to get secondary data.

### **3.4. Method of Data Analysis**

Panel data analysis, correlation analysis, and multiple linear regression analysis were used to examine the data. The data patterns from 2014 to 2022 were analyzed using mean values and standard deviations according to the firms. Additionally, the correlation analysis was utilized by the researcher to look at the link between the independent and dependent variables. The statistical program "EViews -10" was utilized to do ordinary least square (OLS) analysis in order to determine the most important and crucial explanatory factors influencing the quality of financial reporting in Ethiopian insurance businesses.

### **3.4. Definitions of Variables**

#### **A. Dependent variable**

A wide range of metrics, including models, proxies, qualitative traits, and other financial report components, must be used to evaluate the quality of financial reporting. Three distinct characteristics of financial reporting quality Accrual-Based Models, Accounting Conservatism, and Earnings Management (abnormal accrual) are commonly employed in the literature. The quality of financial reporting has been measured and assessed using a variety of methods, and

new methods are always being created. For this study the accrual-based model developed by Dechow and Dichev (2002) were employed to measure the financial reporting qualities of Ethiopian insurance companies.

Dechow and Dichev (2002) extend the idea on a practical measure of accrual and earnings quality. The model developed a way of combining Dechow and Dichev (2002) and Jones model. They provide a new approach to estimate the quality of accruals, as an example which is related to earlier researches. The accruals quality and earnings process advocates that the size of estimation errors is related to business systematically. The modified model were added to the model of Dechow and Dichev (2002) the essential variables present in the model of Jones, as the annual revenue variation and the value of gross property, plant and equipment as proposed by McNichols (2002).

**The modified Dechow and Dichev's (2002) model is specified as:**

$$\Delta WC_{it} = \beta_0 + \beta_1 CFO_{it-1} + \beta_2 CFO_{it} + \beta_3 CFO_{it+1} + \beta_4 \Delta REV_{it} + \beta_5 PPE_{it} + \varepsilon$$

Where:  $\Delta WC$  is the change in working capital accruals or current accruals from the statement of cash flows, CFO denotes the cash flows from operating activities,  $\Delta REV$  is change in revenue and PPE is property, plant and equipment.

The residuals for the modified Dechow and Dichev's model, after adding the firms' data represented financial reporting quality in the second regression model specified for the study. However, the residual measure the accrual quality, the lower the residuals, the higher and the quality of accruals vice versa as in McNichols (2002). To solve this problem, multiplied the absolute values of the modified Dechow Dichev measure by  $-1$  (Dechow and Dichev's model). Thus, higher values of Dechow and Dichev's model represent higher FRQ.

## **B. Independent Variables**

**Profitability ratio:** is determined by the asset's return. These measurements evaluate a business's capacity to make money in relation to its sales, operational expenses, assets on the balance sheet, and shareholders' equity. It demonstrates how well businesses produce value and profit for their owners.

**Liquidity:** Divide current asset by current liability to get an idea of how well insurance businesses are able to fund asset growth and pay bills on time without suffering intolerable losses (CR). It is the insurer's capacity to meet its short-term obligations to policyholders without having to raise revenue via underwriting, investing, or the sale of financial assets.

$$\text{Liquidityratio} = \textit{CurrentAssets/Current Liabilities}$$

**Leverage:** is calculated as the whole debt to owners' equity ratio. It describes the practice of using debt, or borrowed money, to increase the return on an investment or undertaking. Rather than issuing shares to obtain cash, businesses can utilize debt to invest in their operations and finance their assets in an effort to maximize shareholder value.

$$\textit{LeverageRatio} = \textit{TotalDebt/Totalequity}$$

**The firm size:** A company's operations and financial transactions are impacted by its size. The business unit or endeavor that owns the company's resources, including its tools, controls, and management style, is referred to as the firm. For a certain company, there is no specific description available.

**Age of the insurance company:** age was calculated using the years plus one. Thus, the number of years (plus one) that has passed since the company's founding year is known as the company age. This variable is known as the listing age of the company. To prevent ages of zero, we add a year.

**Auditor change:** Auditor change is measured by dummy variable, 1 if auditor was changed in the year and 0 otherwise.

### **3.7. Model Specification**

To assess the determinants of financial reporting quality in insurance companies in Ethiopia, the following general empirical research model will be taken from empirical studies (Ahmed, 2012; Hassan and Bello, 2013; Fathi, 2012; Dechow, Ge and Schrand, 2010; Atanasko, 2013; Ole, Wayne and Dushyantkumar, 2011; Ferrero, 2014).

$$Y = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \beta_5 x_5 + \beta_6 x_6 + e_{it}$$

$$FRQ_{it} = \beta_0 + \beta_1(ROA_{it}) + \beta_2(FS_{it}) + \beta_4(Ac_{it}) + \beta_5(LE_{it}) + \beta_6(LQ_{it}) + \beta_7(FA_{it}) + \varepsilon$$

Where

- $FRQ_{it}$  is financial reporting quality of insurance companies  $i$  at time  $t$
- $\beta_0$  is intercept
- $ROA_{it}$  is Return On Asset of insurance companies  $i$  at time  $t$
- $FS_{it}$  is firm size of insurance companies  $i$  at time  $t$
- $FA_{it}$  is Firm Age of insurance companies  $i$  at time  $t$
- $Ac_{it}$  is change of auditor of insurance companies  $i$  at time  $t$
- $LE_{it}$  is leverage size of insurance companies  $i$  at time  $t$
- $LQ_{it}$  is liquidity of insurance companies  $i$  at time  $t$
- $\beta_1 - \beta_6$  are Coefficient's parameters
- $\varepsilon_i$  is error term

## CHAPTER FOUR

### RESULTS

#### 4.1. Introduction

The evaluation of the relevant literature in the earlier chapters aided this study in identifying the issue and choosing the best research strategy to address it. The research design used to accomplish the study's goals and test its hypotheses is also covered in the chapter before this one. In Chapter Four, data acquired using a variety of statistical procedures is analyzed, and the results and discussion are presented appropriately. The structure of this chapter is as follows. The findings are shown in the first subsection, which also contains a discussion section and results for descriptive statistics, correlation analysis, normality testing, heteroskedasticity testing, multi-co linearity testing (variance inflation factor), random regression, and confidence interval testing.

#### 4.2. Descriptive statistics

The researcher provides descriptive statistics of the study's independent and dependent variables in this section. The study's dependent variable is financial reporting quality (FRQ), while its independent variables include return on asset, liquidity ratio, leverage ratio, audit change, business age, and firm size. There were sixteen Ethiopian insurance companies covered by the 144 observations during the period of 2014–2022. The variables included in the research period's mean, median, maximum, minimum, and standard deviation are given in the descriptive statistics.

**Table 1: Descriptive statistics**

	FRQ	ROA	LQ	LE	FS	AC	FA
Mean	-47886.54	1.8128	2.0541	2.3753	8.3083	0.3611	16.3333
Median	-10865.50	0.0981	1.2555	1.8982	8.5940	0.0000	17.0000
Maximum	2154.000	93.296	13.240	31.62	9.6137	1.00000	46.0000
Minimum	-14178	-4.701	0.2457	0.0954	0.7909	0.0000	1.0000
Std. Dev.	144988.3	8.1200	2.7102	3.3447	1.1956	0.4819	10.004
Observations	144	144	144	144	144	144	144

Source: output of EViews

The result in the above table 1 showed that, financial reporting quality, have a mean value of -47886.54 and standard deviation of 144988.3. This indicates that the Ethiopian insurance companies have abnormal accrual, on average, with mean value of -47886.54 and the minimum and maximum value of the financial reporting quality is -1417810 and 2154.000 respectively. This implies that the sampled Ethiopian insurance company with -2154.000 has the highest financial reporting quality on the contrary insurance company with -1417810 have a minimum financial reporting quality. The finding showed that the Ethiopian insurance companies have on average negative 47886.54 of abnormal Accrual, financial reporting quality and a 144988.3 is its standard deviation.

The maximum and minimum value of the independent variable return on asset is 93.29600 and -4.1750 respectively. This result showed that there are insurance companies with the maximum value of 93.29600 and insurance companies with minimum value of -4.1750, and a standard deviation of 8.120054 from its mean value with 1.812835. The finding implies that the Ethiopian insurance company generates the average value of 1.812835 of return for each asset in the study period.

The next independent variables which explain dependent variable is liquidity ratio. Its mean, maximum, minimum, and standard deviation are 2.054188, 13.24000, 0.245780 and 2.056260 respectively. This implies that the insurance companies used on average 205.42% of current asset to cover their current liability. According to this Ethiopian insurance companies have ability to pay its short-term liabilities during the study period.

The result as shown on the above table 1 shows that the other explanatory variable of the study is leverage ratio, which has a minimum value and maximum value of 0.095418 and 31.62590 respectively. The result showed that there are Ethiopian insurance companies with the maximum value of 31.62590 and a minimum value 0.095418 and the standard deviation of 3.344736 from its mean value with 2.375296. This implies that on average Ethiopian insurance companies finance their business around 2.375 from long term loan.

The auditor change shows the change of an audit firm for a given insurance company's in a given year while providing external audit service. The mean of this variable for the insurance company's stands at 0.361111 which implies that the average period of a given insurances changes its audit firm. The minimum and maximum value for the variable is 0 and 1

respectively with a standard deviation of 0.48199. The minimum value implies that there is an insurance company which did not change an audit firm within the study period and the maximum value indicates that there is insurance company which changed its audit firm within the study period.

As shown in the table 1 above indicates that the independent variable, firm size included in this study. It is computed by the log of total asset and its maximum, minimum, standard deviation and the mean value of 9.613740, 0.790940, 1.195662 and 8.308307 respectively. The result showed that there are insurance companies in Ethiopia which has a maximum and minimum value of 0.790940 and 9.613740 of asset size. In addition to this result, Ethiopian insurance has an average value of 8.30837 of asset size on average.

The final independent variable included in this study is firm age. This is computed by log of counting the number of years of establishment of the Ethiopian insurance company and it has a maximum, minimum, standard deviation and mean value of 46.00000, 1.000000, 10.00419 and 16.33333 respectively. This implies that there is Ethiopian insurance company which has a maximum and minimum value of 46.0000 and 1.0000. Moreover, the finding showed that the Ethiopian insurance company has 16.333 of age on average.

### **4.3. Correlation Analysis**

Correlation is defined as the linear association between the dependent and independent variables values of the correlation coefficient are always between positive one, negative one and zero. The correlation coefficient of positive one indicates that there is a perfect positive association between the dependent and independent variables; while a correlation coefficient of negative one indicates that there is a perfect negative association between the dependent and independent variables. However a correlation coefficient of zero indicates that there is no linear relationship between the independent and dependent variables. As shown below table 2 presents the relationship between the explanatory variables and financial reporting quality in the study. As displayed in Table 2 the explanatory variables, return on asset (roa), liquidity (lq), leverage, (le), firm size, (fs) and age of the firm (fa) are correlated with dependent variable financial reporting quality (frq).

**Table 2: Correlation analysis**

	FRQ	LQ	FA	FS	LE	AC	ROA
FRQ	1						
LQ	0.0559	1					
FA	-0.2383	0.2998	1				
FS	-0.1302	-0.1950	-0.4972	1			
LE	0.3099	0.1123	0.5385	-0.1589	1		
AC	0.7061	0.0984	0.2488	0.0148	0.1385	1	
ROA	0.1163	-0.1996	-0.1099	-0.1464	-0.2439	-0.1702	1

Source: output of eveiews

As shown on the above table 2 the correlation coefficient of the independent variable return on asset, has a correlation coefficient of 0.1163. This indicates that return on asset has positive correlation with financial reporting quality. Accordingly the numerical value provides the evidence that Ethiopian insurance companies are profitable during the study period. The correlation coefficient of liquidity ratio is 0.0559. This indicates that liquidity has a positive association with that of the financial reporting quality. This suggests that Ethiopian insurance company has ability to pay its current liability. The correlation coefficient of leverage indicates that the value of 0.3099. This implies that leverage has a positive association with that of financial reporting quality. The correlation coefficient of firm size is a negative (-0.1302). Accordingly there is a negative relationship between firm size and financial reporting quality in Ethiopian insurance company.

The correlation coefficient of audit change indicates the value of 0.7061. This displays that there is a positive association between audit change and financial reporting quality. The correlation coefficient of firm age indicates that a value of negative 0.2383 this displays that there is a negative correlation between firm age and financial reporting quality.

## 4.4. Diagnosis test of error

### 4.4.1. Normality test

Ho: Residuals are approximate normally distributed verses

H<sub>1</sub>: Residuals are not normally distributed

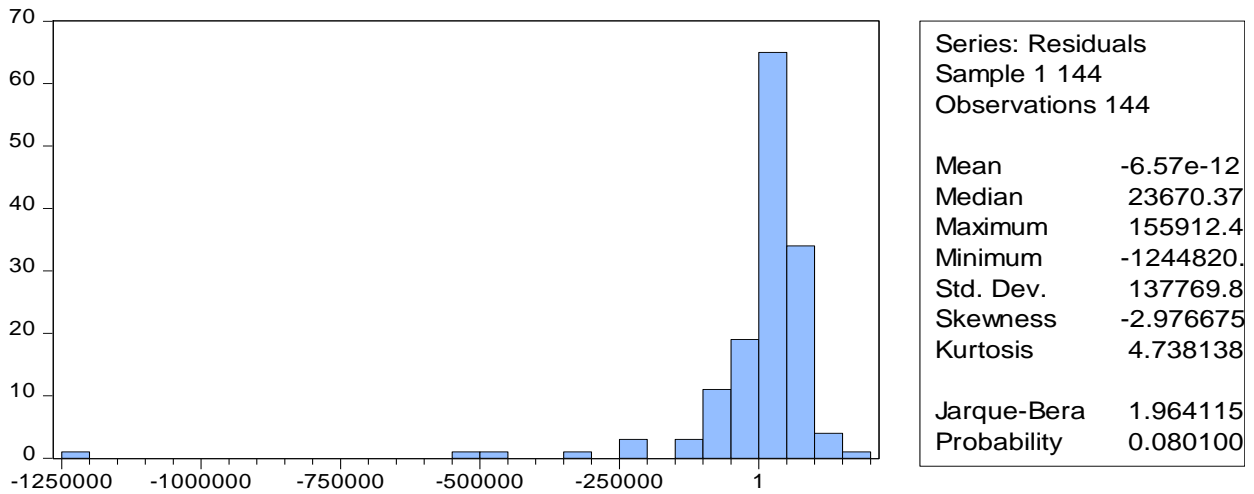


Figure 1: Normality test

The result in the above figure 1 indicates that there is no the problem of error normality. Since the p-value of 0.0801 is greater than 0.05 implies residuals are normally distributed as a result the researcher decide to accept the null hypothesis during the study period.

### 4.4.2. Error autocorrelation test

The conventional test of significance (t-test) is invalid since the disturbances are heteroscedastic. One possible solution is to use White's heteroscedasticity consistent estimators which are robust to the violation of the homoscedasticity assumption.

Ho: Error is constant variance versus H<sub>1</sub>: Error is not constant variance

Table3: Heteroscedasticity

F-statistic	1.114413	Prob. F(26,117)	0.3369
Obs*R-squared	28.58277	Prob. Chi-Square(26)	0.3304
Scaled explained SS	630.4659	Prob. Chi-Square(26)	0.2607

Source: Output of Eviews

Heteroscedasticity test is used to detect whether variance of the disturbance term is constant or not in the distributed. In order to test for the existence of White's heteroscedasticity consistent estimators which are robust test was employed for this study. The result in the above table 3 indicate that the p-value for chi-square (0.3304) is greater than 0.05, therefore there is no heteroscedasticity problem in the study and the decision is accept the null hypothesis.

#### 4.4.3. Multicollinearity

Multicollinearity is a problem that arises from high correlations among the independent variables used in a multiple regression model. Technically, multicollinearity is caused by independent variables in the regression model that contain common information.

Ho: There is no existence of multicollinearity problems

H<sub>1</sub>: There is existence of multicollinearity problems

Table4: variance inflation factor

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	83000000	60.29824	NA
ROA	2190227	1.094681	1.042364
LQ	36896064	2.257643	1.126026
LE	13691220	1.667007	1.105550
FS	103000000	52.78815	1.063801
AC	615000000	1.614593	1.031545
FA	1598453	4.254197	1.154720

Source: Output of Eviews

Multicollinearity defined as a condition for existence of exact (linear) or inexact (nonlinear) relationship between the independent variables. The result in the above table 4 indicates that there is no a problem of multi-collinearity in the explanatory variables. The value of all the independent variables has a Coefficient Variancefactor which is less than 10; this implies that there is no evidence of multi-collinearity problemamong the explanatory variables,This result led to the researcher decides to accept the null hypothesis.

#### 4.4.4. Confidence Interval Test

Confidence interval display the probability that a parameter fall between a pair of values around the mean .confidence interval measure the degree of uncertainty or certainty in a sampling method .They are most often constructed using confidence interval of 95% and 99%. The confidence interval for a mean gives us a range of likely value for the population mean. If a confidence interval does not include a particular value, we can say that, it is not likely that the value is the true population. The result showed below table 5 the independent variable return on asset (ROA) lies between the confidence interval of -2789.305 and 3063.66. This implies that, the sample is not likely fall around the mean of the true population. The independent variable liquidity (LQ) lies between the confidence interval of -7419.024 and 16603.653. This numerical value indicated that, it is not likely that the value is the true population. The independent variable leverage (LE) lies between the confidence interval of -4308.488 and 10325.157. It implies that, it is not likely that the value is the true population. The independent variable firm size (FS) lies between the confidence interval of -37224.083 and -2931.592. This implies that the sample is fall around the mean of the true population. The explanatory variable auditor change (AC) lies between the confidence interval of 25874.573 and 32215.038. The result displayed that it is fall around themean of the true population. The explanatory variable firm age (FA) lies between the confidence interval of -67728.663 and -1728.532. This showed that it is fall around the mean of the true population.

Table 5: Confidence interval

Variable	Coefficient	95% CI	
		Low	High
C	138441.9	-41666.577	318550.47
ROA	137.1772	-2789.305	3063.66
LQ	4592.315	-7419.024	16603.653
LE	3008.335	-4308.488	10325.157
FS	-15864.90	-37224.083	-2931.592
AC	27085.37	25874.573	32215.038
FA	-4228.597	-67728.663	-1728.532

Source: Output of Eviews

#### 4.5. Random effect testing

**Table 6: Correlated Random Effects - Hausman Test**

Test cross-section random effects			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	9.64	6	0.1408

Commonly there are two panel data analysis, these are random and fixed effect models, in order to select the appropriate models to estimate the study variables. However, the choice between fixed effects and random effects model is by computing fixed effect testing and the Hausman specification tests to decide which model is appropriate to estimate the data.

Ho: Random- effect model is more appropriate

H1: Fixed-effect model is more appropriate

In order to select the appropriate model for the study the Hausman's specification test was employed during the period. The table 6 showed that random effect model is more appropriate than fixed effect model for this study, as the p-value (0.1408) is greater than 0.05 to conduct the panel regression estimation of the model. As a result, the researcher decides to accept the null hypothesis.

The researcher used correlated random effect regression models to analyze result of the study and the output is shown in the above table 6. Accordingly, the R-squared statistics and the adjusted-R squared statistics of the model are 0.870950 and 0.575510 respectively. This implies that the independent variables included in this model could explain variation in the dependent variable by about 87% and 57.5% respectively. The remaining 13% indicates that explanatory variables that are not included in this model but that have impact on the financial reporting quality. The F-statistics probability value 0.027538 implies that the data fit the mode well and the explanatory variables are jointly having significant effect on financial reporting quality of Ethiopian insurance companies.

#### 4.6. Random effect result

**Table 7:** Random effect result

					CI (95%)	
Variable	Coefficient	Std. Error	t-Statistic	Prob.	Low	High
C	138441.9	91082.07	1.52	0.129	-40075.63	316959.5
ROA	137.1772	1479.942	0.09	0.926	-2763.455	3037.809
LQ	0.002171	0.163958	0.76	0.450	-7312.924	16497.55
LE	3008.335	3700.165	0.81	0.416	-4243.856	10260.53
FS	-15864.9	6912.696	-1.69	0.0023	-37224.083	-2931.592
AC	27085.37	8103.115	0.93	0.0008	25874.573	32215.038
FA	-4228.597	1264.3	-3.34	0.001	-6706.579	-1750.616
R-squared		0.870950	Mean dependent var		-47886.54	
Adjusted R-squared		0.575510	S.D. dependent var		144988.3	
S.E. of regression		140754.3	Sum squared resid		2.7112	
F-statistic		2.455401	Durbin-Watson stat		1.095088	
Prob(F-statistic)		0.027538				

#### 4.7. Discussion of the results

Under this section, particularly the researcher analyzed in detail the regression result of random effect model. The results of this study show that all variables in the model except Return on asset (ROA) not affect financial reporting quality of Ethiopian insurance companies. Moreover, the regression result indicates that ROA has positive and insignificant impact on the financial reporting quality of Ethiopian Insurance companies. On the other hand, the regression result shows that LQ has positive and insignificant effect; LE has negative and insignificant effect,

The researcher analyzed the result of random effect model and shows that the explanatory variables included in the model such as return on asset (roa), liquidity (lq), leverage (le), and

audit, (ac) and the dependent variable is financial reporting quality (frq). While firm size (fs) and firm age (fa) are constant variables.

### **Financial Reporting Quality Vs Profitability**

The random effect regression result indicates that the coefficient of the independent variable return on asset has a positive and statistically insignificant effect on financial reporting quality at a value of 137.1772 and the p- value of 0.926. It implies that return on asset is statistically insignificant at 5% level. It interpreted as a one percent (1%) increase in return on asset results a 137.1772 increase in financial reporting quality on average. said that profitability is the determinants of quality financial reports. In line with this the study conducted by AlAsiry (2017), Takhtaeiet *al.* (2014), and Fathi(2013) showed that profitability is one of the determinant of quality report. Other empirical studies contradict the finding of the current study. The study conducted by Eyunobo *et al.* (2017) and Hosseinzadeh *et al.* (2014) showed that profitability is not determinants of quality report.

### **Financial Reporting Quality Vs Liquidity**

The independent variable liquidity has a positive and statically insignificant effect on a financial reporting quality at the coefficient of 4592.315 and the p-value of the 0.450. It is not significant at 5% level. Finally, it is interpreted as a one percent (1%) increase in liquidity ratio results a 4592.315 increase in financial reporting quality on average. Therefore, the hypothesis that liquidity has a positive and statically insignificant effect on a financial reporting quality is rejected the null hypothesis. Similarly, the finding of Amihud's (2002) and Chung *et al.* (2009) showed that liquidity and financial reporting quality had positively related to each other. Moreover, the finding of John *et al* 2017 showed that liquidity has positive but insignificant effect on financial reporting quality. This means that a strong and high liquidity position of the in the sectors and Natural Resources firms in Nigeria will enhance financial reporting quality. This finding agrees with the position that firms with good performance indicator such as liquidity, profitability, etc, will like to disclose their performance in the financial report.

Other authors also found the same results that liquidity had Positive and insignificant impact on financial reporting quality Takhtaei and Mousavi (2012), Amr (2016) and Shehu and Farouk (2014). This understanding of the positive relationship between liquidity and financial reporting quality in the Agriculture and Natural Resources sectors could elicit, as a matter of policy, the maintenance of an optimum level of liquidity by management. On contrary, the finding of Ng (2011) showed that they have negative relationship. The author therefore, reported that higher information quality was associated with lower liquidity risk and that the reduction in cost of capital due to this association was economically substantial. The author also reported that the negative association between information quality and liquidity risk was stronger in times of large shocks to market liquidity

### **Financial Report Quality VsLeverage**

The explanatory variable leverage has a positive and statistically insignificant effect on financial reporting quality with its coefficient of 3008.335 and the p-value of 0.416. This implies that leverage ratio has statically insignificant effect on financial reporting quality at 5% level. Generally it is interpreted as a one percent increases in leverage results a3008.335 decrease on financial reporting quality on average. As result, the hypothesis that states that leverage has positive and statistically insignificant impact on financial reporting quality of Ethiopian insurance companies is rejected and accepted the null hypothesis, that leverage has negative and statistically insignificant impact on financial reporting quality of Ethiopian insurance companies. This finding showed that leverage is not the determinants of financial reporting quality of the company. In the same way, Studies of Prihata and Rahaya (2019) and ALAsiry (2017) established leverage is not a determinant of financial reporting quality. Furthermore, the studies of Zarzeski (1996) and Ahmed (2012) found a negative relationship between leverage and disclosure, suggesting that highly leveraged companies tend to disclose private information to their creditors which may not be reflected in their annual reports. The regression result is contradictory with some previous studies. The study conducted by Watts (1990) showed that highly leveraged firms are more likely to engage in opportunistic activities and manipulation to avoid violation of debt covenants. This means that firm leverage is negatively and significantly affects the relationship

between financial reporting quality and investment efficiency in the Ethiopian insurance companies, is rejected at 95 percent significance level.

While, studies of Hossain, tan and Adams (1994), Naser, Al-Khatib and Karbhari (2002), Hassan, Percy and Stewart (2006) and Adelopo (2010) have all found a positive relationship between leverage and financial reporting quality. In addition, the works of Shehu (2013), Karami and Akhgar (2014), Kim and Yang (2014), Shehu and Farouk (2014) and Amr (2016) different from the finding of this study and they founded that leverage has a positive and significant influence on financial reporting quality. More over Leverage is also connected to financial reporting choices. Agency theory clarifies this link. The results of the study not the same as this theory, highly leveraged firms have an inducement to voluntary increase the level of corporate reporting to stakeholders through conventional financial statements (Jensen &Meckling, 1976).

### **Financial Reporting Quality Vs Auditor Change**

The explanatory variable of audit change is a positive and statically significant impact on financial reporting quality with the coefficient of 27085.37 and the p-value of 0.0008. This numerical value indicates that audit change is statically significant at 5% significance level. It is interpreted as a one or more increase in audit change results a 27085.37 increase in financial reporting quality on average. Similarly, the study conducted by (Dabor and Ibadin, 2013) found a positive relationship between auditor change and earnings management. This study supports the finding that auditor change brings earnings management.

The evidence indicated by IAF plays an important role in completing the financial statements audit (Felix et al., 2001; Zain et al., 2006), implying that IAF has an effective role in improving the audit quality and, in turn, FRQ. In the same way, the study conducted by (Dabor and Ibadin, 2013) found a positive relationship between auditor change and earnings management. This study supports the finding that auditor change brings earnings management. Carcello and Nagy (2004) found that duplicitous financial reporting occurs early in an auditor-client relationship.

### **Financial Reporting Quality Vs Firm Size**

More over the constant variable for the firm size has a negative and statically significant impact on financial reporting quality with the coefficient of a -15864.9 with a p-value of 0.0023. The finding implies that firm size has statically significant at 5% level. Many studies have researchers founded that firm have positive and significant effect on FRQ and the results were mixed. In opposite to this, larger firms are incentive to show a positive effect on FRQ (Prior *et al.*, 2008; Surrocaet *al.*, 2010). Moreover, Naser and Al-Khatib (2000), Street and Bryant (2000), Alsaeed (2006), Mangena and Tauringana (2007), Haji and Ghazali (2013), Agyei-Mensah (2013), Ebrahim, abadi and Asadi (2016) and Monday and Nancy (2016) found a significant positive relation between firm size and FRQ.

### **Financial Report Quality VS Age of the Insurance Company**

The other constant variable included in the study is firm age. It has a negative and statically significant impact on financial reporting quality with coefficient of -4228.597 at p-value of 0.001. The result showed that firm age is significant impact at 5% level. It is interpreted as a one or more increase in age of the firm results a -4228.597 decrease in financial reporting quality on average. Similarly, Umoren and Asogwa (2013) found that company age has a positive and significant effect on financial reporting quality. In the study the authors argued that older, experienced and well-established companies are likely to disclose more information because they have established and cost-effective reporting systems. Moreover, firms advance in age 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). From this one can understand that firm age had a positive and significant impact on and financial reporting quality.

The firm gets stronger with age, and a strong and well-structured internal control system guarantees quality financial reporting process, (Huang, Ena& Lee, 2012). On the other hand, younger companies disclose more information to boost investor confidence and reduce skepticism.

Table 8: Summary of Hypothesized and Actual Impact

Independent variables	Measurement	Hypothesis	Actual Impact or effect
Profitability ratio	Measured in return on asset	Positive and significant	Positive and insignificant
Age of the Insurance Company (FA)	Measured age by the numbers of years plus one	Positive and significant	negative and significant
Leverage (LE)	Measured as the ratio of total non-current liabilities to owners' equity and long-term liabilities	Positive and significant	positive and insignificant
Liquidity (LQ)	Measures the ability of insurance companies to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses (CR) is measured by dividing current asset to current liability.	Positive and significant	Positive and insignificant
Firm Size (FS)	The firm is described as the business unit or undertaking which owns the resources of the business, within the scope of its plant's arsenal, its controls and how it is been managed	Positive and significant	Negative and significant
Auditor Change (AC)	Auditor change is measured by dummy variable, 1 if auditor was changed in the year and 0 otherwise	Positive and significant	Positive and significant

## **CHAPTER FIVE**

### **CONCLUSION AND RECOMMENDATIONS**

#### **INTRODUCTION**

The previous chapter presented the results, discussion and summary of chapter four whereas this chapter discusses with the conclusions and recommendations based on the findings of the study. Therefore, this chapter is organized into conclusions and recommendation.

#### **5.1. Conclusion**

Financial institutions are important to the country's socioeconomic development and progress. Research on the quality of financial reporting is becoming more and more popular nowadays. The existing accounting literature does not, however, include much research on the factors influencing the quality of financial reporting that were not specifically focused on insurance businesses. Examining the factors that influence the quality of financial reporting in Ethiopian insurance businesses was the primary goal of this study. The study employed a quantitative research approach to accomplish its goal. Reviewing the yearly audited reports of a sample of thirteen insurance firms from 2014 to 2022 allowed for the collection of quantitative data. EViews 10 was used as the statistical package to examine the obtained data.

The study draws a number of conclusions from its findings, including the following: first, that the quality of financial reporting is the central component of economic activity; second, that the nature of reporting quality varied with insurance, as demonstrated by differences in the trends of the variables; and third, that the determinants of financial reporting quality are poorly defined in the literature because the definition of quality in accounting differs significantly from that of many other fields of study.

Contrary to the researcher's expectations, the study's findings indicate that the profitability ratio, leverage, and liquidity do not have a statistically significant impact on the financial reporting quality of Ethiopian insurance companies. The study's results also indicate that auditor change, firm size, and firm age have a statistically significant effect on the financial reporting quality of Ethiopian insurance companies.

## 5.2. Recommendations

The study's findings demonstrated a substantial association between financial reporting quality and the variables of auditor change, company age, and firm size. Additionally, the study found a favorable relationship between financial reporting quality with liquidity, auditor change, leverage, and profitability. Thus, while assessing the quality of their financial reporting, insurance firms ought to give these important factors more consideration. The study's conclusions have led to the following suggestions.

- It is observed that compared to underperforming insurance firms, very profitable insurance companies may have worse quality financial reports. The explanation might be that when insurance business revenues rise, management may manipulate numbers out of worry of how shareholders would react to significant tax payments. The insurance businesses' financial reporting is of poor quality as a result of management's manipulation of earnings. Therefore, it is recommended that auditors, analysts and regulators should consider intensive investigation on the financial information conveyed by low performing insurance companies.
- It was discovered that the quality of the financial reports produced by insurance firms improved with age. In order to ensure that Ethiopian insurance businesses, both new and old, meet a minimal degree of quality in their financial reporting methods, it is advised that NBE establish a minimum standard for internal control. In addition, to ensure the caliber of their financial reporting, businesses must have robust internal controls in place from the moment they launch.
- Although the impact of liquidity on an insurance company's financial reporting quality is not statistically significant, it is still advised that insurance companies enhance their liquidity management systems by diversifying and expanding their funding sources and reducing the duration of their assets, as these actions will enhance the quality of their financial reports.
- The quality of insurance businesses' financial reporting is significantly improved by auditor changes. This implies that in order to enhance the firms' auditing operations, insurance companies should rotate their auditors on a set schedule. As a result, it is advised that insurance firms oversee and limit the frequency of auditor changes inside their organizations. To dispel any doubts on the subject, more in-depth research is required as this survey did not include all insurance firms in the nation.

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