

## Capital Structure and Financial Reporting Quality; Evidence from Listed Consumer Goods firms of Selected Commonwealth African Countries

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*Hence, we recommend that firms with high leverage positions must be scrutinized keenly by both shareholders, auditors, and regulatory bodies as the propensity for low quality reporting indicative of manipulatory tendencies could be stronger*

**Keywords:** Capital Structure, Debt to Equity, Financial Reporting Quality, Jones Discretionary Accrual, Commonwealth African Countries

### Abstract

*The study investigates the effect of capital structure on financial reporting quality by employing samples from listed consumer goods manufacturing firms of selected Commonwealth African countries between the periods of 2011-2020. Particularly, the study provides evidence on the effect of capital structure on the financial reporting quality of listed consumer goods firms in Kenya, Nigeria, and South Africa. We conducted pool least square regression before proceeding to check for inconsistencies with the basic assumptions of the OLS regression. The diagnostic test reveals the absence of both multicollinearity and heteroscedasticity, hence implying that the OLS estimates can be employed for policy interpretation and recommendation. The results shows that firms which have higher debt in their capital structure are prone to higher agency cost. Particularly, the study fails to confirm the position of Agency theory to explain the relationship between firm leverage and financial reporting quality. Hence, the study concludes that financial reports may be used to avoid agency costs and to reduce information asymmetries.*

### 1.0 Introduction

The capital structure of companies is made of equity or debt (Lin & Lee, 2016). The use of debt in the capital structure of organizations varies from one country to another, industry to another, and firm to another firm within the same industry. The use of debt in the capital structure of a company depends on the funding needs of a firm as well as the desire and ability of stockholders to provide funds to a company. A primary concern in corporate finance is how organizations make decisions regarding their capital structure. According to the trade-off theory, the optimal leverage of a firm should be chosen from a trade-off between the benefits as well as the costs of the debt. The benefits include tax savings and reduced cost between the managers and shareholders (Onodugu, Kalu, Anowor & Ukwueni, 2014; Hohenfels, 2016). On the other hand, the costs include financial distress costs and agency conflicts between shareholders and debt holders. Additionally, the pecking order theory suggests that a company should implement a financing hierarchy that minimizes negative selection costs incurred in security issuance (Baber, Kang, and Li, 2011).

Financial reporting is important for management to make informed business decisions based on facts of the company's financial health. Financial reporting quality can be defined as the precision with which financial reporting conveys information about the firm's operations; its expected cash flows, in order to inform equity investors (Uwuigbe, Eluyela, Uwuigbe, Obarakpo, & Falola, 2018). Financial reporting quality is focused on the notion of shareholder/investor protection. This perspective defines quality financial reporting as full and transparent financial information that is not designed to obfuscate or mislead users (Jonas & Blanchet 2000). There is a fundamental distinction between these two perspectives of financial reporting quality. The user needs perspective is mainly concerned with providing relevant information to users for making decisions, whereas the shareholder/investor protection perspective aims to ensure that the information provided to users is sufficient for their needs, transparent and competent (Jonas and Blanchet 2000).

Capital structure is one of the most important firm-level decisions, affecting the firm's risk profile to its expected return to its sensitivity to micro- and macroeconomic business conditions. Under asymmetric information, adverse selection concerns affect a firm's capital structure options (Cooney and Kalay, 1993; Myers, 1984; Myers and Majluf, 1984; Nachmann and Noe, 1994; Noe, 1988; Onodugo, Anowor & Ofoegbu. 2018) and can result in suboptimal firm-level capital structure. An important role of financial reporting is to reduce the amount of information asymmetry between management and external parties. Due to lower amounts of the risk of bonds, the expected return on the part of creditors is lower than the return

expected by shareholders. Therefore, up to a certain amount, the more use of debts for financing will lead to less overall firm's capital cost and greater profitability. However, increasing debts increases firm's financial risk and thus, the creditors demand higher interest rates.

Recent studies on capital structure have used the characteristics of organizations and industries to explain the variation of financial leverage. However, most of the studies fail to acknowledge the quality of financial report, although it is an essential proxy for information quality that companies present to the insiders and outsiders. Furthermore, majority of the studies reviewed in the literature are single country studies and to the best of the researcher's knowledge there are no studies especially in developing countries that have examined this subject using Commonwealth African countries. Hence, we investigate the effect of capital structure on financial reporting quality by employing samples from listed consumer goods manufacturing firms of selected Commonwealth African countries between the periods of 2011-2020

## **2.0 Conceptual Review and Hypotheses Development**

### **Capital Structure**

There are many definitions given to capital structure of companies. Brealey and Myers (1991) defined capital structure as comprising of debt, equity or hybrid securities issued by the firm. VanHorn (1989) defined capital structure as the proportion of debt to the total capital of the firms. Pandey (2005) defined capital structure as a choice of firms between internal and external financial instruments. From the definitions given by many

previous researchers, capital structure of a firm describes the way in which a firm raise capital needed to establish and expand its business activities. It is a mixture of various types of equity and debt capital a firm maintains, resulting from the firm's financing decisions. The amount of debt that a firm uses to finance its assets is called leverage. A firm with a lot of debt in its capital structure is said to be highly levered. A firm with no debt is said to be unlevered. Capital structure essentially refers to a firm's combination of debt and equity financing (Brealey et al. 2007; Onodugo & Anowor, 2013). A major distinction between the two instruments is that the former creates a financial obligation to repay a principal sum plus an interest thereupon, while the latter accrues any residual earnings to its holders.

### **Financial Reporting Quality**

Schipper (2009) is of the opinion that poor financial reporting quality results from a deliberate action taking by an external hand in the financial reporting process, aimed at attaining some personal benefits. It can be gathered from this viewpoint that earnings management has been largely perceived to be behind the kind of reporting that is geared towards manipulating various users for personal gain and also altering the outcome of contract agreements. It can be concluded from this view that an inverse relationship exists between the quality of earnings and earnings management. In other words, the more involved the organization is in earnings management the lower will be the quality of earnings and vice versa. In the event that opportunistic behavior is being detected in the management of earnings, then the

accounting number and the entire financial report would be of a low quality. According to Bruggemann, Hitz and Sellhorn (2012), financial reporting is a standard accounting practice that uses financial statements to disclose a company's financial information and performance over a particular period, usually on an annual or quarterly basis. In simple terms, a financial report is critical for understanding how much money you have, where the money is coming from, and where your money needs to go.

### **Hypotheses Development**

#### **Capital Structure and Financial Reporting Quality**

An important role of financial reporting is to reduce the amount of information asymmetry between management and external parties. Consequently, a growing literature shows the quality of financial reporting reduces adverse selection issues, which reduces financing frictions in both the debt and equity markets (Bharath, Pasquariello, and Wu, 2009; Bushman and Williams, 2014; Francis et al., 2005; Lang and Maffett, 2011; Agbarakwe and Anowor, 2018). Thus, we conjecture that financial reporting may play a role in a firm's capital structure. Specifically, as the quality of financial reporting increases, the financing frictions of the firm are reduced. This reduction in financing frictions may lead to a more efficient or optimal capital structure within the firm. Prior research also suggests that while financing frictions can affect both debt and equity holders, depending on the parameter values of the models, equity may have a greater adverse selection discount (Cooney and Kalay, 1993; Nachmann and Noe, 1994; Noe,

1988). Thus, we examine how financial reporting quality relates to over- versus-under levered firms. We posit that in our setting the effect could be more pronounced for over levered firms due to the fact that financial reporting is a public signal and debt holders use not only public but also private signals (Bharath, Sunder, and Sunder, 2008; Zhang, 2008). Thus, as financing frictions in the equity market relatively increase, management may be more likely to over lever the firm. As the degree of information asymmetry increases between management and outsiders, the firm is faced with greater financing frictions. From the foregoing, we state our hypothesis as:

***H0: Capital Structure has no significant effect on the financial reporting quality of listed consumer goods firms of Selected Commonwealth African Countries***

### **Theoretical Review**

The agency relationship which is the baseline for the theory is seen as a contractual relationship that holds between the principal which are the owners of the firm and agent which is management (Jensen & Meckling 1976). The relationship is defined or bounded by expectations of principal from the agent who largely based on the grounds that the agent will act in the best interest of the owners of the business. However, in the process of both agent and principal trying to optimize their positions, conflicts of interest are unavoidable. The theory posits that in trying to address and minimize surge of this divergence in interest between agent and principal, the principal must introduce monitoring and hence incur the monitoring

costs. According to agency theory, to reduce agency problem there must be better monitoring and controlling mechanisms which helps to ensure that managers pursue the interests of shareholders rather than only their own interests. The agency theory is useful for the study because it presupposes that manager can act opportunistically to alter the financial reporting quality. Firms with higher leverage compared to those with low leverage also face higher agency cost. Therefore, the agency theory provides the theoretical lens for us to understand how capital structure can directly influence reporting quality depending on the extent to which these attributes heighten agency conflict between management and shareholders.

### **Empirical Literature**

Mortahan and Talebnia (2016) studied the relation between financial information disclosure and capital structure decisions of companies listed on Tehran Stock Exchange. The statistical population of the study consisted of companies listed on Tehran Stock Exchange during the time period of 2009 to 2014 and sample volume was equal to 118 companies by using screening method and after the elimination of outlying observations. Results obtained from firm data analysis by using multivariate regression at 95% indicated that there is a direct relationship between rating of timely financial disclosures, rating of financial forecasts disclosure and rating of annual financial reports disclosure with capital structure decisions. It was also indicated that there is no significant relationship between rating of regulations compliance and rating of company web site

disclosure with capital structure decisions of a company.

Chen, Lim, and Lobo (2016) find that firms with better information quality raise more equity whereas firms with poorer information quality prefer to issue debt when they seek external financing. They examine the relation between accounting information quality (measured by earnings precision, accruals quality, and analyst consensus) and financial leverage across 24 countries and whether that relation varies systematically with country-level investor protection and financial orientation. They document a lower financial leverage for firms with better information quality. More importantly, they find a stronger relation between information quality and financial leverage in countries with weaker investor protection and more market-oriented economies. These cross-country results suggest that information quality is especially important in shaping a firm's capital structure decision when investor demand for information is greater.

Hashem and Mehdi (2011) conducted a study on corporate debt and earnings quality with the aim of investigating the relationship between corporate debt financing and earnings quality and to find negative influence of debt on earnings quality. They collected data from 81 firms listed on Tehran Stock Exchange (TSE), for the period of five (5) years (2005-2009). To test the research hypothesis, comparative method of T-test, correlation matrices and multiple regression analysis were applied. The findings of their study showed that there is a negative relationship between debt and earnings quality. They explained that debt have a positive influence on

earnings quality because managers are likely to use their accounting discretion to provide private information about the firms' prospects to lower financing costs. The study was however conducted in a country with a different legal system from that of Nigeria. A similar study in Nigeria may yield a different result.

## **1.0 Methodology**

The study is longitudinal covering a period of ten (10) years; that is, from 2011 to 2020 employing listed consumer goods firms in selected Commonwealth African countries. The population of the study consists of all the listed consumer goods manufacturing firms with representation from Nigeria, Kenya, and South Africa. As of December 2020, we had 22 consumer goods manufacturing firms in Nigeria, 16 consumer goods manufacturing firms in Kenya and 35 consumer goods manufacturing firms in South Africa. The sampling technique employed is purposive since firms were included in the sample on certain selection criteria. These criteria were that firms are listed on the selected countries' exchanges for 2011-2020; there was access to their annual financial reports within the period and they were not firms operating subsidiaries in the countries that are not listed in the Stock Exchange. Newly listed firms and delisted firms were excluded from the study. Thus, only consumer goods manufacturing firms that had all relevant data due to continuous existence were included in the sample. Our final sample size consists of 16 consumer goods manufacturing firms in Nigeria, 7 consumer goods manufacturing firms in Kenya, and 30 consumer goods

manufacturing firms in South Africa. Thus, the study adapted the model specified by Bolarinwa and Adegboye (2020) which was modified for the purpose of establishing the relationship between the dependent variables and the linear combinations of several determining variables captured in the study. Succinctly, the econometric form of our model is expressed as:

$$JOSA_{it} = \beta_0 + \beta_1 DETA_{it} + \beta_2 FSIZ_{it} + \mu_{it}$$

**Where:**

- JOSA = Jones Discretionary Accrual Measure of Financial Reporting Quality
- DETA = Debt to Asset Measure of Capital Structure
- FSIZ = Firm Size
- $\beta_0$  = Constant
- $\beta_1$ -  $\beta_2$  = Slope Coefficient
- $\mu$  = Stochastic disturbance
- i = i<sup>th</sup> firm
- t = time-period

**Variable Measurement**

The dependent variable of this study is financial reporting quality. In line with prior studies, the study measures financial reporting quality using the Jones Discretionary Accrual Model. The independent variable of capital structure is measured using the ratio of debt to total asset which have been employed in line with the studies of Echobu et al. (2017). In the case of the control variable, we measured firm size as the natural logarithm

of total asset following the study of Ahmed (2012).

**4.0 Empirical Results and Discussion**

The study investigates the effect of capital structure on financial reporting quality by employing samples from listed consumer goods manufacturing firms of selected Commonwealth African countries between the periods of 2011-2020.

**Descriptive Statistics Analysis**

In this section, we examine the descriptive statistics for both the explanatory and dependent variables of interest. Each variable is examined based on the mean, standard deviation, maximum and minimum. Table 1 below displays the descriptive statistics for the study.

**Table 1: Descriptive Statistics**

VARIABLES	MEAN	SD	MIN	MAX	NO. OBS
JOSA	-0.02	0.16	-1.05	1.42	516
DETA	27.57	34.30	3.17	298.63	519
FSIZ	6.95	0.80	5.30	9.19	525

**Source:** Author (2022)

The table above shows the descriptive statistics of this study. From the table, we find that the mean of financial reporting quality as proxied by Jones discretionary accrual (JOSA) was -0.02 with a standard deviation of 0.16. In the case of our independent variable, the table shows leverage (DETA) for the combine sample was 27.57 with a standard deviation of 34.30. For the control variable, the table

shows that the mean of firm size (FSIZ) for the combine samples was 6.95 with a standard deviation of 0.80.

### Correlation Analysis

In examining the association among the variables, we employed the Pearson Correlation Coefficient (correlation matrix), and the results are presented in the table below.

**Table 3:** Correlation analysis

VARIABLE S	JOSA	DETA	FSIZ
<b>JOSA</b>	1.00		
<b>DETA</b>	0.26	1.00	
<b>FSIZ</b>	-0.21	-0.21	1.00

### Author's computation (2021)

In the case of the correlation between capital structure and financial reporting quality, the above results show that there exists a positive association between financial reporting quality and the independent variable of capital structure (0.26). However, we find that the control variable of firm size (-0.21) has a negative association with the dependent variable of financial reporting quality as proxied by the Jones Discretionary accrual. However, to test our hypotheses a regression results will be needed since correlation test does not capture cause-effect relationship.

### 4.2.2 Regression Analyses

Specifically, to examine the cause-effect relationships between the dependent variables and independent variables as well as to test the formulated hypotheses, we first conducted an OLS regression before proceeding to check for inconsistencies. The OLS pooled results obtained is presented and discussed below:

josa	coef.	std. Err.	t	P> t	[95% Conf. Interval]	
deta	.0006705	.0002077	3.23	0.001	.0002624	.0010787
fsiz	-.0192121	.0088953	-2.16	0.031	-.036688	-.0017361
_cons	.0977061	.0634146	1.54	0.124	-.0268793	.2222915

F-Stat: 8.96 Prob > F: 0.0001 R-squared: 0.0339 VIF: 1.03 Hestest: 0.32(0.5730)

In the table above, we observed from the OLS pooled regression that the R-squared value of 0.03 shows that about 3% of the systematic variations in financial reporting quality proxied by Jones discretionary accrual in the pooled consumer goods firms in selected Commonwealth African Countries over the period of interest was explained by the independent variable and control variable in the model. The unexplained part of financial reporting quality can be attributed to exclusion of other independent variables that can impact on financial reporting quality but were captured in the error term. The F-statistic value of 8.96 and its associated P-value of 0.0001 shows that the OLS regression model on the overall is statistically significant at 5% level, this means that the regression model is valid and can be used for statistical inference. However, we further subject the estimates of the OLS regression to diagnostic test such as multicollinearity and heteroscedasticity. The table above also shows a mean VIF value of 1.03 which is within the benchmark value of 10, this indicates the absence of multicollinearity, and this means no independent variable should be dropped from the model. Also, from the table above, it can be observed that the OLS results had no heteroscedasticity problems since its probability value was insignificant at 5% or 1%. This confirms that the OLS estimates

can be employed for policy discussion and recommendation.

### Discussion of Findings

This study provides evidence on the effect of capital structure on the financial reporting quality of listed consumer goods firms in Kenya, Nigeria, and South Africa. The study is extension of prior studies are not in agreement with the position of this study. Particularly, the results from the OLS regression shows that capital structure (OLS regression 0.001 (0.001)) as an independent variable to financial reporting quality appears to have a positive and significant influence on financial reporting quality. This therefore means we should reject the null hypothesis *{H0: capital structure has no significant effect on the financial reporting quality of listed consumer goods firms of selected commonwealth African countries}*. This suggests that an increase in debt and equity financing will significantly increase financial reporting quality of consumer goods manufacturing firms of the three countries in our sample. This result disagrees with prior empirical results which show that leverage insignificantly increases financial reporting quality (Devalle et al. 2010). Furthermore, we fail to agree with the studies of Agostino et al. 2010, Devalle et al. 2010 who concluded that leverage significantly reduces financial reporting quality. The study fails to confirm the position of Agency theory to explain the relationship between firm leverage and reporting quality. Firms which have higher debt in their capital structure are prone to higher agency cost (Alsaeed, 2006). Financial reports may be used to avoid agency costs and to reduce information

asymmetries. Hence, it is argued that leveraged firms have to disclose more information to satisfy information needs of the creditors. However, on a contrary argument, leverage increases wealth transfers from fixed claimants to residual claimants. High leverage indicates that debt holders would exercise control over firm's management and hence their financial reporting.

### 5.0 Conclusion and Recommendation

The study investigates the effect of capital structure on financial reporting quality by employing samples from listed consumer goods manufacturing firms of selected Commonwealth African countries between the periods of 2011-2020. We conducted pool least square regression before proceeding to check for inconsistencies with the basic assumptions of the OLS regression. Succinctly, these diagnostics tests include test for multicollinearity as well as test for heteroscedasticity. We also perform preliminary pre-regression analysis such as descriptive statistics and correlation matrix. The diagnostic test reveals the absence of both multicollinearity and heteroscedasticity, hence implying that the OLS estimates can be employed for policy interpretation and recommendation. Particularly, the study fails to confirm the position of Agency theory to explain the relationship between firm leverage and financial reporting quality. We find that firms which have higher debt in their capital structure are prone to higher agency cost. Succinctly, financial reports may be used to avoid agency costs and to reduce information asymmetries. Hence, we recommend that firms with high leverage positions must be



scrutinized keenly by both shareholders, auditors, and regulatory bodies as the propensity for low quality reporting indicative of manipulatory tendencies could be stronger.

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