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Corporate Governance and Earnings Quality of Listed Banks in Rivers State

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ABSTRACT: *This study investigated 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. It adopted the quantitative approach in investigating the assumed relationships. Using regression analysis and Pearson product moment correlation coefficient, the result indicated a positive relationship between corporate governance and earnings quality. It revealed positive association between board size, independent directors and accrual quality. No relationship was established between independent audit committee and accrual quality. It is recommended 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. Finally, further study is recommended for other sectors using different research to correct the limitation of the research method and tools.*

I. INTRODUCTION

Earnings quality is premier form of the financial quality as earnings constitute a major source of firm-specific information (Francis, La ford, Olsson and Schipper, 2004). High quality reporting will require well-structured and implemented corporate governance mechanisms. The effectiveness of corporate governance in the financial reporting process is a major source of confidence building in the capital market (Ebaid, 2013). Klein (2002) revealed that managers act with a short-term self-interest motive and use weaknesses, for example, poor corporate governance structures to manage earnings for short term benefit. Accordingly, considerable attention given to corporate governance issues in recent years suggests that stronger governance mechanisms are likely to reduce opportunistic management behaviour, thereby enhancing the quality and reliability of financial reporting.

IMF identifies weak corporate governance as one of the factors that influence financial crisis. It increases investor's confidence by encouraging more accurate financial reporting and, transparent accounting and disclosure practices by management. When there is reliable and transparent financial reporting practices, investors will be able to make more informed financial decisions (Machuba and Teitel, 2007).

Lin and Hwang (2010) claim that corporate governance positively influences the quality of reported earnings. However, prior literature on earnings has developed evidence that indicate that there are large cross-sectional differences across countries. These differences may be due to the use of different research design and empirical setting.

The relationship corporate governance and earnings quality has been investigated in the developed economies such as USA and Europe, much is not known about this relationship in developing economies. Liu and Lu (2009) indicated that Chinese listed firms with higher corporate governance levels have lower levels of earnings management. Similarly, Muchuga and Teitel (2007) reported that the quality of earnings increased after the implementation of the corporate governance code in Mexico. Also, Sarka, Sarka and Sen (2008) show that boards that have directors with multiple appointments indicate higher earnings management in India. However, Abdul Rahman and Ali (2006) argue that earnings management is positively associated with board size in Malaysia. In Pakistan, Ali Shan, Butt and Hassan (2009) show that corporate governance is positively associated with earnings management among the listed firms. Ali-Abbas (2009) did not find any relationship between board size, value relevance and accrual with earnings management in the Saudi economy. Finally, the result from Chalevas and Tzovas (2010) indicate that mandatory corporate governance mechanisms do not positively influence earnings quality in Greece. These studies provide mixed and inconclusive findings justify the need to investigate this relationship in Rivers State, Nigeria.

In Nigeria, the banking sector has witnessed several reforms that are attributable to reducing earnings manipulation. Despite the number of governance codes and regulations, many banks collapsed between 2006 and 2007 after Recapitalization and Consolidation exercise. The cases of the defunct Oceanic Bank, Intercontinental Bank, and First Inland Bank (Finbank) in 2009 raised questions on the effectiveness of corporate governance of banks in Nigeria. Abdul Rahman and Ali (2006) assert that the high level of reliance placed on financial reports poses the risk of manipulation of earnings by managers to their own advantage and may be responsible for bank failure. The demand for high return on investment by shareholders put management under pressure and lures them into involving themselves in unethical practices in financial reporting and disclosures (Dalhat, 2014).

This study provides empirical evidence on the relationship between corporate governance and earnings quality of listed banks in Rivers State. It extends the scope of corporate governance research to earnings quality and assist in broadening the limited international and Nigeria literature on corporate governance.

The next part of this article is organized as: empirical review, methodology and discussion of findings, conclusion and limitation/recommendation.

II. EMPIRICAL REVIEW

For the purpose of this article, we will discuss previous studies under the following sub-heads:

The size and independence of Board of Director

One of the most important factors that influence the integrity of financial accounting process involves the board of directors (Niu, 2006). There are claims that strong independent directors are positively related with the effective monitoring of managers and significantly influence corporate governance. According to Dezoort and Salterio (2001), boards exist to protect the interest of those that are not involved in the day to day running of a company. With its responsibility of monitoring and control, the board is assumed to assure the shareholder of the quality of financial reporting. Klein (2002) asserts that the board of directors mitigates the manipulation of accounting information through its monitoring process.

Previous research suggests that the effectiveness of board of directors' oversight role may be influenced by factors such as board size, board members independence, members' expertise and meeting. A board with large number of people with varied expertise may increase the synergetic monitoring of the board in minimizing the level of earnings manipulation. Peasnell, Pope and Young (2005) reported that large board size is related to a reduced level of discretionary accruals. Similarly, Beasley (1996) revealed that the proportion of independent directors was negatively associated with financially reported frauds. Klein (2002) found that board size and independence does not positively influence abnormal accruals. However, Anderson, Mansi and Reeb (2004) indicated that board size and independence are positively associated with the integrity of financial reporting. The mixed findings suggest that these relationships are inconclusive.

Audit Committee

Gendron and Bedard (2006) assert that the role of audit committees in monitoring the processes of financial reporting has received significant attention since the beginning of the 1990s in corporate governance literature. In Nigeria, section 359 of CAMA 1990 compels all publicly owned companies to establish an audit committee of 12 members, six representing the directors and shareholders respectively. Further, the Security and Exchange Commission provides that at least one member of the audit committee must be financially literate such that his knowledge and expertise will enable him take appropriate decision.

An audit committee is responsible for the soundness and quality of internal accounting practices and control, making recommendations for the selection of an external auditor, and the monitoring of the activities of the auditor. Mc Mullen (1996) asserts that audit committee is positively associated with a lower incidence of management fraud, quarterly earnings restatement, SEC enforcement actions as well as auditor's turnover.

In addition, there are claims that the effectiveness of the audit committee oversight function may be influenced by some qualities such as the independence of audit committee members, financial literacy and expertise. De Zoort and Salterio (2001) reported that the financial expertise of audit committee increases the likelihood that the detected material misstatements will be communicated and corrected on time. Klein (2002) found a negative association between audit committee independence and abnormal accruals. Persons (2005) revealed that audit committee independence is positively associated with the reduced level of fraud. These results are mixed and will require further investigation.

Earnings Quality

There is increased pressure on companies to provide timely and precise information about their organisation's earnings. The completeness of a company's financial information will support the dividend expectation of shareholders in a particular situation.

Kamarudan and Ismail (2014) claim that the potential of a company's performance realized from enhanced business activities in the current trading year is capable of revealing anticipated level of success in future returns. The current state of financial position may significantly influence the actual worth of the entity.

Further, the standard of earnings may not depend on financial inclination to the existing regulations. Income is not observable, thus may not represent true earnings. According to Yee (2006), there is fundamental earnings and reported earnings. Fundamental earnings represent the company's financial potential of the company. On the other hand, reported earnings represent a defector estimation of core inflows than reported to shareholders. A company may use existing opportunities to change reported earnings. The earnings ability of a company should represent its performance. According to Povolotskaya (2014), the corporate income generated is conceived as the concise measurement of a company performance. However, Dechow and Dichev (2002) argue that accruals should be used to adjust the earnings to indicate improved reflection of a company's performance. That is, reported earnings should have lesser level of uncertainty but reflect value relevance.

Value Relevance

Value relevance is a measure of the applicability of financial report in the perspective of shareholders and the quality of a value relevant accounting report resides in the association between accounting numbers and current company value (Hung, 2001). Similarly, Beishland (2009) assert that value relevance refers to the ability of financial statement information to capture and summarize information that determines a company's value. There must be a mutual interaction linking corporate financial result and company value. Thus , financial statement is value-relevant when "it is able to recapitulate relevant information that has direct bearing on the firm's quality.

III. JUSTIFICATION FOR THE STUDY

Nigeria is a unique and interesting environment in which to test the sensitivity of the association between corporate governance and the integrity of the financial reporting process to new governance initiatives. First Nigeria regulations are not the same with other countries. Second, Nigeria adopts flexible measures to address matters of corporate governance. Finally, many Nigerian banks have limited capacity to attract large number of independent directors, thus, for these banks to comply with a strict set of corporate governance codes may be result to financial and administrative burden.

In addition, this study provides support to the argument that high quality financial reporting requires well-balanced corporate governance structures in the banking industry. Moreso, high quality financial reporting is achieved through those that prepares the report not supply by the governance codes.

Further, it provides evidence on how the involvement of outside directors on board and audit committee may enhance earnings quality when implemented. The code of corporate governance released by securities and change Commission in 2009 defines the Scope of Board Size and Composition, Independent Directors, Multiple Directorships, Family Interlocking Directorships, Board Committees, Frequency of Board Meetings, Shareholders meeting, Audit Committee, Internal Audit Function, Rotation of External Auditors and code of Ethics.

Lastly, Leuz, Dhananjay and Wysocki, (2003) revealed that earnings quality has developed considerable evidence that there are cross-sectional differences across economies. Accordingly, it is assumed that earnings quality is homogeneous across sectors in an economy. However, these studies indicate that the earnings quality in the banking sector in Nigeria is different from other sectors and countries.

IV. METHODOLOGY

This is an empirical study that adopts quantitative method. Descriptive statistical tools such as percentages, mean, and standard deviation were used for the computation of variables and measures. Regression analysis was used to evaluate the formulated hypotheses, while Pearson Moment correlation efficient analysis was conducted to make inference necessary for reaching valid conclusion for the study.

Population/Sample Size

The study population and sample size consists of all listed banks in Nigeria Stock Exchange available for the five year period – 2010 – 2014 that does business in Rivers State. We focused on the five year window – 2010 – 2014, which represents the period of mandatory application of the corporate governance code for all listed banks in Nigeria. This period represents the years in which corporate governance practices were subjected to increased scrutiny from regulators, the media and investors.

Rivers State has one of the largest cities in Nigeria after Lagos State.

Model Specification

The following models were stated to guide the test of hypotheses;

$AQ = \beta_0 + \beta_1 BS + \beta_2 ID + \square_t$ …………………………….(1)

$VR = \beta_0 + \beta_1 ACI + \varepsilon_t$ ……………………………………(2)
Where:
AQ = Accrual Quality
BS = Board Size
ID = Independent Directors
VR = Value Relevance
ACI = Audit Committee Independence
ε = Error term
t = Time period
β_0 = Constant
β_1 - β_2 = Coefficient of independent variables

Findings
The result revealed that accrual quality, board size, audit committee independence and directors' independence indicated mean of .0397, 14.20, .507 and 1.80 respectively and standard deviation of .27052, 2.020, .0251 and .658 respectively.

Correlations

	AQ	**BS**	**ACI**	**ID**
AQ	1.000	-.304	.044	.581
BS	-.304	1.000	.240	-.224
Pearson Correlation ACI	.044	.240	1.000	.082
ID	.581	-.224	.082	1.000
AQ	.	.004	.354	.000
BS	.004	.	.019	.027
Sig. (1 – tailed) ACI	.354	.019	.	.243
ID	.000	.027	.243	.
AQ	75	75	75	75
BS	75	75	75	75
N ACI	75	75	75	75
ID	75	75	75	75

The result of multiple regression analysis showed a relationship between corporate governance and earnings quality. R^2 indicated that 37% of the variation in the criterion variable of earnings quality using accrual quality as proxy is explained in the variation of the predictor variables of board size, audit committee independence and directors' independence. The adjusted R^2 is 0.345, F-statistics, showing the validity of the model was 14.008 with a significant probability (P-statistic) value of 0.000.

V. CONCLUSION

The foregoing results indicate positive relationship between earnings quality and corporate governance of listed banks doing business in Rivers State. Also, board size, independence of the directors and accrual quality are positively correlated. However, the result did not show any relationship between independent audit committee and accrual quality. Based on the findings It is concluded that corporate governance is important for banks' earnings quality and improved performance.

VI. LIMITATION AND RECOMMENDATION

This study has limitations, in particular, because of its research method. The correlated data do not allow causal interpretation of the results. In addition, despite the benefits of convenience sampling technique, this work is limited in scope.
Therefore, it is recommended that further study should be conducted to address the limitations of scope, methodology, causality and other aspect of corporate governance.

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