

**EFFECT OF BANK SPECIFIC CHARACTERISTICS ON  
THE FINANCIAL REPORTING QUALITY:  
EVIDENCE FROM PRIVATE COMMERCIAL BANKS  
IN ETHIOPIA**

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**Abstract**

This study targeted at examining the impact of bank-specific characteristics on the quality of financial reporting of selected private commercial banks in Ethiopia. This study used both primary and secondary data that were collected from private commercial banks included in the sample. First secondary data, annual audited financial statements, have been collected, and then content analyses have been conducted on the annual audited financial statements to collect primary data. Fixed effect model was selected to estimate the effect of banks specific characteristics on the FRQ. The regression analysis result shown that age of banks and bank liquidity have a direct significant effect on the FRQ; whereas, Leverage and profitability have a direct impact on the quality of financial reporting, but are not material. Finally, it was recommended to the banking sector governing body to set definite rule or minimum criteria for financial reporting so that both banks with shorter and longer operating life will produce and report financial reports with better quality. It is also recommended to conduct a study considering additional bank specific characteristic and corporate governance features.

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**KEYWORDS:**

Bank Specific  
Characteristics,  
Financial reporting,  
Private commercial  
banks, Quality

Received: 26 March 2023

Accepted: 24 June 2023

Published: 10 July 2023

**TO CITE THIS ARTICLE:**

Zerihun, H. L., & Devi,  
M. U. (2023). Effect Of  
Bank Specific  
Characteristics On The  
Financial Reporting  
Quality: Evidence From  
Private Commercial  
Banks In Ethiopia.  
Seybold Report Journal,  
18(04), 187-203.  
[https://seybold-  
report.com](https://seybold-report.com)

## 1. Introduction

Financial reporting is a way of providing users of accounting information with information about a company's operations; and the quality of financial reporting depends on the quality of accounting standards and the corresponding regulatory oversight of the standards (Kantudu & Samaila, 2015). The main target of financial reporting is to deliver information on a company's financial statements that can be utilized to aid in making economic decisions. The need for preparing high-quality financial reports is currently receiving a lot of attention worldwide. It is imperative to offer accurate financial reporting data since doing so will enable investors, creditors, and other stakeholders to make decisions that will increase market efficiency overall. (IASB, 2018).

Hussain et al. (2019) indicated that any firm must have high-quality financial reporting in order to respond appropriately to information they received, even investors can get high returns using this information that can positively influence their decision and achieve their goals.

According to Martnez-Ferrero (2014), the quality of financial reporting can be expressed as the veracity of the data generated by the process of financial reporting. The fullness, neutrality, and error-free nature of the information are characteristics of a faithful presentation of information. According to Jimoh (2018), for financial institutions to make effective judgments, the preparation and presentation of both financial and non-financial information must be standardized.

The quality of financial reporting can vary due to the complex interaction of many factors, which makes it difficult to measure, especially across borders (Tang et al., 2016). Prior studies used different methods to measure the quality of financial reporting. For instance, operationalizing the elements of qualitative features of accounting information (Yurisandi and Puspitasari, 2015), Mahboub (2017) and (Al-Dmour et al., 2018); earning management using accruals, accounting conservatism and accrual quality as a proxy of financial reporting quality (Martínez-Ferrero, 2014); using anomalous loan loss provision as a substitution for earning management was used to measure the persistence and predictability of earnings. (Juliani and Siregar, 2019); earning management (Sisay, 2017) and Olowokur, Tanko and Nyor (2016) are used to measure the quality of financial reporting.

An organization's financial reporting quality is influenced by a variety of factors. These factors can be entity specific factors like age of firms, size of firms, leverage, liquidity, profitability and others; and corporate governance feature variables like board independence, audit committee and

board size. A number of studies have been done to find out how various variables influence the quality of financial reporting. Rahman & Hasan (2019) examined how profitability, leverage, and firm size affected the quality of financial reporting. They found that size of firms has adverse immaterial effect; whereas, leverage and profitability have an adverse substantial influence on the quality of financial information. (Balios et al., 2021) observed the many factors that affect the quality of financial reporting following the adoption of the New Greek accounting standards. The result of their study indicated that firm size, audit firm size, leverage and geographical distribution more specifically the location of the headquarters have a positive substantial effect on the quality of financial reporting. Profitability has a negative correlation with the quality of financial reporting; whereas, liquidity has little impact on the quality of financial reporting. Usman et al. (2013) also found that firm size, leverage, board composition, institutional shareholding, profitability and firm growth have a positive significant effect on the quality of financial reporting, but liquidity has a negative substantial effect.

Another study by Putri & Indriani (2020) inspect the effect of bank specific factors on the quality of financial reporting. They found that leverage and profitability have significant effect on FRQ, but size of firm has an insignificant impact on the FRQ of a firm. As indicated above, most of the studies proved a mixed result for the different factors affecting the quality of financial reporting and most studies used other methods to measure the quality of financial reporting than the operationalization of elements of quality characteristics of financial statements. Therefore, this study attempted to inspect the effect of bank specific features on the quality of financial reporting. By making the components of qualitative traits of financial reports operational, the quality of financial reporting has been assessed. The bank specific characteristics identified for this study are age of banks, leverage, profitability and liquidity.

## **2. Research Methodology**

### **2.1 Research Design**

Both descriptive and explanatory research designs have been used in this study. Descriptive research aims to provide an accurate and methodical description of a population, circumstance, or phenomenon. The questions of what, where, when and how can be addressed, but why question cannot be addressed by the descriptive research. When a population, or a variable's characteristics,

frequencies, trends, or categories need to be identified, descriptive research is a good option. Explanatory research, which examines patterns and trends in existing data and is frequently regarded as a type of casual research, can also be described as a “cause and effect” model. Casual refers to the association between the explanatory and response variables. In other words, the variables are directly related to one another.

## **2.2 Sample Size and Sampling Method**

The commercial banks operating in Ethiopia were the study’s target populations. According to the national bank of Ethiopia’s annual report for 2020-21, there are one state owned and 17 private owned commercial banks operating in Ethiopia. From the private commercial banks, the researcher purposively selects eight banks having 15 consecutive years annual audited financial statements. These banks are Abyssinia Bank, Awash Bank, Cooperative Bank of Oromia, Dashen Bank, Hibret Bank, Nib International Bank, Wegagen Bank, and Lion International Bank.

## **2.3 Data Type and Sources**

This study has been conducted based on a data including qualitative and quantitative data. The primary and secondary sources used to gather these data. First, secondary data has been gathered from sampled private commercial banks for 15 years’ time period, from 2007 to 2021, in the form of annual audited financial statements. The collected annual audited financial statements were subjected to a content analysis in order to gather primary data.

## **2.4 Data Analysis**

This study made use of both descriptive and inferential statistics. Descriptive statistics are used to present the qualitative descriptions in a manageable format, give straight forward summaries of the sample and measures, and describe the fundamental characteristics of the data in the study. Descriptive statistics includes mean value, standard deviation, minimum value and maximum value of the variables of the study. Inferential statistics includes correlation analysis and regression analysis. Finding out whether there is a relationship between variables and then figuring out the strength and direction of that relationship are the main goal of correlation analysis. Regression analysis helps to decide the statistical association between response and explanatory variables.

## 2.5 Model Specification

Data collected from primary and secondary sources were analyzed using panel regression analysis to inspect the impact of bank-specific features on the FRQ. The panel regression model includes one dependent variable and four independent variables. The panel regression model was stated as follows:

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + E_{it} \quad (1)$$

$$FRQ_{it} = \beta_0 + \beta_1 BAG_{it} + \beta_2 LV_{it} + \beta_3 ROA_{it} + \beta_4 LQ_{it} + E_{it} \quad (2)$$

Where:

$FRQ_{it}$  = Represents financial reporting quality of banks  $i$  at time  $t$

$\beta_0$  = Constant, Y intercept

$BAG$  = Age of Bank  $i$  at time  $t$

$LV$  = Leverage of bank  $i$  at time  $t$

$ROA$  = Return on Asset (Profitability) of bank  $i$  at time  $t$

$LQ$  = Liquidity of bank  $i$  at time  $t$

$E_{it}$  = Error term

**Table 2.1 Summary of variables and their measurement**

No	Code of Variable	Variables	Measurement	Category
1	FRQ	Financial Reporting Quality	Content analysis index	Dependent
2	BAG	Age of Banks	Number of bank's operating year	Independent
3	LV	Leverage	Total liabilities to total assets ratio	Independent
4	ROA	Return on Asset	Net income to total assets ratio	Independent
5	LQ	Liquidity	Liquid assets to deposit ratio	Independent

### 3. Results and Discussion

This section presents statistical analyzes of the response and explanatory variables incorporated in this study. The response variable in the study was the quality of financial reporting, and the explanatory variables were bank age, leverage, profitability, and liquidity. The statistical analysis included descriptive statistics and inferential statistics. The descriptive statistics include mean, standard deviation, minimum and maximum for each response and explanatory variable, whereas the inferential statistics includes correlation and regression analysis.

#### 3.1 Descriptive Statistics

Table 3.1 Descriptive statistics of variables

Variables	Observations	Mean	Std. Dev.	Min.	Max
FRQ	120	.6183333	.0919475	.45	.79
BAG	120	15.25	6.033686	1	27
LV	120	86.41667	5.061941	49	92
ROA	120	2.703167	1.109032	-3.76	5
LQ	120	38.57567	21.37608	13	137.5

Note: FRQ stands for Financial Reporting Quality, BAG stands for Age of Banks, LV stands for Leverage, ROA stands for Return on Asset (profitability) and LQ stands for Liquidity

Source: STATA Output

Table 3.1 above shows the descriptive statistics for the response and explanatory variables included in the study. The response variable, Quality of Financial Reporting, has a mean index score of 0.6183333. Also, the minimum and maximum index values are 0.45 and 0.79 respectively. The minimum and maximum age of banks are 1 year and 27 years respectively. This indicates that either of the bank has one year of operation at the beginning of the study period and the other bank has 27 years of operation at the end of the study period. The mean value for leverage indicates 86.41667. This indicates that from the total asset of the private commercial banks on average 86.42% represents liabilities and the remaining 13.58% represents the balance of equities on the reporting date. Also, the minimum and maximum values of leverage are 49% and 92% respectively, and the average profitability as measured by return on asset is 2.703167.

This shows that a birr investment in assets yields an average return of about 2.70% on the investment made. The minimum and maximum values of profitability are -3.76% and 5% respectively. The last variable which is liquidity has a mean value of 38.57567. This represents on average the liquid asset of private commercial banks is 38.58% of the deposits accepted from customers. The minimum and maximum values of liquidity are also 13 and 137.7.

### 3.2 Correlation Analysis

Table 3.2 Correlation matrix of variables

	FRQ	BAG	LV	ROA	LQ
FRQ	1.0000				
BAG	0.5141**	1.0000			
LV	0.4126	0.4640**	1.0000		
ROA	0.0482	0.1006	0.3802**	1.0000	
LQ	0.4157**	-0.6838**	-0.5503**	- 0.0621**	1.0000

**Note:** \*\* significant at 1%; FRQ stands for Financial Reporting Quality, BAG stands for Age of Banks, LV stands for Leverage, PROF stands for profitability and LQ stands for Liquidity

Source: STATA Output

The table above, Table 3.2, shows the degree of association among the variables included in the study using Pearson's correlation coefficient. The table shows that FRQ is positively significantly related to bank age and liquidity. FRQ also has an insignificant correlation with leverage and profitability. Liquidity also has a negative significant relationship with age of banks and leverage, and a positive insignificant relationship with return on asset. Return on asset also has a positive insignificant relationship with age of banks and a positive significant relationship with leverage. Finally, leverage and age of banks have a positive significant relationship.

### 3.3 Test of Normality

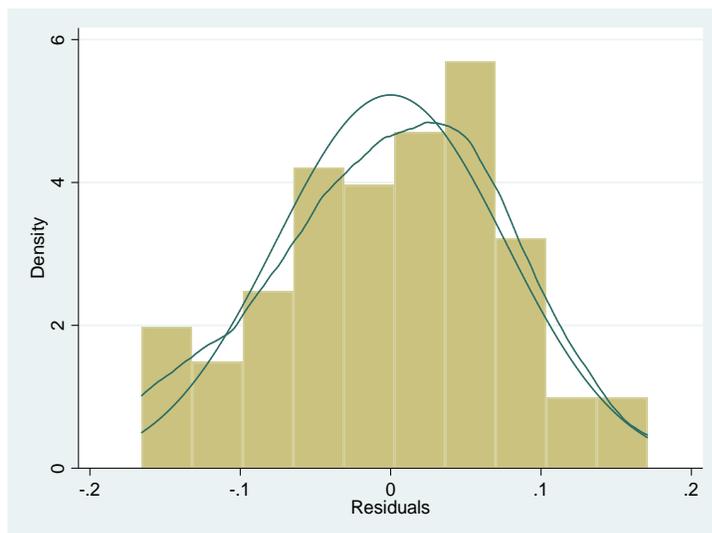
One of the assumptions of classical linear regression model is normal distribution of the residual (normality). One of the most commonly applied tests for normality, the Jarque-Bera (JB) test, was utilized by the researcher to determine whether or not the normality assumption was violated in this study. A normally distributed series has a Skewness of zero and a kurtosis coefficient of three.

This indicates that, if the residuals are normally distributed, the histogram should be bell-shaped and the Jarque-Bera statistic would not be significant. Gujarati & Porter (2010) indicated that the null hypothesis for testing normality using Jarque-Bera testing method is stated as:

Ho: The distribution is normal.

The Jarque-Bera test statistics with a P-value of greater than 0.05 leads to the acceptance of the null hypothesis.

**Figure 3.1 Normality Curve**



Source: STATA Output

Series: Standardized Residuals	
Sample: 2007 – 2021	
Observations: 120	
Mean	3.35e-10
Median	.0046233
Maximum	.1707098
Minimum	-.1656163
Std. Deviation	.076355
Variance	.0058301
Skewness	-.2110895
Kurtosis	2.490544
Jarque-Bera	2.65
Probability	0.2654

As shown on figure 3.1 above, the results of Skewness and Kurtosis of -0.2110895 and 2.490544 respectively, indicates that the two parameters meet the suggested criteria of normality. In addition to the result of Skewness and Kurtosis, Jarque-Bera test was employed to assess the significance of the result. The Jarque-Bera test result of a P-value greater than 0.05 leads to the acceptance of the null hypothesis: the distribution is normal. As indicated on figure 3.1 above, the result of Jarque-Bera 2.65 with a P-value of 0.2654 indicates that the distribution satisfies the requirement of normality.

### 3.4 Test of Multicollinearity

Table 3.3: VIF for independent variables

Variables	VIF	1/VIF
LQ	2.47	0.405246
BAG	2.13	0.469229
ROA	1.75	0.572477
LV	1.21	0.823306
Mean VIF	1.89	

Source: STATA Output

To test the existence of multicollinearity problem, the Variation Inflation Factor (VIF) has been used. The above table, table 3.3, shows that the variation inflation factor value for each explanatory variable is below the threshold value of 10, even less than 5. The mean variation inflation factor for the explanatory variables included in the model is 1.89. This indicates that there is no problem of multicollinearity among the explanatory variables incorporated in the model.

### 3.5 Test of Heteroskedasticity

Breusch-Pagan test for Heteroskedasticity

Ho: Constant variance

chi2(1) = 0.00

Prob > chi2 = 0.9895

The result of Breusch-Pagan test for heteroskedasticity is Prob > chi2 = 0.9895, where P is more than 0.05. As a result, the null hypothesis was accepted; which declares that the residuals are distributed with constant or equal variance. Therefore, there is no problem of heteroskedasticity.

### 3.6 Test of Autocorrelation

The absence of autocorrelation is the other basic assumption of classical linear regression. Autocorrelation exists if residuals in one time period are related to residuals in another period; that is correlation of errors/residuals over time. The study used Durbin-Watson statistics to test for the presence of autocorrelation. As indicated by Saunders et al. (2016) and Field (2013) Durbin-Watson test is used to test for serial correlations between errors; that is, it tests whether adjacent residuals are correlated. The test statistics can vary between 0 and 4. The hypotheses for Durbin-Watson test are specified as follows:

Ho: there is no first order autocorrelation

Ha: there is a first order autocorrelation

A Durbin-Watson statistics which falls in the range of 1.5 - 2.5 indicates the absence of autocorrelation. In this study, Durbin-Watson value of 1.73 falls in the range that indicates absence of autocorrelation. This result recommends accepting the null hypothesis that indicates there is no first order autocorrelation.

### 3.7 Model Selection: Hausman Test

The first test, test of parameters, was made to check the joint significance of dummies. The test result showed that  $P > F = 0.0000$ , this is a significant result which is  $P < 0.05$ . This means that the dummies are not equal to zero. Therefore, this indicates that the OLS model is not the fitting model for the data. The next test, hausman test was made to pick the best model among the fixed effect and the random effect models. The hausman test result indicates  $\text{Prob} > \chi^2 = 0.0000$ , which is a significant result ( $P < 0.05$ ). This result leads to rejecting the null hypothesis and accepting the alternative hypothesis. This indicates that the fixed effect model is preferable than the random effect model. Therefore, the regression analysis is made using the random effect estimation model and discussions are made based this result.

### 3.8 Regression Result

Table 3.4 Fixed effect estimates of the model

FRQ	Coefficients	Std. Err.	t	P >  t	[95% Conf. Interval]	
BAG	.0166331	.0024107	6.90	0.000*	.0118545	.0214116
LV	.1992941	.1874743	1.06	0.290	-.1723126	.5709007
ROA	.8785937	.7056424	1.25	0.216	-.520112	2.277299
LQ	.1446318	.0533378	2.71	0.008*	.0389071	.2503566
_Constant	.1129132	.1674765	0.67	0.502	-.2190542	.4448807
R-sq = 0.4345, N = 120, Prob > F = 0.0000, * indicates the level of significance at 1%						

Source: STATA Output

indicated that 43.45% of the variation in FRQ could be explained by the explanatory variables included in the model. There are 120 observation for each variables collected from eight banks for 15 years. The F-test result of  $P > F = 0.0000$  indicated that the model is properly fit with the data used in the study. From the explanatory variables incorporated in the model, the coefficient of age of banks variable is positive and the highest from the other variables and significant at 1%. Age of banks have positive significant effect on the FRQ. This indicates that age of banks tends to increase the FRQ: as age of banks increase the FRQ of banks will also increase. This result agreed with the result of Fanani (2011) and Sisay (2017), but not consistent with the result of Olowokure et al. (2016) and Echobu et al. (2017) as they found immaterial effect of age of banks on FRQ.

The result of leverage indicates a positive coefficient but the lowest from the coefficient of the other independent variables and insignificant. Leverage positively impacts private commercial bank FRQ, but is not significant. This indicates, as the level of leverage increases the FRQ will also increase but the effect of increase is insignificant. This outcome is similar with the result of Olowokure et al. (2016) and Sisay (2017), but contradicts with the result of Fanani (2011), Echobu et al. (2017), Mahboub (2017) and (Putri & Indriani, 2020) as they found a positive significant effect. To the opposite, Rahman & Hasan (2019) found a negative significant effect of leverage on the FRQ. The same result is found for profitability like leverage. Profitability has a positive coefficient but insignificant effect. This result corroborates with the result of Mahboub (2017) and Adedapo & Samuel (2019). The result of profitability in this study is not consistent with the result of Sisay (2017) found a negative significant effect and Asegdew (2016) and (Putri & Indriani, 2020) found that profitability has a substantial positive impact on FRQ.

Finally, liquidity variable has a positive coefficient and significant at 1%. This means liquidity has a positive substantial influence on the FRQ of private commercial banks in Ethiopia: as the liquidity position of banks increases the FRQ tends to increase significantly. This result is similar with the result of Abang'a (2017), Sisay (2017) and Echobu et al. (2017), but Fanani (2011) and Adeiza Farouk et al. (2019) found that liquidity has insignificant effect on the FRQ.

#### 4. Conclusion and Recommendations

The study sought to examine the influence of bank-specific features on the quality of financial reporting by private commercial banks in Ethiopia. FRQ was measured by operationalizing the five qualitative features of financial reporting: relevance, faithful representation, understandability, comparability and timeliness. The bank specific characteristics used in the study are age of banks, leverage, profitability and liquidity. The result of descriptive statistics depicts the mean index value of FRQ is 0.6183333, and the minimum and maximum values are 0.45 and 0.79 respectively. The mean values for the independent variables are: approximately 15 years of operating life for age of banks, 86.42% of total liability from the total asset for leverage, 2.70% return on asset for profitability and 38.57% of liquidity.

The correlation analysis also indicates a positive strong relationship of FRQ with age of banks, leverage and liquidity; age of banks with leverage; and profitability with liquidity. A negative significant relationship was also found for liquidity with age of banks and leverage. The rest of relationships are insignificant.

The result of fixed effect model showed that the explanatory variables incorporated in the model explained a 42.75% variation of FRQ. It also shows that bank age and liquidity position has a substantial positive impact on FRQ. The remaining variables leverage and profitability have an insignificant positive impact on the FRQ for private commercial banks in Ethiopia.

The regression analysis result indicated that age of banks and liquidity variables have positive substantial effect on the quality of financial reporting, whereas leverage and profitability have positive but immaterial effect on FRQ. Thus, age of banks and liquidity can be taken as the most important variables that impact the FRQ. Therefore, it is recommended to the governing body to set definite rules or minimum criteria for financial reporting so that both banks with shorter age and longer age will produce quality financial reports that will ultimately increase the confidence of different stakeholder for using the financial reports as a base for decision making or different purposes. It is also recommended for banks to give attention for their liquidity position as it is the main determinant of FRQ.

## 5. Direction for Further Study

This study was conducted considering four bank specific characteristics variables. Therefore, consideration of other bank-specific characteristics and corporate governance characteristics variables is recommended for further study.

## COMPETING INTERESTS

The author has no competing interests to declare.

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**HOW TO CITE THIS ARTICLE:**

Zerihun, H. L., & Devi, M. U. (2023). Effect Of Bank Specific Characteristics On The Financial Reporting Quality: Evidence From Private Commercial Banks In Ethiopia. *Seybold Report Journal*, 18(04), 187-203. <https://seybold-report.com>

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