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Wanderah, P. O., & Maniagi, G. M.

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Wanderah, P. O.,[1*] & Maniagi, G. M. [2]

*[1] MBA Scholar, Jomo Kenyatta University of Agriculture & Technology [JKUAT], Nairobi, Kenya

[2] Ph.D, Lecturer, Masinde Muliro University of Science and Technology [MMUST], Nairobi, Kenya

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ABSTRACT

The objective of this study was to investigate the influence of profitability on financial instruments disclosure quality among listed firms on the Nairobi Securities Exchange. The target population for this research comprised of companies listed at the Nairobi Securities Exchange over the period 2012 to 2018. The study examined a sample of fifty nine listed firms. Empirical study developed an un-weighted disclosure index consisting of forty six disclosure items and the scores were used to measure financial instruments disclosure quality. Data were mainly collected from firms' annual reports. The collected secondary data was analyzed using Stata software where descriptive and inferential statistics were generated. Correlation and panel multiple regression analysis was employed to test the hypothesis and determine association between the independent variable and the dependent variable. The study findings revealed that profitability is significantly and positively associated with financial instrument disclosure quality. Firms should provide high quality financial instrument disclosures to the various stakeholders in order to restore investor confidence minimize information asymmetry and enable informed investment decision making. These can be achieved by strict adherence to disclosure guidelines that financial and accounting regulators have formulated. Additionally, regulators should conduct periodic checks and audits to ensure companies comply with the set policies and the regulatory framework. Further research was encouraged to establish whether the determinants of disclosure would be the same if a weighted disclosure index was used to determine disclosure quality in the Kenyan context.

Key Words: *Profitability, Financial Instruments Disclosure*

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INTRODUCTION

The global dynamics in business settings and globalization have directed companies to conduct business at the international level. This has necessitated significant development and use of more complex and innovative financial instruments to cater for the needs of current business world (Zadeh & Eskandari 2012; Hunziker 2013). Financial instruments, either equity-based or debt-based (derivatives) are widely used by companies as a medium to raise more capital (Ismail & Rahman 2011). Kota and Charumathi (2018) state that banking and financial firms may use derivatives both as dealers and end-users while non-financial firms may use derivatives to hedge themselves against any one or more of the following market risks: adverse movements in interest rates, commodity prices, foreign exchange rates and equity values. Further, reliance on external exports has forced companies to increase their usage of financial instrument products (mainly derivatives) in order to maintain the stability of their cash flows and smooth revenues (Yahat, Mardini & Power, 2017).

Different financial instruments have different degrees of risk. They expose firms to financial, economic, and operational risk. According to Hassan, Saleh and Rahman (2008), firms essentially confront exposure to financial and economic risks which result from changes in market conditions or financial position of the parties to financial instruments and transactions that the said firms handle. This complex and ever-changing business environment has brought to the fore the necessity and importance of developing reliable and relevant disclosure norms to help protect all stakeholders, as derivatives, due to their underlying complex nature, can be a significant source of systematic risk (Kota & Charumathi, 2018).

The Chartered Institute of Accountants in England and Wales (ICAEW), (2013) noted that disclosure in the financial statements has spanned from the nineteenth century and has existed as long as the accounting profession has been in existence. The accounting scandals and financial crises that happened in numerous distinguished firms have undermined investors trust concerning the financial reports and have introduced several criticisms about financial reporting quality (Akeju & Babatunde, 2017).

A significant number of disclosure studies have been conducted in Africa (Oluwagbemiga, 2014; Hassan, 2014; Hussainey, 2014, Shehata, 2014; Mensah, 2015). Agyei-Mensah (2015) examined the determinants of financial ratio disclosures and quality of listed companies on the Ghana Stock Exchange and found the extent of financial ratio disclosure level of 62.78%. Further, the results showed that leverage and return on investment are associated on a statistically significant level as far as the extent of financial ratio disclosure is concerned. Kribat, Burton and Crawford (2013) investigated the degree of compliance with mandatory disclosure requirements by Libyan Banks and established an overall mean disclosure compliance of 54.45%. They found that while many items are disclosed on a regular basis, on average, barely more than half of all possible items appear in the annual reports. The study found higher compliance with regard to mandatory disclosure, which was influenced by bank profitability.

Provision of quality disclosures in financial statements is important as it enables users to evaluate the significance of financial instruments for the entitys financial position and performance; and the nature and extent of risks arising from financial instruments. Adoption of quality disclosure compliance is valuable in terms of promoting financial stability, both globally and locally, reduces risk of failure of companies and fosters economic growth.

The Nairobi Securities Exchange was established by a voluntary association of stockbrokers under the Societies Act in 1954. It is the largest capital market in the East and Central Africa and also considered the third largest securities market in Africa. It is the principal bourse in Kenya, offering an automated platform for the listing and trading of multiple securities (NSE 2017-18 Investors handbook). As of 2018, it had 62 listed companies from all sectors of Kenya's economy.

Statement of the problem

Proper financial instrument disclosure overcomes the mispricing of financial instruments, crystallization of risk and misallocation of capital. Further, it enhances investors ability to make sound investment decisions and ability to provide market discipline on a timely basis. Additionally, it contributes to disorderly capital market corrections in the valuation of companies securities and analysis during crises as investors belatedly recognize that disclosing firms are riskier than they were assumed to be. A study by Gathaiya (2017) found that transparency and disclosure issues were partly to blame for the failure of Dubai Bank, Imperial Bank and Chase Bank between the year 2015 and 2016. Financial reporting of the collapsed banks was less transparent and credible. Imperial bank deployed a software-reporting program, which ensured fictitious, unlawful and fraudulent accounts were created and used to defraud depositors and concealed non-performing loans and provisioning figures. These were not reflected in the bank's financial statements, and its true financial position was understated, thus creating information asymmetry. Most studies (Ogwe, 2014; Mathuva, 2016; Abanga, 2017; Wachira, 2017; Wachira, 2018) conducted in Kenya investigated the level of financial, risk and corporate disclosures for non-financial institutions for a period one to six years. These studies gave contradicting and inconclusive results on the relationship between disclosures and gearing level and liquidity. The authors recommended further research to be done for a longer period to capture periods of various trade cycles in order to give broader dimension for the problem and establish the effect of leverage on financial reporting and other possible determinants of financial instrument disclosure quality among listed firms. This study was conducted to fill this gap empirically.

Objectives of the Study

The objective of this study was to determine the influence of profitability on financial instruments disclosure quality among listed firms in Kenya. The following hypothesis was tested in this study:

- **H_0**: Profitability does not significantly influence financial instrument disclosure quality among listed firms in Kenya.

LITERATURE REVIEW

Signaling Theory

Spence (1973) developed signaling theory as a means to describe people conducts in the labour market. It has a general phenomenon, which is applicable to and concerned with the problems relating to information asymmetries in markets, and illustrates how the party with more relevant information can reduce these asymmetries by signaling it to others (Morris, 1987). Watts and Zimmerman (1986) stipulated that the asymmetric information surrounding an organization and investors causes adverse selection. This is mitigated by disclosure, and providing signals to calm the market. According to Connelly, Certo, Ireland and Reutzel (2011), signaling theory is useful in describing disclosure behaviour when two organizations have access to different information.

Signaling theory recognises modern firms detachment of ownership from control (Fama and Jensen, 1983) and this contributes to the widening information gap between managers (insiders) and investors (outsiders). Thus, there is a great need for corporate risk disclosure as it represents a vital line of communications between the two parties. Cooke (1989) argued that where there is a detachment of ownership from control, the likelihood of agency costs arises due to disagreement between shareholders and managers and between bondholders and shareholder-managers. Also, Healy and Palepu (2001), Verrecchia (2001) and Hassan, Romilly, Giorgoni, and Power, (2009) contended that the need for more corporate disclosure arises from the information asymmetry problem. Henceforth, enhancing voluntary disclosure can reduce such conflicts and lessen future corporate performance uncertainty as well as facilitate trading in shares hence increases firm valuation (Hassan *et al.*, 2009).

Under this theory, the signalers are insiders (executives or managers) who have information about an organization that is not available to outsiders. This information may be both positive and negative, and the signalers must decide on whether they should communicate this information to outsiders (Connelly, Certo, Ireland & Reutzel, 2011). To reduce that asymmetry, managers use signals in order to show that the company operates well and has a good and sustainable performance (Shehata, 2013). The theory suggests that voluntary information disclosure in corporate annual reports can be used as a signal in order to improve the corporate image, attract new investors, lower capital costs and also help to improve its relationships with the relevant stakeholders, (Hawashe, 2014). Based on the signaling theory viewpoint, companies managers are interested in disclosing good news to the market participants in order to avoid the undervaluation of their shares.

According to Al-Maghzom (2016), literature on disclosure pinpoints a number of variables as a representative of signaling process, which are leverage, profitability and liquidity. The signaling process affirm that firm executives who trust that their firm can perform better than other firms will desire to signal this to investors as a means of enticing more capital and investments. They could carry out this signaling process in a form of disclosure additional to any disclosure mandated by law. Moreover, this theory indicates that when a firms performance is good, directors will signal their firms performance to their investors and the rest of the market by reporting information, which bad performance firms cannot report.

A number of previous investigations have stressed the association between financial factors and disclosure quality based on signaling theory (Gordon, Loeb, & Sohail, 2010; Anam, Fatima, & Majdi, 2011). In essence, signaling theory implies that a company is attempting to signal good news to investors and other interested groups by disclosing more voluntarily (Oliveira, Rodrigues, & Craig, 2006). Signaling theory acts as an underpinning theory in this study. It is vital in interpreting the results of this investigation and facilitates explanation on the rationale of firm disclosure. This study adopts signaling theory since it helps in explaining the relationship between financial factors and disclosure quality.

Profitability
- Return on Assets
- Return on Equity

→

Financial Instrument Disclosure Quality
- Disclosure Index

Independent variables **Dependent variable**

Figure 1: Conceptual Framework

Profitability

Earlier researchers (Takhtaei, *et al.*, 2014; Sharma, 2013; Mathuva, 2016; Lindqvist, 2016; Anna & Johansson, 2016) in this area of study have suggested a number of profitability measures such as return on assets (ROA), return on equity (ROE), return on capital employed (ROCE) and net interest margin (NIM), for use as proxies for profitability. In this study, return on assets (ROA) and return on equity (ROE) will be used to determine profitability. Return on assets is

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regarded as having prominence for accounting profitability measure (Maniagi, 2016). Return on assets reflects the ability of firms to generate profits from assets though the ratio may be biased due to off balance sheet activities. On the other hand, return on equity measures profitability from shareholders perspective, thus measure accounting profit per shilling of book value of equity capital, which is determined by dividing net income by total equity. This can be broken down into equity multiplier (EM) and return on assets (Ofosu-Hene & Amoh 2015). Therefore: ROE is equal to ROA times equity multiplier EM*;* EM is total assets / total equity. Return on equity on the other hand shows return on shareholders equity this show return on assets times total assets to equity ratio. Firms with higher equity will report a higher ROA but will have lower ROE. Return on equity measures leverage and it tends to disregards the greater risk associated with higher leverage (Gul, Faiza & Khalid, 2011).

Prior studies present different viewpoints on the effect of profitability on the disclosure quality (Sarikhani & Saif, 2017). Studies such as (Habbash, Hussainey & Awad, 2016; Fathi, 2013; Uyar, Kilic, & Bayyur, 2013, Takhtaei *et al*., 2014; Al-Asiry, 2017) found a significant positive relationship between profitability and financial reporting quality. The quality of information is more for a firm with a higher performance. Such a relationship exists because firms do not voluntarily provide rich accounting disclosures when they are not performing well and firms that perform well voluntarily disclose detailed accounting information (Iatridis & Alexakis, 2012). Furthermore, management of companies which have more profits are motivated to disclose more information to support continuance of firms position and to increase its compensation (Naser, Al-Khatib, & Karbhari, 2002). On the contrary, Monday and Nancy (2016) and Ebrahimabadi and Asadi (2016) found a negative relationship between profitability and quality of the information disclosure. This finding can be explained by the fact that competitive costs of disclosure increase when the firm is highly profitable; thus, companies do not want to utilize their advantage to competitors and therefore the quality of information disclosed could decrease (Prencipe 2004). Other studies (Agyei-Mensah, 2013; Haji & Ghazali, 2013; Hosseinzadeh, Kangarlouei, & Morteza, 2014; Mahboub, 2017) found an insignificant relationship between profitability and FDQ.

According to the signaling theory, profitable companies try to distinguish from less profitable through enhanced financial reporting. Also, more profitable companies have extra financial resources and have more incentives to disclose to both the stakeholders and the public that they are more profitable than their counterparts in the same industry (Basuony & Mohamed, 2014). By contrast, there are opposite opinions that less profitable companies will try to explain the reasons of poor financial performance and mitigate negative consequences and loss of reputation through increased financial reporting.

Takhtaei *et al.* (2014) examined the effect of profitability on disclosure quality of listed companies on the Tehran Stock Exchange (TSE) over the period from 2006 to 2008. The results showed that there is positive and significant relationship between information disclosure quality and return on equity (ROE) and return on assets (ROA). The existence of positive and significant association of information disclosure quality with return on equity (ROE) and return on assets (ROA indicates that corporations with higher return on equity (ROE) and return on assets (ROA have higher and appropriate information disclosure quality and vice versa.

Disclosure Quality

Annual report is one of the channels available for firms to report their financial affairs. According to Hassan *et al*. (2008), concern about the usefulness of financial information has caused pressure groups to lobby accounting standard setters to require greater detail and more extensive information especially concerning derivative financial instruments so that high quality accounting standards are produced. High quality standards should lead to high quality financial reports, and as a result investors confidence in the credibility of financial reporting is enhanced. Consequently, for the users of annual reports, increasing the disclosure quality reduces information asymmetry (Chakroun & Hussainey, 2014).

High quality disclosure is all about providing investors with useful information that keeps them aware of possible scenarios of the company and helps them make informed value creating decisions (Lindqvist, 2016). Pownall and Schipper (1999) argue that disclosure is of high quality if financial reports possess three attributes: transparency, full disclosure and comparability. Transparent financial statements are statements that reveal the events, transactions, judgments, and estimates underlying the statements, and their implications Transparency allows users to see the results and implications of the decisions, judgments and estimates of statement preparers. Full disclosure relates to the provision of all information necessary for decision-making, thereby providing reasonable assurance that investors are not misled. Finally, comparability means that similar transactions and events are accounted for in the same manner, both cross-sectionally among firms and over time for a given firm.

International standards accounting board (IASB) has formulated IFRS 7 which requires the disclosure of information about the significance of financial instruments of an entity, and the nature and extent of risks arising from those financial instruments, both in qualitative and quantitative terms (PriceWaterHouse coopers, 2010). The standard consolidates and expands a number of existing disclosure requirements and adds some significant and challenging new disclosures. The standard requires entities to report in their external financial statements the metrics they use internally to manage and measure financial risks. Hassan and Marston (2010) argue that in the absence of a generally agreed model for disclosure quality as well as relevant and reliable techniques to measure it, prior studies tend to use disclosure quantity as a proxy for disclosure quality assuming that quantity and quality are positively related, although quantity and quality measures may lead to different ranking for a sample of companies.

Empirical Review

This section reviews studies previously done on determinants of financial instruments disclosure quality of firms. Rhyne (2012) states that through the use of a systematic approach to previous scholarly work, literature review allows a researcher to place his research work into an intellectual and historical context, that is, it enables the researcher to declare why his research matters. Agyei-Mensah (2015) in his research examined determinants of financial ratio disclosures and quality in Ghana. The study investigated the influence of firm-specific characteristics which included profitability, debt equity ratio, liquidity and leverage on the extent and quality of financial ratios disclosed by firms listed on the Ghana Stock Exchange and was conducted through detailed analysis of the 2012 financial statements of the listed firms. Descriptive analysis was performed to provide the background statistics of the variables examined. The multiple regression results indicate that leverage and profitability are significant in predicting the extent of financial ratio disclosures.

Panditharathna and Abeywardana (2016) conducted a study to identify the extent of voluntary disclosure level and its determinants in banking and finance companies in Sri Lanka. Secondary data was from annual reports of quoted public banking and finance companies for the time period of 2012 to 2015. The sample consisted of 50 companies and employed panel data analysis. The study found profitability and leverage as determinants of voluntary disclosure level and among them profitability has a positive relationship while leverage has negative relationship. Takhtaei *et al.* (2014) in their research examined the determinants of disclosure quality among listed companies on the Tehran Stock Exchange (TSE) over the period from 2006 to 2008. In their study data collection was by library method. The findings were that quick assets ratio is negatively and significantly associated with information disclosure quality, however current assets ratio, return on equity (ROE), return on assets (ROA), and financial leverage ratio are positively and significantly associated with disclosure quality.

Boshnak (2017) researched on the determinants of mandatory disclosure and voluntary disclosure in the annual reports of listed firms in Gulf Co-operation Council (GCC) member states over the period 2010 to 2013. The extent of mandatory disclosure and the level of voluntary disclosure are examined using two different disclosure indices. The empirical approach is applied to the financial statements of 120 listed firms. Multivariate regression analysis is employed to explore the relationships between the extent of mandatory and voluntary disclosures and firm-specific characteristics and year dummy variables. Results show that the extent of mandatory disclosure is found to be significantly negatively related to profitability, as measured by return on equity (ROA) while liquidity is not a significant explanatory variable. Mahboub (2017) conducted research on main determinants of financial reporting quality in the Lebanese banking sector. He used 88 annual reports of a sample of 22 Lebanese banks for the period 2012-2015. Financial reporting quality index with 40 items was used as the dependent variable, while bank specific characteristics of leverage, and profitability were independent variables. Using multivariate OLS model, the results indicate that financial leverage has significant and positive relationship with financial reporting quality. On the other hand, profitability and was found to be not statistically significant in explaining the quality of financial reporting of banking sector in Lebanon.

METHODOLOGY

Descriptive research design was adopted in this study. The population of this study was all the 62 firms which were listed on Nairobi Securities Exchange, Kenya during the period 2012 to 31.12.2018. The sampling frame of this study was the Nairobi Securities Exchange (NSE) in Kenya. A list of 62 firms listed on the NSE formed the sampling frame for the research. This study adopted purposive sampling as the researcher only selected listed firms which had data for a 7-year period from 2012-2018. The data type collected and utilized in the study was purely secondary data based on the annual reports of listed companies disclosed in their financial information for the period 2012 to 2018 through NSE web portal and firm website. The data collected for both the dependent and independent variables were adjusted ratios and averages derived from listed firms financial statements. Secondary quantitative data was the sole source of data for this study. Data analysis involved both descriptive and inferential statistics where model specification estimation and rationale of variables was done. This study employed stata statistical software to analyse data.

RESULTS AND DISCUSSION

Effect of Profitability on Financial instruments disclosure

The study sought to determine the influence of profitability on financial instruments disclosure quality among listed firms in Kenya. The first null hypothesis denoted, **H_o:** Profitability does not significantly influence financial instrument disclosure quality among listed firms in Kenya. Profitability in this study was measured using return on assets and return on equity. Having gone by the random effect model basing on the Hausman test, the results of the random effect model are presented in Table 1.

Table 1: Regression Random Effect of profitability on Financial instruments disclosure

Random-effects GLS regression		Number of obs =	413
Group variable: FIRM		Number of groups =	59
R-sq:		Obs per group:	
within =	0.0000	min =	7
between =	0.0000	Avg =	7
overall =	0.1558	max =	7
		Wald chi2(2) =	75.66
corr(u_i, Xb) = 0 (assumed)		Prob > chi2 =	0.0000

FID	Coef.	Std. Err.	T	P>t	[95% Conf. Interval]	
ROA	0.026559	0.004273	6.22	0.000	0.018185	0.034933
ROE	-0.00029	0.004157	-0.07	0.870	-0.00843	0.007861
_cons	0.707567	0.003683	192.12	0.000	0.700349	0.714785
sigma_u	0					
sigma_e	.03936356					
Rho	0	(fraction of variance due to u_i)				

The analysis showed that the panels were strongly balanced for this analysis as shown by the number of observations per group. There were a total of 413 observations used in this analysis considering 59 groups of entities implying strongly balance panels. The minimum, maximum and average numbers of observations per groups were all equal to 7.

The result obtained from random effect model indicated that profitability accounted for 15.58% (Overall R square=0.1558) of the variation in financial instrument disclosure quality among listed firms in Kenya. To test the goodness of fit, the study computed Wald chi-square since the model used random effect regression analysis. The findings revealed Wald chi-square = 75.66 with a corresponding p-value =0.0000. The partial regression coefficient for return on asset was 0.026559 shows that increase in one percent in return on assets across time and listed firms in Kenya makes financial instruments disclosure to increase by 0.026559 per cent. However, the partial regression coefficient for return on equity was -0.00029 shows that decrease in one percent in return on equity across time among listed firms in Kenya makes financial instruments disclosure to increase by 0.00029 per cent.

The regression model is as shown below

FID_{it}=-0.707567+0.026559ROA-0.00029ROE

From the above results, only ROA has significant positive effect on financial instrument disclosure while ROE has insignificant negative effect on financial instrument disclosure. The results confirmed findings by Soliman (2013) who found a significant positive relationship between profitability and financial reporting quality. On the contrary, Monday and Nancy (2016) and Ebrahimabadi and Asadi (2016) found a negative relationship between profitability and quality of the information disclosure. Mahboub (2017) found an insignificant relationship between profitability and FDQ.

CONCLUSIONS AND RECOMMENDATIONS

The study sought to determine the influence of profitability on FIDQ among listed firms in Kenya. The study results indicated that there is a significant relationship between financial instruments disclosure and profitability as measured by ROA and ROE at 5%

level of significance. This implied that the level of profitability influences disclosure quality. The study concluded that firms that are more profitable may disclose more information in order to justify the level of their reported profits. Further, this finding was an indication that profitable companies have growth opportunities hence disclose better information to show the reliability of their earnings and the projects they anticipate to undertake; this would spread their reputations and keep away from under-estimation of their actions.

Firms should provide high quality financial instrument disclosures to the various stakeholders in order to restore investor confidence, minimize information asymmetry and enable informed investment decision making. These can be achieved by strict adherence to disclosure guidelines that financial and accounting regulators have formulated.

Suggestions for Further Studies

The current study suggests that a further study should be carried to determine the relationship between market risk as measured by value at risk and financial instruments disclosure in the annual reports for companies listed at NSE. This would lead to determination on whether there would be a significant association between those two variables.

Further research is encouraged to establish whether the determinants of disclosure would be the same if a weighted disclosure index was used to determine disclosure quality in the Kenyan context.

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