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Effective Management of Financial Reporting Quality in Business Entities.

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Abstract

Financial information is the cornerstone of the sustainable development and competitiveness of business entities. Financial statements have become the principal decision-making tool for management, investors, creditors, government bodies, and other stakeholders. Within the framework of the economic reforms implemented in the Republic of Uzbekistan in recent years, particular attention is being paid to integrating business entities into the international market, attracting foreign investment, and creating a transparent business environment. In particular, the strategic objectives set for transitioning national accounting to International Financial Reporting Standards (IFRS) oblige business entities to substantially improve the qualitative characteristics of financial statements, namely faithful representation, understandability, and comparability. Financial reporting quality should not merely be monitored; its effective management through accounting policy and internal control mechanisms is a key factor in mitigating financial risks and enhancing investment attractiveness.

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environment. In particular, the strategic objectives set for transitioning national accounting to International Financial Reporting Standards (IFRS) oblige business entities to substantially improve the qualitative characteristics of financial statements, namely faithful representation, understandability, and comparability. Financial reporting quality should not merely be monitored; its effective management through accounting policy and internal control mechanisms is a key factor in mitigating financial risks and enhancing investment attractiveness.

The issues of assessing financial reporting quality have been extensively studied in world economic science. In this regard, the scholarly works of P. Jones (the Jones model), M. Beneish (the Beneish M-Score model), S. Dechow, and other foreign scholars serve as a fundamental basis. In Uzbekistan as well, a number of local scholars are conducting research on formulating accounting policy and developing financial analysis methodology in the context of the transition of enterprises to IFRS. However, the comprehensive assessment of the impact of changes in accounting policy on the quality of financial indicators in local business entities through empirical models (for example, by integrating the Jones and Beneish models) has not been sufficiently addressed.

B.I. Isroilov, N.Sh. Xajimurotov, and B.B. Ibragimov: “… have conducted a fundamental analysis of the role of accounting policy in the conduct of the financial and economic activities of business entities. In their view, accounting policy is a mechanism for “modelling” an enterprise’s financial results. The quality of final statements is managed by altering the procedures for asset measurement and liability recognition, which requires external analysts to audit each item of the accounting policy separately,” they have emphasized.

A.B. Jumanov and a team of associate professors: “The textbook demonstrates the role of financial analysis in assessing reporting quality. The authors emphasize that external financial analysis in business entities relies solely on indicators of the accounting statements. If an enterprise employs aggressive accounting methods in its accounting policy (for example, artificially extending collection periods when measuring receivables), external financial analysis will detect a real crisis late. Therefore, it is imperative to incorporate ratios that test the quality of financial reporting into the analytical process,” they have emphasized.

Robert J. Resutek and Vernon J. Richardson analyzed the impact of accounting policy on reporting quality using Excel and Tableau labs. In their view, the concept of “financial reporting quality” depends on the extent to which net income is backed by cash flow. In their textbook, the

authors propose a data-analytics-based methodology for exposing the manipulation of working capital in business entities.

David Spiceland, Wayne Thomas, and Don Herrmann explain how the elements of accounting policy, such as inventory valuation (FIFO, AVCO) and the formation of an allowance for doubtful accounts on receivables, shape financial indicators. The authors substantiate with examples that the management of business entities may mislead investors and lower reporting quality by selecting accounting principles in their own interests.

According to monographic observations, in assessing the reliability of data in financial statements, a multi-criteria approach and a broad coverage of analytical indicators enhance the quality of the final analytical conclusions. A distortion in the quality of financial statement data can usually be concealed within one or two indicators. However, when a system of interrelated indicators is involved in the analysis, inaccuracies in the data come to light. In this regard, Messod Beneish's views have distinctive features. His model is calculated on the basis of eight separate financial ratios. Each of them tests a particular risk aspect of a company's financial condition. In particular:

$$\text{M-Score} = -4.84 + (0.920 \times \text{DSRI}) + (0.528 \times \text{GMI}) + (0.404 \times \text{AQI}) + (0.892 \times \text{SGI}) + (0.115 \times \text{DEPI}) - (0.172 \times \text{SGAI}) + (4.679 \times \text{TATA}) - (0.327 \times \text{LVGI})$$

If the M-Score is greater than −2.22, the company's financial statements are deemed to be of low quality and unreliable. If the M-Score is less than or equal to −2.22, the company's statements are assessed as accurate and of high quality.

Where:

$$DSRI = \frac{Accounts\ receivable_t / Sales\ revenue_t}{Accounts\ receivable_{t-1} / Sales\ revenue_{t-1}}$$

DSRI > 1 means that receivables are growing faster than sales. This often indicates that the company is recording sales "on paper" in order to inflate revenue artificially.

$$GMI = \frac{Gross\ profit_{t-1} / Sales\ revenue_{t-1}}{Gross\ profit_t / Sales\ revenue_t}$$

GMI > 1 indicates that the company's gross profit margin has declined. In enterprises with deteriorating profitability, management is more inclined to inflate income in order to window-dress the financial statements.

$$AQI = \frac{1 - \frac{Current\ assets_t + PP\&E_t}{Total\ assets_t}}{1 - \frac{Current\ assets_{t-1} + PP\&E_{t-1}}{Total\ assets_{t-1}}}$$

AQI > 1 suggests that, instead of writing off current expenses, the company may be capitalizing them as assets (that is, concealing expenses on the balance sheet). This artificially inflates profit.

$$SGI = \frac{Sales\ revenue_t}{Sales\ revenue_{t-1}}$$

SGI > 1 may look favorable. However, according to Beneish's research, growth companies under pressure to sustain their growth rates often resort to revenue manipulation.

$$DEPI = \frac{Depreciation\ rate_{t-1}}{Depreciation\ rate_t}$$
$$= \frac{Depreciation_{t-1}/(Depreciation_{t-1} + PP\&E_{t-1})}{Depreciation_t/(Depreciation_t + PP\&E_t)}$$

DEPI > 1 means that the rate of depreciation charged in the current year has slowed. This may indicate that the company has artificially extended the useful lives of its assets, thereby reducing current expenses and inflating profit.

$$SGAI = \frac{SG\&A\ expenses_t/Sales\ revenue_t}{SG\&A\ expenses_{t-1}/Sales\ revenue_{t-1}}$$

This ratio enters the formula with a minus (−) sign. If a company manages its administrative expenses inefficiently (SGAI > 1), this signals problems in the enterprise but does not directly imply manipulation.

$$LVGI = \frac{Total\ liabilities_t/Total\ assets_t}{Total\ liabilities_{t-1}/Total\ assets_{t-1}}$$

LVGI > 1 heightens the company's financial risk. There is a risk that management may be compelled to falsify the financial statements in order to avoid breaching loan covenants.

$$TATA = \frac{Operating\ profit_t - Cash\ flow\ from\ operating\ activities_t}{Total\ assets_t}$$

This is one of the most important ratios in the Beneish model (its weight in the formula is 4.679). If net income is high while operating cash flow is very low, the TATA ratio rises sharply. This demonstrates that the profit exists only in accounting records and is of low quality.

Under the Law of the Republic of Uzbekistan "On Accounting", the head of the organization is directly responsible for the preparation and presentation of financial statements and for the accuracy of the information contained therein. Liability for such cases is likewise established in the Civil Code of the Republic of Uzbekistan and the Code of the Republic of Uzbekistan on Administrative Liability.

In our view:

1. Traditional analysis is carried out after the fiscal year-end, and, owing to this approach, a joint-stock company (JSC) identifies the quality of its financial statements too late. Therefore, it is advisable to examine financial reporting quality at the end of each quarter.

2. We consider it necessary to introduce a mandatory monitoring procedure for the quarterly ratio of net sales revenue to actual cash inflows from operating activities in JSCs.

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