
Financial Reporting Quality in a Crisis Period

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Abstract

The Covid Pandemic has this far been a devastating event for the world economy, but it wasn't the only crisis of the 2020 financial period. Despite the health emergency, military conflict has not halted since the dawn of the coronavirus plague. In the current paper the authors try to analyze the combined impact of the COVID pandemic and war for a sample of 352 Turkish and Azeri equities during the 2019 and 2020 financial periods. Their findings suggest that the Nagorno-Karabakh war enforced timeliness for Azeri and Turkish issuers while overall the relevance of financial statements has dropped during the crisis period of 2020. IFRS compliance became a significant moderating factor during the crisis period. Overall, the year 2020 has been a turning point for accounting practice.

Key words: financial reporting; Turkey; relevance; war; pandemic; crisis;

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Introduction

From its onset, COVID-19 global pandemic has led to profound mutations in social and economic systems worldwide. Social and political systems already strained to the limit collapsed, altering the lives of billion people. Containment measures such as social distancing and closed borders became the new reality. As the days turn into weeks, weeks into months and months into years, the pandemic was changing the reporting framework in surprising ways.

While globalization has fostered the entrenchment of cooperation across accounting jurisdictions for convenience mainly through supranational organizations such as the European Union, there are jurisdictions who engage in economic and social contacts for the sake of shared ethnicity. As the European Union was established a new financial order on the Old Continent (Shiller, 2009) an alternative power bloc developed in the Middle East and Central Asia around Turkey (Matej et al., 2021), based around the loose ideology of pan-Turkism.

Since the fall of the Soviet Union, Turkey has engaged in diplomatic, cultural, and economic ties with all Turkic states and autonomous regions. The most successful of these has been with Azerbaijan, under the slogan „One Nation, Two States” (Progonati & Gashamli, 2021). These renewed ties have extended into accounting research as well. Mansurov (2019) compares the Turkish and Azeri accounting systems development. Varici and Hasanov (2019) compare the Azeri experience in IFRS adoption with the Turkish one. Both papers serve to tie the Turkish and Azeri accounting profession, furthering the „One Nation, Two States” ideal.

The impact of the COVID Pandemic on the accounting systems has been a major topic of interest for the accounting profession in multiple jurisdictions, including emerging markets. Aljawaheri et al. (2021) find that in Iraq the value relevance of financial reporting has decreased due to the COVID lockdown and other related phenomena. Badawy (2021) finds that adding a key audit matters paragraph during the COVID pandemic didn't bring informational value for the Egyptian investors. Pham et al. (2021) discover that the predictive value of the financial statements during the COVID pandemic has decreased.

Our exploratory study is the first which deals with both accounting jurisdictions from the perspective of financial reporting quality during the COVID pandemic and the

Nagorno-Karabakh conflict. While Turkish accounting professionals have studied the impact of the Covid pandemic, their focus has thus far been channeled into global markets (Güngör, 2021). The only similar study to our own we could identify was the one performed by Iatridis (2012), which dealt with the impact of the terrorist attacks on Istanbul.

The paper is structured in three parts. The first part deals with the shared economic and accounting history of Azerbaijan and Turkey. The second chapter presents a basic value relevance model for the 2019 and 2020 financial periods.

1. Accounting history in the two accounting jurisdictions and sampling

Turkey and Azerbaijan are Turkish nations sharing part of the Caucasus plateau and thus common borders. While Turkey has developed independent institutions as the core of the Ottoman Empire Azerbaijan has had to develop in the shadow of the Soviet Union until its independence on 18th of October 1991.

At the beginning of the 19th century Azerbaijan was annexed by the Russian empire through the Treaty of Turkmenchay (Axworthy, 2008). Thus, the early Azeri accounting system developed closely in tandem with the Russian and later Soviet one. In the Russian Empire the first accounting firms emerged in 1874, with accounting experts such as F.V. Ezerskii providing training and guidance to aspiring Azeri accountants. While in the pre-revolutionary Russian Empire there were attempts to establish an independent accounting profession, such efforts were ultimately futile (Bailey, 1992).

The first certified Azeri accounting profession joined the IGBE (Institute of State Accounting Experts) in 1924. After the fall of the Soviet Union, Azerbaijan began a lengthy war with Armenia over the disputed region of Nagorno-Karabakh (Cheterian, 2011), which lasted until 1994. Such disturbance inhibited the development of a natural accounting system, yet nevertheless a legal framework was established for the Accounting and Audit systems in 1995 (Asian Development Bank, 2002).

The Baku Stock Exchange became fully established by 2000 (Tofig, 2020) and in the same year the audit and accounting professions were fully legislated (Asian Development Bank, 2002).

In the case of Azerbaijan accounting convergence started with the Accounting Law of 2004 which states that IFRS are adopted in their entirety for use by credit organizations, insurance companies, investment funds, non-state (private) social funds, entities with securities traded on the stock exchange, and commercial organizations exceeding specific levels concerning revenue, employees' number, and total balance sheet (Hüseynli, et al., 2015). Such measures have created a surprisingly vibrant and dynamic financial market for a CIS economy, with Azerbaijan scoring high in investor protection along Kyrgyzstan (Huseynov, 2010).

Unlike Azerbaijan, in the case of Turkey the evolution of accounting can be best described as a string of gradual reforms. The accounting reforms begin with Sultan Mahmud II (1808-1839), whose reign signaled the beginning of westernization for the Ottoman administrative apparatus (Yayla, 2011). Further economic developments in the Late Ottoman Empire include the Istanbul Stock Exchange which emerged between 1853-1866 as a response to the Crimean War (Toprak, 2016).

The overthrow of the Ottoman Empire and the beginning of the Turkish republic marks a new era for the development of Turkish accounting practices, with the gradual assimilation of German and French accounting practices as well as their broader legal frameworks into the national economy (Arzova & Arsoy, 2010). The Association of Expert Accountants and Organizers of Enterprises, in 1949, passed a German-based Tax Law, which introduced accounting principles into law (Balsari & Varan, 2014).

Accounting practices were standardized in 1992 with the passage of "The Uniform Accounting System" (Bahadır & Tolga, 2013) and in 1994 the IFAC-affiliated Accounting and Auditing Standards Commission of Turkey was established, publishing unsanctioned accounting standards in line with the IAS (Balsari & Varan, 2014). A new Turkish Accounting Standards Board (TASB) was established in 1999. It held its first meeting in 2002 and in 2004 it issued its first regulatory guidelines, named "The Regulation on the Principles and Procedures on the Operations of the Turkish Accounting Standards Board" (Alp & Ustundag, 2009).

European Directives requiring the mandatory implementation of IFRS into the consolidated accounts of listed European equities, became a catalyst for accounting change and IFRS-harmonized TFRS (Turkish Financial Accounting Standards) came into effect January 1 2005 (Bahadır et al., 2016). The TASB regulatory process involves translating the official IASB pronouncements into the Turkish language (Alp & Ustundag, 2009). Thus, the difference between the IFRS and TFRS is merely a translation lag. A Turkish listed company can opt between the original English language IFRS guidelines or the translated counterpart (Deloitte, 2021).

Despite operating in an emerging market, the Istanbul stock exchange is a dynamic stock market with multiple accounting studies revolving around value relevance and timeliness being published in the recent decades, as seen in **Table no. 1**. No meaningful study was discovered from published Azeri financial data and as such it is difficult to assess the extent of value relevance and timeliness studies produced for the Azeri accounting ecosystem.

Table no. 1. Selected value relevance and timeliness, involving Turkish equities

Study	Period	Sample size	Model
Aksoy et al (2021)	2010–2018	1683 firm-year observations	Timeliness
Ertugrul (2020)	2009-2018	2226 firm-year observations	Value Relevance
Suadiye (2019)	2016	286 firm-year observations	Timeliness
Özcan (2019)	2014-2017	90 firm-year observations	Timeliness
Vuran & Adiloğlu (2013)	2009	178 firm-year observations	Timeliness
Sudaiye (2012)	2000-2002	579 firm-year observations	Value Relevance
Gümrah & Adiloğlu (2010)	2005-2008	58 firm-year observations	Value Relevance
Türel (2009)	2007	211 firm-year observations	Timeliness
Kirkulak & Balsari (2009)	2003	140 firm-year observations	Value Relevance
Balsari & Serdar (2009)	1992-2003	1619 firm-year observations	Value Relevance

Source: Own research, 2022

The 2020 financial year was an extraordinary period for both accounting jurisdictions as the dual crisis of the COVID-19 pandemic and the Second Nagorno-Karabakh war provided both risks and opportunities to Turkish and Azeri companies.

The COVID-19 virus was first isolated on 7 January 2020 and the COVID pandemic was officially declared on 30 January 2020 (Cucinotta & Vanelli, 2020). Following a rapid spread through neighboring Iran the first COVID 19 case was recorded in Azerbaijan on 28th February 2020 (Xinhua, 2020), followed closely by the first clinical case in Turkey on 9th March 2020, mandating the imposition of customary quarantine and social distancing measures (Demirbilek et al., 2020). Studies performed in the context of the Turkish capital markets for this period reveal that the performance of the Istanbul stock exchange equities was negatively impacted by the COVID-19 pandemic (Özen & Özdemir, 2021)

The Nagorno-Karabakh conflict started in 1988 within the framework of the USSR, between the forces of the Azerbaijan SSR and Armenia SSR (Melander, 2001). It continued as a low-intensity conflict for thirty years until the Second Karabakh war, which lasted for 44 days, between September 27, 2020 and November 10, 2020 (Rozkošová, 2021). While the Turkish Armed Forces were not directly involved in the armed conflict, Turkey emerged as a key international backer of Azerbaijan, providing

assistance such as military equipment and diplomatic support (Khan, 2021).

The Nagorno-Karabakh conflict of 2020 ended with an Azeri victory and ceasefire terms favoring the Azeri side of the conflict. The signing of the ceasefire paved the way for reconstruction work in the disputed Nagorno-Karabakh region (Pegolo, 2021).

Our sample was derived from the Refinitiv Eikon database on 7th December 2021 using the Advanced Search function. The selected equities were drawn from the database based on the following criteria:

- a) Primary quotes only
- b) Primary issues only
- c) Active only
- d) Ordinary Shares
- e) Country of issuer was either Turkey or Azerbaijan

Following this filtering an initial sample of 442 unique Turkish and Azeri equities was created for the study (Table no. 2). The Baku Stock Exchange was not included in the Reuters Refinitiv database at the time of the data extraction and thus only one Azeri equity could be found, listed on the London Stock Exchange. Also, while some Turkish equities and the Azeri equity were listed on other stock exchanges, they nevertheless are affected by socio-political conditions which affect their respective homelands.

Table no. 2. Initial Sample	
Stock Exchange	Equities
London Stock Exchange	1
BORSA ISTANBUL	439
US 'Other OTC' and Grey Market	1
Canadian Securities Exchange - CSE Listed	1
Total	442

Source: Own research, 2022

2. Data relevance models

Value relevance has been a hot topic ever since Feltham and Ohlson (1995) published their landmark model. Such studies were conducted for the Australian equity market (Dahmash et al., 2009), the Portuguese stock exchange (Craig et al., 2010) and the Stockholm stock exchange (Hamberg & Beisland, 2014). Each of these expanded and adjusted the basic 1995 model.

Although other studies remove equities belonging to financial institutions (Tahat et al., 2016), our study did not discriminate between the equities based upon their GICS or TRBC code. All equities, regardless of economic sector were considered for inclusion in the study.

Following the initial data extraction, the data in Table no. 3 was extracted for all the relevant equities in the sample, using the Eikon Refinitiv Excel add-in called Function Builder.

Table no. 3. Extracted raw data for the equities

Data Item	Currency	Financial Years	Reporting State	Align Type
TotalEquity	EURO	2019/2020	Original	PeriodEnd
NetIncomeAfterTaxes	EURO	2019/2020	Original	PeriodEnd
CompanyMarketCap	EURO	2019/2020	-	-
TtlCmnSharesOut	-	2019/2020	Original	PeriodEnd
IsShariah	-	-	-	-
BSAuditorCode	-	2019/2020	Original	PeriodEnd
BSPeriodEndDate	-	2019/2020	Original	PeriodEnd
BSSourceDate	-	2019/2020	Original	PeriodEnd
BSAccountingStandard	-	2019/2020	Original	PeriodEnd

Source: Own research, 2022

This subsequent data extraction protocol caused our sample to further narrow down as we eliminated the equities with missing data, outliers, and anomalous data. The outliers were eliminated using a top

10/bottom 10 trimming criteria applied on the market value of one outstanding share for the financial year 2019. Thus, the sample was further reduced as illustrated in **Table no. 4**.

Table no. 4. Sampling filtration

Original Sample	442 equities
Incomplete/missing data for 2019/2020	67 equities
Equity with 2019/2020 figures released the same day	3 equities
Outliers	20 equities
Remaining sample	352 equities

Source: Own research

The derived Feltham and Ohlson (1995) model is illustrated below, where KB is $\text{CompanyMarketCap}/\text{TtlCmnSharesOut}$, KP is $\text{TotalEquity}/\text{TtlCmnSharesOut}$, PR is $\text{NetIncomeAfterTaxes}/\text{TtlCmnSharesOut}$ and ST is a Boolean value with 1 for IFRS financial reports and 0 for non-IFRS financial reports.

$$KB = \beta_1 + \beta_2 * KP + \beta_3 * PR + \beta_4 * ST + \varepsilon$$

Net income after taxes was used in accordance with the model. The CompanyMarketCap is calibrated to the day of the original final financial reports, unlike Vázquez et al (2007) who uses the price of a share three months after fiscal year-end. The ST dummy variable is used to differentiate between the entities which use full IFRS and those which use other financial standards, including TFRS. The model was generated for both FY2019 and FY2020. The software package used is Microsoft Excel 2007 with the free RealStatistics add-in (www.realstatistics.com).

Table no. 5. Pearson correlation coefficients for 2019/2020

2019 \ 2020	KB	KP	PR	ST
KB	1	0.466**	0.228**	0.083
KP	0.604**	1	0.226**	-0.019
PR	0.532**	0.722**	1	-0.012
ST	0.014	-0.049	-0.032	1

Source: Own research, 2022

In **Table no. 5** we can see the two-tailed Pearson correlation coefficients for 2020 above and 2019 below. The typical significant correlations for the Feltham and Ohlson model (1995) are observed,

such as the positive and significant correlations between equity, net income and capital. What is surprising for the year 2020 is a weakening of the correlations.

Table no. 6. Key OLS metrics from the data relevance models

Metrics	2019	2020
Multiple R	0.6212	0.4914
R Square	0.3859	0.2414
Adjusted R Square	0.3806	0.2349
Standard Error	1.7458	3.8140
Observations	352	352
F	72.9105	36.9305
p-value	1.31×10^{-36}	9.61×10^{-21}
D-stat	2.0635	2.0057
D-lower	1.8079	1.8079
D-upper	1.8423	1.8423

Source: Own research, 2022

As we can see from **Table no. 6**, which indicates the OLS metrics derived for a multiple linear regression, the 2020 metrics are worse than those derived from the previous financial period,

indicating a drop in financial data relevance. The D-stat does not indicate auto-correlation between the residuals. The F-stat indicates that both models are statistically significant.

Table no. 7. Coefficients and statistical significance of the regressors

2019	Coeff	std err	t stat	p-value	Lower	Upper	vif
Intercept	0.0857	0.3730	0.2299	0.8182	-0.6478	0.8194	0
ST	0.3909	0.3770	1.0369	0.3005	-0.3505	1.1324	1.0024
KP 2019	1.0328	0.1357	7.6091	0	0.7658	1.2997	2.0915
PR 2019	2.0333	0.6188	3.2859	0.0011	0.8162	3.2503	2.0885
2020	Coeff	std err	t stat	p-value	Lower	Upper	vif
Intercept	-0.4245	0.8116	-0.5230	0.6012	-2.0208	1.1717	0
ST	1.6438	0.8227	1.9979	0.0465	0.0256	3.2621	1.0004
KP 2020	2.3385	0.2557	9.1444	0	1.8355	2.8414	1.0541
PR 2020	2.0841	0.7707	2.7039	0.0071	0.5681	3.6001	1.0539

Source: Own research, 2022

As we can observe in **Table no. 7**, in 2020 the net income after taxes and equity retain statistical significance. The ST variable, a moderating variable, became significant in 2020 at 5%, meaning investors found the updated full IFRS more relevant than other convergent financial reporting standards in the previous financial period. Also, the Vif coefficients do not indicate collinearity, being below the 10 cut-off value, also used in recent studies such as Gharbi & Othmani (2022).

Conclusions and further research

Our model consistently validated the research hypothesis and was proposed to analyze the dual impact of the COVID outbreak and the Nagorno-Karabakh war on the quality of financial reporting in the Turkish and Azeri framework. Our value relevance study results hint at deteriorating financial environment during the COVID pandemic. However, without a wider data panel it is uncertain if this is part of a trend or a localized event resulting from the COVID pandemic. Of particular note is

the growing importance of the full IFRS adoption as a moderating factor for the Feltham and Ohlson (1995) model during the pandemic, when the IASB had a growing reliance on practical expedients in International Financial Reporting Standards (IFRS) to maintain the IASB's output legitimacy (Moscariello & Pizzo, 2022). The lag between the IASB pronouncements and that of other national standard-setting bodies engaged in a convergence process with the IASB could only widen during the pandemic due to translation delays and other unfortunate events.

Regarding the impact of the second Nagorno-Karabakh war on the timeliness of financial statements, our approach considered a scenario where the management of an Azeri or Turkish company primarily listed on their native stock exchanges would see the upcoming operational success during the earliest stages of the conflict and prepare assets for the eventual reconstruction process and expansion of their business activities in the controlled areas.

Previous research performed in the Islamic world by Shamy and Al-Qenae (2005) showed that IAS/IFRS implementation could lead to an increase in value relevance. The added value of our research showed that during the uncertain pandemic period of 2020 experienced by reporting entities, Shariah compliance significantly impacted timeliness, thus hinting at the necessity to increase convergence between Islamic accounting practices and principles with the IFRS.

Our model could have benefitted from a better tuning of the variables to adjust for lockdown-related effects. Future research might perhaps shed light on other aspects, such as the impact of vaccination policies on audit quality and financial performance or financial reporting quality. Thus, a wider panel for the data relevance model, such as the one developed by Ionaşcu et al. (2018), might be required.

Our database could have been augmented a lot by the inclusion of more Azeri equities for a more balanced sample. While focusing on both Azeri and Turkish reporting equities, our sample is skewed in favor of the Turkish data. The Baku Stock Exchange data could not be processed for a more accurate picture of the confusing context during the COVID-19 pandemic and the Second Nagorno-Karabakh War. At the time of the data extraction process there were more listed Armenian equities on Reuters Eikon Refinitiv than Azeri ones so more accurate conclusions should be drawn from a greater sample.

Finally, while other human tragedies such as terrorist attacks had a short-term impact on the performance of the Turkish equities (Christofis, et al., 2013) the Second Nagorno-Karabakh war is likely to influence the accounting and regulatory environment for years, providing an opportunity for other accounting researchers to test their assumptions in volatile and extraordinary circumstances.

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