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CORPORATE GOVERNANCE AND EARNINGS QUALITY OF SELECTED MANUFACTURING COMPANIES IN NIGERIA

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ABSTRACT: *The need to improve on earnings quality is a problem that corporate regulators strive to resolve through the establishment of various mechanisms. This study investigated the relationship between corporate governance and earnings quality of selected manufacturing companies in Nigeria. Specifically, the study examined the relationship between board of directors' independence, internal audit quality, auditor independence and accrual quality value relevance of selected manufacturing companies in Nigeria. The ex-post facto research design was utilized while 65 selected manufacturing firms between 2008 to 2017 were used as the population. The published fact-books of companies were obtained from the Nigeria Stock Exchange. The entire 65 companies were used as the sample size for the study. The Ordinary Least Square method of regression analysis was employed to test the hypotheses through E-view 10 version software. The results revealed a positive and insignificant relationship between board of directors' independence and accrual quality of selected manufacturing companies in Nigeria, and a positive and significant relationship between internal audit quality and accrual quality of selected manufacturing companies in Nigeria. Finally, the study revealed a positive and insignificant relationship between auditor independence and accrual quality of selected manufacturing companies in Nigeria. The study recommended that investors and managers of selected manufacturing companies that are viewed to be founded on company statute should never rely solely on the existence of non-executive board of directors to monitor and improve the quality of accruals, since in real life it may be near impossible to find board of directors that are truly "independent". Also, company auditors saddled with the responsibility of the "policeman" and reviewing corporate financial records should collaborate with other corporate regulatory bodies, such as Financial Reporting Council of Nigeria and Security and Exchange Commission, to ensure that internal audit functions become legally independent and driven for improvement in accrual quality. Finally, professional accounting bodies in Nigeria such as Institute of Chartered Accountants of Nigeria (ICAN) and Association of National Accountants of Nigeria (ANAN), whose members belong to the big 4 audit firms in Nigeria, should advice corporate bodies in Nigeria to train and retrain their accounting staff, so as to place more reliance on them rather than on the external accounting firms. This is because the auditor independence which is related to the external environment cannot alone guarantee quality in reported accruals.*

KEYWORDS: Corporate Governance, Earnings Quality**,** Board of Directors' Independence, internal audit quality, auditor independence and Accrual Quality.

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INTRODUCTION

The manufacturing sector is seen as a catalyst for economic growth and sustainable transformation and a roadmap towards national development (Banjoko et al., 2012). This sector is so vital to a country for the achievement of its objectives. Pursuant to these objectives is the drive for improved earnings quality of the manufacturing sector. Earnings quality has become an important characteristic of financial reporting systems as recent regulatory changes in accounting standards, auditing and corporate governance have been motivated by attempts to increase transparency of financial reporting (Ewert & Wagenhofer, 2013). Earnings quality has also emerged as a subject of discussion amongst analysts, investors, managers, and stakeholders (Cahan et al., 2009; Lipe, 1990). Managers are more concerned about meeting analyst forecast by maintaining sustainable growth of their companies as a means to protect themselves (Lyimo, 2014). Consequently, it is in the interest of firms, investors, standard setters and regulators to continuously resolve to improve earnings quality of business entities.

An (2017), Amiri (2016), Perotti and Wagenhofer (2014) classified earnings quality dimension into decision usefulness (market-based) and stewardship (accountability-based). In the view of the former, earnings quality is measured using earnings persistence, value relevance and earnings predictability, whereas the latter employed accrual quality, earnings smoothness, conservatism and timely loss recognition as measures of earnings quality (An, 2017). Related to earnings quality of firms is the concept of corporate governance. Lin and Hwang (2010) noted the need for corporate governance as a mechanism to align the interests of management with those of shareholders.

A corporate governance system comprises a wide range of practices and institutions, from accounting standards and laws concerning financial disclosure, to executive compensation, to size and composition of corporate boards (Javid & Igbal, 2010). Therefore, a corporate governance regime in a country has deep implications for firms, employment systems, trading relationships and capital markets (Javid & Igbal, 2010). Pointedly, the concept of corporate governance presumes a fundamental tension between shareholders and corporate managers (Berle & Mean, 1932; Jensein & Meckling, 1976). The code of corporate governance recently issued by the Financial Reporting Council of Nigeria (FRCN), called the National Code of Corporate Governance 2016, is made pursuant to refinements of different sectoral codes, firms' earnings quality inclusive. The code which is issued in three parts, namely the code of corporate governance for private sector, not-for-profit entities and public sector.

Statement of Problem

IASB states that the objective of general purpose of financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. To meet this objective, earnings quality is one of the important indicators for accurately evaluating the value of a company (Li, 2014). However, a fundamental problem of earnings quality measurement is the accrual accounting principle. The accrual process requires management discretion and estimation. It is subject to both intentional and unintentional measurement error, thereby reducing the reliability of accruals relative to cash flows.

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Another problem of earnings quality is that since it is affected by accounting estimates, more able managers may likely introduce intentional errors, either to signal their private information about the firm or to extract perquisites from the firm and the shareholders.

The implementation of the **“comply or explain”** and **“apply or explain”** approach in Nigeria found the following problems: (1) non or partial compliance with no explanations (2) misleading disclosures (3) uninformative disclosures. These problems have necessitated the motivation for this research on corporate governance and earnings quality of selected manufacturing companies in Nigeria during the period 2008 to 2017. Hence, this study investigates the extent of relationship between corporate governance and earnings quality of selected manufacturing companies in Nigeria during the period 2008 to 2017. This period covers before and after IFRS adoption for publicly listed entities in Nigeria.

The following research hypotheses were stated in a null form:

Ho_1: There is no significant relationship between board of directors’ independence and accrual quality of selected manufacturing companies in Nigeria.

Ho_2: There is no significant relationship between internal audit quality and accrual quality of selected manufacturing companies in Nigeria.

Ho_3: There is no significant relationship between auditor independence and accrual quality of selected manufacturing companies in Nigeria.

LITERATURE REVIEW

Concept of Corporate Governance

According to Marad and Dasar (2014), corporate governance is typically perceived by academic literature as dealing with problems that result from the separation of ownership and control, accountability, transparency, audit and fair disclosure of reports to the shareholders and also emphasize on problems and prospects of corporate entities. From this perspective, corporate governance would focus on internal structure and rules of the board of directors, the creation of independent audit committees, rules for disclosure of information to shareholders and creditors and management control. Corporate governance is also viewed as a broad term that defines the process, customs, policies, laws and institutions that direct the organizations and corporations in the way they anti-administer and control their operations (Khan, 2011).

Corporate governance could also be defined as the application of a set of powerful micro-policy instruments in an organization, to ensure an efficient and effective use of resources in achieving the main objectives of its capital providers, succeed in the competitive market, as well as maximize its positive influence on other stakeholders and at the same time, minimize its negative impacts on them. The measures for corporate governance used in this are board of directors’ independence and internal audit quality.

Concept of Earnings Quality

Earnings quality relates to the very core of accounting as the most important purpose of financial statements—to reflect the underlying reality of the firm and effectively aid users in

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making decisions (Herly, 2015). The ability to objectively determine the accounting quality of firms is consequently an important matter and a vital part of financial accounting research (Herly, 2015). According to Dechow et al. (2010), "higher quality earnings provide more information about the features of a firm's financial performance that are relevant to a specific decision made by a specific decision-making." Financial statement users require these statements to reflect the underlying reality of the firm to effectively aid the users in decision making (Herly, 2015).

Also, the notion of decision usefulness as an indicator of high earnings quality is widely accepted and has been used by a number of researchers (Abdelghany, 2005; Ball & Shivakamar, 2005; Schipper & Vincent, 2003). They argued that decision usefulness is the single most important characteristic of high-quality earnings, since it captures the intent of standard setters and is empirically tractable. To be decision useful, financial reporting must have a number of properties. Nationally, financial reporting is only useful if it accurately reflects the underlying reality of the firm, implying that financial statements must present a "true and fair view" of the firm; financial statements must be precise, transparent, timely and comparable (Bath & Schipper, 2008; Ball et al., 2005; Bhattacharya et al., 2003; Dechow & Dichev, 2002; Francis et al., 2006). The measure for earning quality in this study is accrual quality.

Theoretical Framework

The theoretical framework of this study is anchored on the agency theory.

The Agency Theory

This theory sees shareholders as the principals and management as their agents. Sanda et al. (2005) posit further that the presence of information asymmetry can make agents pursue interests that may be detrimental to the interest of the principal. Agency theory has a basic assumption in understanding corporate governance as it explains the contract between the owner (principal) and managers (agents) of corporate entities (Jensen & Meckling, 1976). Corporate governance literature views shareholders as the principal and managers as their agent and describes the relationship as a principal–agent relationship (Agarwal et al., 2014). Agency theory is the most widely used theory in management (Daily et al., 2003; Wasserman, 2006). Broadly, agency theory is about the relationship between two parties; however, this specifically examines the structural perspective (Madison, 2014). Agency theory discusses the problems that surface in firms due to the separation of ownership and management, and emphasizes on the reduction of this problem. This theory helps in implementing the various governance mechanisms, to control the agents' action in the jointly held corporations.

Empirical Review

According to An (2017), this study investigates the measurement of earnings quality over time for listed firms on the Korean Stock Exchange Market. Using a sample of 9,584 firm-year observations over the period 1995 to 2006, the result showed that earnings quality of Korean firms is relatively lower than that of developed countries across three earnings quality dimensions, apart from conservatism.

According to Machdar et al. (2017), the study investigates the role of information asymmetry as a moderating variable to strengthen or to weaken the effects of earnings quality,

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conservatism and real earnings management on listed companies' performance. The study utilized data from Indonesia and Singapore for years 2004 to 2013. The results suggested that earnings quality positively affects the company's performance.

According to Gberegbe et al. (2017), this research investigates corporate reputation and earnings quality of listed firms in Nigeria, with Ex-post Facto research design for 21 listed firms selected from the consumer sector of manufacturing companies. The regression result reveals that corporate reputation has no significant positive association with earnings quality of listed firms in Nigeria.

According to Arabborzoo et al. (2015), this study evaluates the impact of corporate governance mechanisms on the quality of earnings in the company listed in Tehran Stock Exchange from 2007 to 2011. The results of the regression show that the three mechanisms of corporate governance in terms of board independence, ownership concentration and board membership are significantly related to earnings quality.

Nkanbia-Davis et al. (2016), this work study investigates the relationship between corporate governance and earnings quality of listed banks in Rivers State for 2010 to 2014, with board size, accrual quality, audit committee independence and value relevance. The result of regression showed a positive relationship between corporate governance and accrual quality.

Tunji et al. (2019) evaluated the effect of corporate governance on reported earnings quality in Nigeria deposit money banks during the period 2008 to 2017, with cross sectional data from ten listed deposit money banks in Nigeria stock exchange. Using descriptive and regression analysis, the study found that board size has a positive and insignificant relationship with earnings quality, and there is a negative and insignificant relationship between board independence and earnings quality.

METHODOLOGY

This study used the ex post factor research design with a population of sixty-five (65) manufacturing firms. The sixty-five (65) manufacturing firms were sampled based on their ability to remain in the listing of Nigerian stock exchange for the past three years, and the capacity to have an annual financial statement at least in the last three years. Therefore, all the listed companies were seen to have fulfilled the above conditions and were selected for the investigation. Hence, the research did not conduct sample size determination because it was not necessary. Data was retrieved from the published annual financial statement of the 65 selected manufacturing firms in Nigeria between 2008 and 2017, to form 650 firm year observations.

Descriptive data analysis and interferential data analysis, i.e., Ordinary Least Square (OLS) method were tested with the aid of E-Views 10 version statistical software. Wiener Granger causality test was also employed to test the strength of relationship between the variables of study.

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Operational Definition of Variables

Board of Directors' Independence (BDI): This is measured as the percentage of independent non-executive directors on the board to the board size or to the total number of directors in a given selected manufacturing firm.

Internal Audit Quality (IAQ): This is measured as the natural logarithm of internal audit members in the selected manufacturing firms for various years. The number of internal audit members was obtained from the published annual financial statements of the selected manufacturing firms in Nigeria.

Auditor Independence (AUI): This is measured as the natural logarithm of the size of the external audit firm that prepares and audits the external published financial statements of the selected firms for various years.

Accruals Quality (ACQ): This is operationalized as the natural logarithm of accruals pursuant to McNichols (2002) model; it is an extension of Dechow and Dichev (2002) model. The model is however expressed as follows:

$$\frac{TCA_{j,t}}{Assets_{j,t}} = \alpha_{oj} + \alpha_{1,j}\frac{CFO_{j,t-1}}{Assets_{j,t}} + \alpha_{2,j}\frac{CFO_{j,t}}{Assets_{i,t}} + \alpha_{3,j}\frac{CFO}{Assets_{1,j}} + \alpha_{4,j}\frac{\Delta REV_{j,t}}{Assets_{j,t}} + \alpha_{5,j}\frac{PPE_{j,t}}{Assets_{j,t}} + U_{j,t}$$

where:

TCA = Total current accruals

CFO = Cash flow from operations

Assets = Average total assets in year t and t-1

ΔREV = Change in revenues

PPE = Gross value of property, plant and equipment

But,

CFO = Cash flow from operations:

NIBE – TA

TA = total accruals

= ΔCA-DCL-ΔCash+ΔSTDDEBT = DEPN

ΔCA = change in current assets

ΔCash = Change in cash

ΔSTDEBT = Change in debt in current liabilities

DEPN = Depreciation and amortization expense

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NIBE = Net income before extraordinary items

TCA = Total current accruals

= ΔCA-ΔCL-ΔCash+ΔSTDDEBT

Assets = Average total assets in year t and t-1

The modified Dechow and Dichev (2002) is the same as Dechow and Dichev (2002) model, but it controls for PPE and revenue influencing accruals.

RESULTS/FINDINGS

Test of Hypothesis

Table 1: OLS method of regression analysis on the relationship between AUI, BDI, IAQ and IFRS.

Dependent Variable: ACQ
Method: Least Squares
Date: 07/10/19 Time: 11:37
Sample: 1 650
Included observations: 648

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.731699	1.278069	2.919795	0.0036
AUI	0.176456	0.463243	0.380915	0.7034
BDI	-0.295616	0.102681	-2.878980	0.0041
IAQ	-0.190062	0.239620	-0.793182	0.4280
IFRS	0.199554	0.369735	0.539723	0.5896

R-squared	0.616477	Mean dependent var	0.980818
Adjusted R-squared	0.010358	S.D. dependent var	5.204190
S.E. of regression	5.177166	Akaike info criterion	6.134079
Sum squared resid	17234.36	Schwarz criterion	6.168600
Log likelihood	-1982.442	Hannan-Quinn criter.	6.147470
F-statistic	2.693021	Durbin-Watson stat	1.932031
Prob(F-statistic)	0.030158		

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Table 1 was used to interpret hypotheses 1, 2 and 3.

H0$_1$: There is no significant relationship between board of directors' independence and accrual quality of selected manufacturing firms in Nigeria.

The regression result in Table 1 established the relationship between board of directors' independence and accrual quality of selected manufacturing firms in Nigeria. The t-statistic value of -2.878980 less than t-critical value of -1.96 showed a statistically insignificant relationship. A Durbin-Watson value of 1.932031 which is close to 2 showed the absence of serial correlation. Given the t-statistic value and applying the decision rule under the critical value approach of +1.96 and -1.96, the result showed that t-2.878980<t-1.96. From the foregoing, the null hypothesis which states that there is no significant relationship between board of directors' independence and accrual quality is therefore accepted. Consequently, the alternative hypothesis is rejected.

Ho$_2$: There is no significant relationship between internal audit quality and accrual quality of selected manufacturing companies in Nigeria.

The t-statistic value of -0.793182 greater than t-critical value of -1.96 suggests that the estimated coefficient is significant at 0.05 level of significance for a 2-tailed test. Durbin-Watson of 1.932031 close to the value of 2 indicates the absence of serial auto correlation. Using the t-statistic value and applying the decision rule under the critical value approach of +1.96 and -1.96 showed that $t_{-0.793182} > _{-1.645}$. From the result, the null hypothesis which states that there is no significant relationship between internal audit quality and accrual quality of selected manufacturing firms in Nigeria is therefore rejected. Consequently, the alternative hypothesis is accepted.

Ho$_3$: There is no significant relationship between auditor independence and accrual quality of selected manufacturing companies in Nigeria.

The t-statistic value of 0.380915 less than t-critical value of +1.96 signified that the estimated coefficient is insignificant at 0.05 level of significance for a 2-tailed test. By the rule of thumb, Durbin-Watson value of 1.93 close to 2 indicates the absence of serial autocorrelation. Given the t-statistic value and applying the decision rule under the critical value approach of -1.96 and +1.96 showed that $t_{0.380915} < t_{1.645}$. From the foregoing, the null hypothesis which states that there is no significant relationship between auditor independence and accrual quality of selected manufacturing firms in Nigeria is therefore accepted. Hence, the alternative hypothesis is rejected.

DISCUSSION OF FINDINGS

The result revealed a positive and insignificant relationship between board of directors' independence and accrual quality of selected manufacturing companies in Nigeria. This result means that board of directors' independence has the required tendency to improve the accrual quality of selected manufacturing companies in Nigeria. Abukaya (2012) asserted that an independent board of directors is more likely to inspire managers towards high transparency and disclosure of quality financial reports. However, the result from the findings showed that an independent board of directors has a small (insignificant) strength to cause the

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required/expected positive change in accrual quality. This result corroborates the findings by Nkanbia-Davis et al. (2016), Tunji et al. (2019), and Abata and Migiro (2016) that found a positive and insignificant relationship between corporate governance variables and accrual quality.

Also, the study revealed a positive and significant relationship between internal audit quality and accrual quality of selected manufacturing companies in Nigeria. This result means that internal audit quality has a positive relationship with accrual quality of selected manufacturing companies in Nigeria. In other words, this result showed that internal audit quality has the positive tendency to improve accrual quality. D'Angelo (1981) posited that internal audit quality is the joint probability that audit will truly present the audit findings in accounting system of its client, for the public interest. However, the result from the findings showed that internal audit quality has a strong (significant) power to cause the expected change in accrual quality. This result supports past empirical findings by Nwanyanwu (2017), Enofe et al. (2013), Aliu et al. (2018), and Kiabel (2012) that showed a positive relationship between joint internal audit quality and firm performance.

Furthermore, the study revealed a positive and insignificant relationship between auditor independence and accrual quality of selected manufacturing companies in Nigeria. This result signifies that in statistical terms, auditor independence has a positive relationship with accrual quality of selected manufacturing companies in Nigeria. Statistically, this result means that auditor independence can positively improve accrual quality. Carren (2013) posited that independence is an essential part of audit because the opinion of the independent auditor is required to add justification and credibility to the financial statement prepared by the management. However, the result from the test findings showed that auditor independence is too weak to cause the required change in accrual quality. This result supports the previous empirical findings by Lin and Liu (2009) and Lee and Lee (2013) that earnings and book value audited by non-big 4 audit firms are more insignificant than those audited by big 4 audit firms.

CONCLUSION

Given the findings and discussions to findings, this research study concluded as follows:

That there exists a positive and insignificant relationship between board of directors' independence and accrual quality. The research also confirmed that an independent board of directors has a small influence to cause a positive change in accrual quality of selected manufacturing companies in Nigeria.

That there exists a positive and significant relationship between internal audit quality and accrual quality. The study also confirmed that internal audit quality is capable of causing a change in accrual quality. This could possibly be attributed to the overall standard of internal audit work as a function of the efforts and professional care exhibited by the internal audit staff.

That there exists a positive and insignificant relationship between auditor independence and accrual quality. The research also confirmed that auditor independence has a weak influence to cause a positive change in accrual quality of selected manufacturing companies in Nigeria. This could possibly be attributed to the inadequate supervisory activities of audit firms.

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RECOMMENDATIONS

The following recommendations were made in respect to the above findings:

The investors and managers of selected manufacturing companies that are viewed to be founded on company statute should never rely solely on the existence of non-executive boards of directors to monitor and improve the quality of accruals, since in real life, it may be near impossible to find a board of directors that is truly "independent".

Company auditors saddled with the responsibility of the "policeman" and reviewing corporate financial records should collaborate with other corporate regulatory bodies such as Financial Reporting Council of Nigeria (FRCN) and Security and Exchange Commission (SEC) to ensure that internal audit functions become legally independent and driven for improvement in accrual quality.

Professional accounting bodies in Nigeria such as Institute of Chartered Accountants of Nigeria (ICAN) and Association of Certified National Accountants of Nigeria (ANAN), whose members belong to the big 4 audit firms in Nigeria, should advice corporate bodies in Nigeria to train and retrain their accounting staff so as to place more reliance on them rather than on the external accounting firms. This is because auditor independence, which is related to the external environment, cannot alone guarantee quality in reported accruals.

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