

Reviewing the effect of intra-industry correlation on the financial reporting environment

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ABSTRACT

Recognizing and understanding the *financial reporting* environment of companies and the factors affecting it is crucially significant because they are important in the process of analyzing *financial* reports and developing standards. To this end, the present study aims to review the effect of intra-industry correlation on financial reporting environment in companies listed in Tehran's Stock Exchange. To test the research hypotheses, 126 companies that were listed in Tehran's Stock Exchange during a period from 2013 to 2016 were selected using the screening method. In this study, the effect of *intra-industry correlation on quality of profit, accuracy of management's projection of future profits and quality of exposure*. The EViews software has been used for analyzing the research data. The results obtained from this research indicates that if intra-industry correlation is high, the profit will also be of high quality. Moreover, intra-industry correlation has a significant impact on the accuracy of projection of future profits, but it does not have such an effect on the quality of exposure.

Keywords: Intra-industry correlation, financial reporting environment, auditors.

Introduction

Nowadays, it is quite obvious that industrial clusters play a significant role, as a spatial representation of small and medium-sized industries, in the obtainment of development in its general sense both in developed and developing countries. That is because industrial clusters are created when small and medium-sized industries come together in a geographical substrate and since they have broad horizontal and vertical links, they provide a high level of efficiency and productivity for businesses to be formed. In fact, industrial clusters are created as specialization and division of labor increase and therefore there are more job opportunities created and productivity and income are

increased [1] Because of the financial information presented in these industries, users trust financial statements. Financial reporting must present information that is useful for potential and actual investors, creditors and other users in logical investments, credit granting and similar decisions. The information that is presented must be easily understandable for those who have a reasonable perception of business affairs and economic activities or those who wish to make efforts and study the information. Some of the objectives of financial reporting is providing information required for assessing the financial status and economic foundation of the firm reporting the information, assessing performance and potential profitability, evaluating the financing of the organization and how organization's cash is spent, assessing management's supervision responsibility and how legal obligations are being followed and providing complementary information required for having a better understanding of the presented financial information and projection of the future status of the organization. Some of the users of financial reports are potential investors, actual investors, loan lenders, credit granters and those who provide other financial facilities, goods and services salesmen, customers, managers, employees, government, society (Stock Exchange, legal and judicial authorities, financial advisers and accounting, management and economics journals). The higher

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the quality of financial reports is and the more valid and creditable standards and regulations are used in preparing and auditing these reports, the more the users will trust them. Also, the risk of information will be reduced and share price will be positively affected.

Many studies in the field of auditory and financial affairs have shown that the quality of the financial reporting has been defined as the level of honesty of managers who present true and fair information to decision makers. In other words, whenever managers are objective and impartial while presenting the items written in the financial statements, it can be said that quality of the financial reports is desirable and high quality improves the profitability of the presented financial information. Therefore, it is evident that legislators and investors agree when it comes to having high-quality financial reports; because the final belief is that the quality of the financial report directly affects the capital markets. Thus, considering that the quality of financial reports has a significant effect on the capital markets, it can be concluded that at a macro level, the quality of financial reporting has important economic impacts^[2]. Given the conditions of industries and their relations with the reporting environment, the present study aims to answer this question: does intra-industry correlation have an impact on the financial reporting environment?

Research hypothesis

Intra-industry correlation has an impact on quality of exposure.
Intra-industry correlation has an impact on quality of profit, accuracy of projection of future profits.

Research background

Aflatooni and Bakhtiarvand (2016) wrote an article and reviewed the quality of financial reporting and quality of exposure on capital cost: a toolkit approach. The results obtained from studying the relationship between the aforementioned variables are indicative of an endogeneity bias^[3]. Moreover, the results obtained from using the toolkit approach suggest that there is a significant and negative relationship between the two variables quality of financial reporting and quality of exposure and capital cost.

In their article, Janani and Chaman Gard Khoram Abadi (2013)^[4] have reviewed the role of quality of exposure in financial reporting and the main reason for discussing the subject, i.e. the crucial significance of exposure of financial information in today's business world^[4]. Their article is a scientific – descriptive research which has been conducted using the library research method. In this article, the definitions of exposure and quality of exposure have been overviewed and optional and mandatory exposure as well as audience and levels of exposure have been discussed and ultimately, the relationships between quality of exposure and features such as asymmetric information, profit management, capital cost and firm size have been studied and specified.

Namazi *et al.* (2011) have conducted a research and showed that there is a positive and yet weak relationship between auditor's

measurement criteria (auditor's fame) and profit management and auditor's tenure; however, this relationship is not statistically significant. On the other hand, the findings of Etemadi *et al.* (2009) also indicate that the work auditors specializing in the industry do and what they present to their employers is of higher quality.

Helfin *et al.* (2016) have found out that profit quality criterion cannot totally cover the quality of exposure criterion in explaining capital cost and both quality of exposure and quality of profit play an independent role in explaining capital cost. None of the researches carried out in Iran in the field of the effect of quality of financial reporting and quality of exposure on capital cost has focused on the concept of endogeneity^[5].

Larker and Rasticcas (2010) have reviewed the relationship between quality of exposure and capital cost with and without the assumption of endogeneity of the quality of reporting variable^[6]. They have shown that only when the quality of reporting variable is assumed to be endogenous and the toolkit approach is used, the negative and significant relationship between quality of exposure and capital cost can be discovered and if the quality of exposure is assumed to be exogenous, only the significant relationship between the aforementioned variable and the cost of ordinary share capital is discovered.

Research Method

The present study is an applied research that puts emphasis on correlational and analytical relationships. Applied research are guided towards practical application of knowledge. Furthermore, considering data collection method used in this research, it is a descriptive – inferential research.

The Excel and Eviews software have been used for analyzing research data and testing the research hypotheses. After extracting the necessary information about the variables under study from the aforementioned sources, the extracted information was put in a sheet in Excel and then, the required computations for obtaining the variables were done and finally, the Eviews software has been used for testing the hypotheses.

Statistical population

Statistical population of this research consists of all of the companies listed in the Stock Exchange. The statistical sampling method for selecting the samples of this research was the screening method. Then, the samples were studied in a period from 2013 to 2016 by taking the following terms of conditions into consideration:

1. Companies whose financial year ends in March 20th.
2. Companies that have not been stopped throughout the aforementioned period.
3. Companies except for investment firms, banks, insurance companies and holdings.

Given the terms mentioned above, 126 companies between the years 2013 and 2016 were selected as the statistical samples of the study.

Research Findings

Descriptive statistics

Table (1) shows the results associated with the descriptive statistics about research variables.

Table 1: descriptive statistics of template variables*

Variable	Average	Median	Maximum	Minimum	Standard Deviation
Intra-industry correlation	1.078	0.997	3.85	0.052	0.57
Quality of exposure	0.326	0	1	0	0.47
Quality of profit	0.817	1	1	0	0.39
Projection of future profits	6.35	6	14	1	4.13

Given the results obtained from the descriptive statistics of research variables, it can be argued that all of the variables have suitable distributions.

Inferential statistics

Before estimating the template, the F-Limer test must be conducted in order to review the application of panel data method with fixed effects as opposed to the cross-sectional data method for the template above. The hypotheses of this test follow:

H_0 : normal cross-sectional data

H_1 : panel data with fixed effects

The results of the F-Limer test have been illustrated in table (2).

Table 2: results of the F-Limer test

Value	Error Level	Accepted Method
4.98	0.000	Panel data method with fixed effects

*source: research findings

As it can be observed in table (2), the results indicate that H_0 is rejected. Therefore, the panel data method with fixed effects is the preferable method. Now, it is time to carry out the Hausman test in order to choose between the panel data method with fixed effects and panel data method with random effects as well. The hypotheses of this test follow:

H_0 : panel data with random effects

H_1 : panel data with fixed effects

The results of the Hausman test have been displayed in table (3).

Table 3: results of the Hausman test

Value	Error Level	Accepted Method
35.41	0.000	Panel data method with fixed effects

As it can be seen in table (3), the results indicate that H_0 is rejected. Therefore, the panel data method with fixed effects is

the preferable method. Here, table (4) shows the results obtained from estimating the research template using the panel data method with fixed effects.

Table 4: results of estimating the research template*

Variable	Variable Coefficient	T-Value	Error Level
Intra-industry correlation	1.81	3.6	0.000
Quality of exposure	0.104	3.12	0002
Quality of profit	-0.167	-3.61	0.000
Projection of future profits	0.01	2.15	0.032
F-statistic (P-Value)		(0.000) 9.39	

Given the results illustrated in table (4) and the obtained f-value (9.39) and its error level (0.000), it can be stated that at a 99% confidence level, all in all the research is quite significant. In addition, considering the adjusted determination coefficient obtained for the template (56%), it can be said that in total, the control variable and the independent variables of the research explain more than 56% of the variances of the dependent variable. Moreover, given the value of the Durbin-Watson statistic (1.89), it can be said that there is no first-order autocorrelation between the residuals.

Testing the first hypothesis

In this hypothesis, the effect of intra-industry correlation on the quality of exposure of the companies listed in Tehran's stock exchange was examined. Given the results obtained from estimating the research template, which have been presented in table (4), and considering the coefficient of the quality of exposure variable (0.104) and its error level, it can be said that at the acceptable error level of five percent, the intra-industry correlation variable has a positive and significant effect on quality of exposure. The results of this hypothesis are not compatible with the findings of Defond et al. (2000) but they do comply with the findings of Lewis Henock (2005).

Testing the second hypothesis

In this hypothesis, the effect of intra-industry correlation on the quality of profit and accuracy of projection of future profits of the companies listed in Tehran's stock exchange was reviewed. Given the results obtained from estimating the research template, which have been presented in table (4), and considering the coefficient of the quality of profit variable (-0.167) and its error level, it can be said that at the acceptable error level of five percent, the intra-industry correlation variable has a negative and significant effect on quality of profit and accuracy of projection of future profits of the companies.

Conclusion

Reporting added value and reporting environmental information have become especially important in the financial reports of some of the foreign companies. However, this

importance has not been substantial enough to lead to development of specific accounting standards and compelling the professional assemblies all over the world to implement these standards. The objective of added value reporting, which is done through preparing and presenting added value statements, is to compute the added value in an economic firm and how it has been distributed among different beneficiaries in the firm. The results obtained from this research indicates that if intra-industry correlation is high, the profit will also be of high quality. Moreover, intra-industry correlation has a significant impact on the accuracy of projection of future profits, but it does not have such an effect on the quality of exposure.

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