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Board Attributes and Earnings Quality of Listed Financial Firms in Nigeria

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ABSTRACT: *The study evaluated the effect of board attributes on earnings on earnings quality of listed financial firms in Nigeria. The study employed secondary data. The study population comprised all the 16 listed financial firms on the Nigerian Stock Exchange. Purposive sampling technique was adopted to select top 10 banks whose shares are consistently traded on the stock market. Data for board attributes and earnings quality were sourced from the audited financial statements of the selected firms, the Nigerian Stock Exchange Factbook over a period of 10 years (2008-2017). Collected data were analyzed using pooled ordinary least square, fixed effect and random effect estimation techniques. The result from the study showed that board independence ($t=2.01$, $p<0.05$) and board size ($t=-2.08$, $p<0.05$) had positive and negative significant relationship respectively with earnings quality while board meeting ($t=-0.56$, $p>0.05$) does not exhibit statistical significance. The study recommended that the percentage of independent non- executive directors on the board should be maintained because it was has a positive relationship with earnings quality and adequate provisions should be made not to allow for the impairment of their independence. The interests of shareholders are better protected when the board is dominated by independent outside directors as this will improve earnings quality. Board size should be kept within limit as its increase might allow for earnings management practices.*

Key words: *Board composition, Board independence, Board size, Earnings quality.*

1. Introduction

In the past decade, issues surrounding corporate governance have generated a lot of attention globally. This is due to the pivotal roles it plays in organizational success or failure. Corporate governance is referred to as a set of procedures and systems by which the activities of an organization are being handled and controlled so as to increase shareholders' worth through improvement of responsibility and performance while considering other stakeholder's interest.

One of the most desirable mechanisms of corporate governance for reducing agency cost relates to board composition that is, what constitute the board of directors of an entity. The primary constituent of an organization is the board of directors due to their monitoring roles over the financial reports of the organization as well as carrying out other duties assigned to them by the owners. Managers often tend to act in their sole interest to smooth earnings causing misinformation to the owner and other stakeholders, this necessitates the monitoring role of the board on the financial statements prepared by managers. What constitutes the board in term of the number of independent members is a pertinent factor. The appointment of

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independent non-executive on the board is a relevant mechanism to align the interest of owners and managers. Incentives are provided for independent non-executive directors to disallow liaising with managers because the worth placed on the human capital of the independent directors depends to some extent, on how well they perform their monitoring roles. Insiders' opportunism will be effectively controlled when the larger part of the board is made up of independent directors (Karamanou & Vafeas, 2005).

Earnings quality refers to the level at which the choice of managers influence reported earnings. It is also viewed in terms of closeness of time between when revenue is recognized and when cash is being collected; and when expenses are acknowledged and when cash is utilized. The quality of earnings reported is essential in the capital market for the efficient distribution of resources. Qualitative earnings are relied upon by investors, institutional owners, regulators and other stakeholder to make important and relevant investment decisions. The performance of a firm is valued by these stakeholders based on earnings information. For instance, earnings values are used to evaluate price securities as well as making future predictions through valuation models.

As a result of the divergence between owners of a business and those charged with the responsibility of controlling its affairs and because managers use information that are not yet made public for their own advantage, owners of a firm are usually of the thought that managers will not act in a way that will improve shareholders' wealth. Jensen and Meckling (1976) According to Fama and Jensen (1983) the mechanisms of corporate governance are perceived to be essential in reducing managers' behaviour that is not in mutual agreement with that of the owners. Therefore, ensuring the quality of financial reports is one of the most relevant functions of corporate governance.

To ensure the maintenance of effective corporate governance practices, the board of directors plays an important role, particularly in publicly held corporations in which agency problems may arise from the separation of ownership and control. However the executive members on the board usually manage earnings to gain investors' confidence and also to encourage and convince potential investors to invest, thereby resulting into actions that are unethical and fraudulent. The central concern of board composition (which is the extent to which outside directors are represented on the board) with earnings quality is that independent non-executive directors are expected to safeguard the interest of shareholders even when agency issues does not arise. Although this depends on who is on the board, and thus the composition of board members may significantly affect the quality of financial information.

In view of this problem, this study was motivated to evaluate the effectiveness of one of the components of corporate governance (board composition) in mitigating managerial unethical practices in relation to the quality of earnings in the Nigerian financial sector.

2. Literature Review

2.1. Theoretical Framework

2.1.1. Agency Theory

The study is anchored on agency theory and it majorly looks into the association involving two separate groups of people, the owner who is the principal and agent who act on behalf of the principal (Eisenhardt, 1989; Jensen & Meckling, 1976; Ross, 1973). The agency theory explicitly observes the interactive and operational aspects of this association. The theory proposes that agents tend to act in their own interest without given adequate consideration to that of the principal when they are given the liberty to act. Eisenhardt (1989); Chrisman, Chua, Kellermanns, and Chang (2007); Jensen and Meckling (1976); Wiseman, Cuevas-Rodríguez, and Gomez-Mejia (2012). Therefore, certain operational components are put in place to control and regulate the activities of agents and also to breach the gap of interest between both parties (Cruz, Gómez-Mejia, & Becerra, 2010; Eisenhardt, 1989; Fama & Jensen, 1983).

One of these components includes financial motivations for agents to act in the best interest of the principal. Certain arrangements are made where top executives own shares in the organization possibly at a cheaper rate to breach the gap of interest between managers and the owners (Jensen & Meckling, 1976). Other related arrangements bond executive reward with the shareholders' benefits and also extending some portion executive reward to the future so as to enhance shareholders' long term wealth maximization and discourage short-run executive manipulations that negatively affects an organization.

The agency theory proposed two possibilities by which agency problems can be reduced (Eisenhardt, 1989) agents' self-interest can be controlled by these two options. The first option is the creation of

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governance system that helps to inspect and regulate the genuine activities of managers (Anderson & Reeb, 2004; Chrisman et al., 2007). For instance, as a part of this system, reporting processes, supplementary management and the board of directors are adequately monitored (Donaldson & Davis, 1991). The other aspect is the establishment of governance system which is based on the real result of manager's behaviour. Eisenhardt (1989). For instance, a form of this structural component is linking reward with the performance of managers. Therefore, risks are transferred to the managers thereby forming an incentive to breach the gap of interest between managers and shareholders (Davis, Schoorman, & Donaldson, 1997; Eisenhardt, 1989).

2.1.2. Empirical Studies

Raheel (2017) conducted a study entitled "*impact of characteristics of the board on earnings management on the firm: evidence from Pakistan stock exchange*" The purpose of the study was to investigate the effect of key features of the board of directors on earnings management of the firms listed in Pakistan. The sample comprises of 100 firms quoted on the Pakistan Stock Exchange between 2008 and 2014. The Modified Cross Sectional Jones Model (1995) was been employed to derive the discretionary accruals used for measuring earnings management. Board features investigated in the research include board independence, board size, CEO duality, gender diversity and institutional ownership, while firm size, leverage and profitability was used as control variables. The results of the study revealed that board independence has a significant negative impact on earnings management, whereas CEO Duality and institutional ownership showed a positive and significant effect earnings management. However, no significant impact of board size and gender diversity was observed on earnings management.

Alves (2014) conducted a study entitled: "*the effect of board independence on the earnings quality: evidence from Portuguese listed companies*". The purpose of this study was to examine the influence of board independence on earnings management to enhance the quality of earnings in Portugal. The sample comprises of 33 non-financial firms quoted on the main market, Euronext Lisbon from 2003-2010. The results of the study revealed that the quality of earnings is enhanced by board independence through reduction in earnings management from the sampled firms. The study recommended that increase in the number of independent directors on the board will help to enhance the quality of earnings. However the sample size and the number of observations used in the study is small which might have affected the result. Although the model used is well recognized model, but there are more recent model which could have been explored.

Bazaz and Mashayekhi (2010) conducted a study entitled: *"the effects of corporate governance on earnings quality: evidence from Iran"*. The purpose of this study was to examine the relationship between some components of corporate governance and the quality of earnings. The study measured the quality of earnings with accrual quality, earnings persistence and earnings predictive ability. The components of corporate governance examined in the study include board leadership, board independence, board meeting and board size. The study sample consists of 150 firms in Tehran Stock Exchange from 2005-2008. The findings of this study indicate that a board size has a negative and significant relationship with earnings quality while board size and board meeting showed a positive and significant relationship with earnings quality. However, board leadership structure has no significant association with earnings quality. The four corporate governance measurements used in the study all point to the board of directors whereas there are other measures which focus on different aspects of corporate governance.

Reskino (2015) conducted a study entitled: "*the effect of corporate governance and earnings quality with surplus free cash flow as a moderating variable"*. The aim of the study was to investigate empirically the impact of some corporate governance mechanisms on earnings quality measured with representational faithfulness. The sample of the study consists of 25 property, real estate and building construction firms quoted on Indonesia Stock Exchange between 2010 and 2012. The findings of the study revealed that independent commissioners and CEO duality of commissioners has significant relationship with earnings quality while audit committee independent has no significant relationship with earnings quality.

Davies, Gberegbe, Ofurum, and Egbe (2016) conducted a study entitled: "*corporate governance and earnings quality of listed banks in Rivers state*". The purpose of this study was to determine the relationship between corporate governance and earnings quality of listed banks in Rivers State. It examined the relationship between Board size and accrual quality; Audit committee independence and value relevance; and directors' independence and accrual quality of listed banks in Rivers State. The sample consists of all listed banks in Nigeria Stock Exchange available for the five year period from 2010-2014 that does business in

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Rivers State. The author adopted the quantitative approach in investigating the assumed relationships. The findings of the study showed a positive association between board size, independent directors and accrual quality. No relationship was established between independent audit committee and accrual quality. It was then recommended in the study that the existing board size should be maintained to sustain bank performance. In addition, quality and independent directors should be hired for earnings and accrual management. The study was limited to just a state out of the 36 states in Nigeria, this scope of the study is small to capture the relationship.

Roodposhti (2010) conducted a study entitled "the effect of board composition and ownership concentration on earnings management: evidence from Iran". The aim of the study was to examine the relationship between mechanisms of corporate governance and earnings management. The sample of the study consists of 196 companies listed on the Tehran stock exchange market from the periods 2004-2008. The study revealed that ownership concentration and board independence have a negative and significant relationship with earnings management. Also there exist a negative and significant relationship between CEO duality and earnings management. However the study did not examine other variables of board composition aside board independent which might also influence the dependent variable.

2.1.3. Methodology

The data for this study was obtained from secondary source. This study used panel data to establish the relationship between board composition and earnings quality in Nigerian financial firms, therefore, the population of this study consisted of all the 16 deposit money banks in Nigerian financial firms as at 31st December, 2018. The purposive sampling technique was adopted in selecting the 10 deposit money banks whose annual reports were adequately available over a period of 10 years (2008-2017).

2.2. Variable Description and Development of Hypotheses

2.2.1. Earnings Quality

Earnings quality is referred to as an increased level in the quality of earnings which make available more detailed financial information about an organization to its individual users in decision making (SFAC No. 1). From the above explanation three characteristics that defines earnings quality are pointed out: earnings quality is centered around the provision of important decision by the an organization to the investors and other users: the second part is related to the informativeness of the figures presented to capture the financial performance of an organization and the third part look into how relevant are these information in decision making and if it actually represent the actual performance of the organization. Also, Penman and Zhang (2002) view earnings quality as that earnings stated on the financial statement, before identifying the extraordinary items, is regarded as an adequate signal for futuristic earnings. Therefore, it is assumed that a high level of earnings quality relates to a desired sustainability of earnings while unsustainability is related to a low level of earnings quality. According to the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) did not define earnings quality in their common Conceptual Framework, but rather itemized a number of qualitative features expected in earnings to be regarded as of a high quality, amongst them are relevance, faithful representation, comparability, verifiability, timeliness, and understandability (International Accounting Standard Board, 2010).

2.2.2. Board Independence

Board independence is among the mechanisms of corporate governance. Independence of the board is examined by what constitute it. A correct proportion of independent non-executive directors must be maintained for adequate monitoring. According to Hillman and Dalziel (2003) the board is deemed to be independent when the required amount of independent non- executive directors exists on the board. The presence of non- executive director is useful for proper monitoring of management affairs leading to security of shareholder's interest (Byrd & Hickman, 1992; Cravens & Wallace, 2001). According to Fama (1980) and Fama and Jensen (1983) the internal control of an organization is improved with the presence of non-executive directors because majority of them are executive directors in other organization. Ahmed and Henry (2012) revealed that organizations that willingly adhere to the principles of corporate governance components are able to minimize the agency problems.

Ho1: There is no significant relationship between board independence and earnings management.

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2.2.3. Board Size

Board size is referred to as the entire number of directors on the board for an accounting year. There are no definite regulations as to the number of directors expected to be on the board and there is no ideal board size as well. It is quite relevant to ascertain the optimal size for the board because adequate and efficient board is dependent on the number and quality of the directors. Scholars who advocate for large board size are of the opinion that a higher level of skills and knowledge can be attained due to different personalities with diverse experiences. The board size cannot be specified at the country level also, as the countries differ in their legal, social, economic, and corporate environment. One size cannot be fit for all. The board size is positively related to firm's performance. Larger board size led to better decision making which further results into better performance of the firm (Dalton, Daily, Johnson, & Ellstrand, 1999).

Ho2: There is no significant relationship between board size and earnings management

2.2.4. Board Meeting

The Nigerian Code of Corporate Governance stipulates the required number of times the board is expected to meet in a year. It states that the members of the board must meet at least once in a quarter, which means they are expected to meet at least four times in a year for the board to be effective in the discharge of its duties. Past research shows that the frequency of board meetings has an effect on earnings management trend in companies (Xie, Davidson III, & DaDalt, 2003). Gulzar, Wuhan, and Wang (2011) found that if the frequency of board meetings is more, then the value of discretionary accruals is lower; they stated that higher frequency of board meetings will improve the monitoring. argued that diligent and effective boards are associated with lower earnings management.

Ho3: There is no significant relationship between board meetings and earnings management.

2.2.5. Control Variables

Empirical research on earnings management usually introduced control variables that show the effect on earnings management (Hsu & Wen, 2015; Xie et al., 2003). This is explained as follows:

2.2.6. Firm Size

It is measured by the natural logarithm of total assets implying that the larger the firm size the more pressure is placed on management to report more desire earnings (Pincus & Rajgopal, 2002).

2.2.7. Leverage

This is measured as total liabilities scaled by total equity. Firms in financial distress or near debt covenant violation may be more motivated to engage in earnings management practices (DeFond & Park, 1997).

The model to capture the relationship between board composition and earnings quality of deposit money banks in Nigeria was specified as follows:

Where;
Earnings Quality
Board Independence
Board Size
Board Meeting
Firm Size
Leverage
Error term

2.2.8. Measurement of Variables

This involves both dependent variable and the independent variables that were used in this study. The dependent variable is the earnings quality while the independent variables are board independence, board size and board meetings. Firm size and leverage was used as control variables. These variables are measured thus;

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Table-1. Variables.

Firm Size (FRSIZ)	Natural log of total assets (Waweru & Riro, 2013)
Leverage (LEV)	Ratio of total debt and total equity (Bala & Kumai, 2015)

3. Results and Discussions

The variables (board size, board independence and board meeting) used in estimating board composition are tested to check for correlation. The correlation results in Table 2 showed that board independence does not have correlation with board size and leverage. However, it showed a low negative correlation 0.01 with board meeting and 0.02 with firm size. Board size and leverage had no correlation with other explanatory variables. The result of the correlation showed that the problem of overstating or understating the standard error was not evident.

Table-2. Correlation matrix of board composition and earnings quality.

Correlation Probability	Q	Brdind	Brdmet	Brdsiz	Fsize	Lev
Q	1. 00					

BRDIND	-0.09	1.00				
	0.38	-----				
BRDMET	-0.03	-0.27	1.00			
	0.76	0.01	-----			
BRDSIZ	-0.01	0.17	0.03	1.00		
	0.94	0.10	0.71	-----		
FSIZE	-0.01	-0.24	0.13	0.03	1.00	
	0.91	0.02	0.22	0.74	-----	
LEV	-0.07	-0.04	-0.01	-0.09	0.17	1.00
	0.50	0.64	0.88	0.36	0.09	-----

Furthermore, Table 3 shows the result of the relationship between board attributes and earnings quality among the selected listed banks. Results of the Lagranger multiplier test (3.78, p>0.05) (Table 4) indicated that the random will not be appropriate while the Hausman test (0.86, (p>0.05)) (Table 5) reported that OLS was preferable to fixed effect. This result informed the adoption and interpretation of the ordinary least square model. The model was the most appropriate and captured the relationship between the dependent variable and the independent variables.

The explanatory power of the model showed that 67.6% of the variation was captured by the explanatory variables while 60.8% was captured by the variables after adjusting for the degree of freedom. The F-statistics of the model (94.9, p<0.05) indicated that the model was statistically significant and the coefficients were different from zero.

Board independence influences earnings quality. The coefficient of 13.66 and t-statistics of 2.01 (t=2.01, p<0.05), indicated that board independence is statistically significant. This result implied that a unit increase in board independence led to 2.01% increase in earnings quality. Increase in the number of non- executive directors on the board tends to enhance monitoring on the board. By this, there is higher likelihood that earnings management practices will fall drastically thereby strengthening the quality of earnings. This is in line with the works of Raheel (2017); Davies et al. (2016); Reskino (2015); Alves (2014); Roodposhti (2010) that, there exist a significant positive impact of board independence on earnings quality. The null hypothesis 1 is therefore rejected.

Board size reported negative relationship with earnings quality. The variable of board size with coefficient of 0.22 and t- statistics of 2.08 (t=2.08, p<0.05) showed that board size is statistically significant. It implied that a unit increase in the size of the board of directors positively influence earnings quality by 2.08%. As the number of members on the board increases, earnings management activities tend to move upward. When the increase in board size is in favour of the executive directors, this might give more space for managers to smooth earnings, however, if the increase is on the side of the independent non- executive members, there is a high tendency that monitoring capacity will be enhanced leading to an improved earnings

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quality. This is consistent with the findings of Bazaz and Mashayekhi (2010) which found that larger board size, yields weaker earnings. But contrary to the empirical work of Raheel (2017) and Davies et al. (2016) which provided evidence that board size positively affect earnings quality. The null hypothesis 2 is therefore rejected.

Board meeting did not exhibit significant relationship with earnings quality. The variable of board meeting with coefficient of 2.84 and t-statistics of 0.55 (t=0.55 p<0.05) failed to significantly influence earnings quality. It implied that the frequencies of meetings of the board of directors will constraint earnings management practices, however, not statistically significant. This is consistent with the empirical work of Bazaz and Mashayekhi (2010) which showed a positive relationship between board meeting and earnings quality. However, Firm size showed negative significant relationship with earnings quality (t=-2.17, p<0.05). This negative and significant relationship implies that the bigger the size of the firm the lower the earnings quality. Similarly, leverage is also negative but insignificant. The null hypothesis 3 is hereby fail to be rejected.

Table-3. Model Estimate of the Relationship between Board Composition and Earnings Quality

Dependent Variable: Earning Quality						
	Pooled OLS		**Fixed Effect**		**Random effect**	
	Coefficient	**t-statistics**	**Coefficient**	**t-statistics**	**Coefficient**	**t-statistics**
BRDIND	13.66*	2.01	19.53	1.31	16.15*	2.15
BRDSIZ	0.22*	2.08	-1.17	-0.31	-5.92*	-2.19
BRDMET	2.84	0.56	2.51	0.45	27.41	0.52
FSIZE	- 1.11*	-2.17	2.49	0.22	3.58*	2.05
LEV	- 0.26	- 0.67	0.24	0.56	2.61	0.64
C	48.11	0.64	-14.89	-0.14	-40.90	-0.48

Note: * significant at 5%

Table-4. Lagrange Multiplier Tests for Random Effects of the relationship between board composition and earnings quality.

Null hypotheses: No effects
Alternative hypotheses: Two-sided (Breusch-Pagan) and one-sided (all others) alternatives

	Test Hypothesis		
	Cross-section	**Time**	**Both**
Breusch-Pagan	0.022169	0.292447	0.314616
	(0.8816)	(0.5887)	(0.5749)
Honda	-0.148894	-0.540784	-0.487676
	--	--	--
King-Wu	-0.148894	-0.540784	-0.495618
	--	--	--
Standardized Honda	0.396903	-0.330020	-3.743344
	(0.3457)	--	--
Standardized King-Wu	0.396903	-0.330020	-3.742611
	(0.3457)	--	--
Gourierioux, et al.*	--	--	0.000000
			(>= 0.10)
*Mixed chi-square asymptotic critical values:			
1%	7.289		
5%	4.321		
10%	2.952		

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Table-5. Model Estimate of the Relationship between Board Composition and Earnings Quality.

Dependent Variable: EQ				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
BRDIND	13.66059	6.77977	2.01490	0.0466
BRDSIZ	0.22055	0.105934	2.08199	0.0326
BRDMET	2.84346	5.09156	0.55847	0.578
FSIZE	-1.11677	0.515299	-2.16724	0.0326
LEV	-0.26572	0.394491	-0.67359	0.5024
C	48.1112	75.35177	0.63848	0.5249
R-squared	0.676135	Mean dependent var		-14022.25
Adjusted R-squared	0.608387	S.D. dependent var		723435.1
S.E. of regression	737895.6	Akaike info criterion		29.92603
Sum squared resid	4.52E+13	Schwarz criterion		30.09380
Log likelihood	-1325.708	Hannan-Quinn criter.		29.99365
F-statistic	94.92286	Durbin-Watson stat		1.758879
Prob (F-statistic)	0.000501			
Hausman Test		0.86 (p>0.05)		

4. Summary and Conclusion

Board independence proved to have a positive relationship with earnings quality, in line with the findings of Raheel (2017) while earnings quality will be affected negatively with a larger board size. This is consistent with the findings of Bazaz and Mashayekhi (2010). However, board meeting report no statistical relationship with earnings quality.

Finally, it was concluded that increase in the percentage of independent non- executive directors on the board have a positive influence to a large extent on the quality of earnings in the sampled firms. While earnings quality will be affected positively with a larger board size. However, board meeting report no statistical relationship with earnings quality.

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