Corporate Governance and Financial Reporting Quality in Nigeria: Evidence from Pre- and Post-Code 2011

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Abstract- Corporate failure has been the issue of discussion in the business environment for a long time Corporate laws, policies and guidelines have been introduced several times to complement or abolish another in some cases. In the case of Nigeria, SEC corporate governance code was introduced in 2003 and replaced with another in 2011. This study aims at finding out the effect of corporate governance code 2011in the pre- (2009-2010) and post- (2012-2013) periods based on 20 of listed Nigerian consumer goods industry as sample. The study concludes that corporate governance mechanism encouraged earnings management in the pre- period while significantly reduced earnings management in the post- period. The study recommends periodic review of corporate governance code for more efficiency of the code.

Keywords: Corporate governance, board diversity, earnings management, pre- and post- code 2011, Nigeria

I. INTRODUCTION

Regulating business environment in Nigeria has a long history. Nigeria has inherited many rules and regulations left behind by the colonial government, such as British Company Legislation 1922 and Company Ordinance of 1922. At the post-independence, there is Companies Act 1968 (Okike, 2007). Subsequently, the following laws were put in place: Indigenization Policy of 1972, Privatization and Commercialization Act 1980, Insurance Act (IA), National Insurance Commission Act of 1977, Bank and Other Financial Institutions Act (BOFIA) Company and Allied Matters Act 1990 (CAMA 90), Investments and Securities Act (ISA),Central Bank of Nigeria (CBN) Act, Nigerian Stock Exchange 1960. Similarly, several general and specific corporate governance codes were introduced in Nigeria to tackle the problems in business environments such as company bankruptcy which mostly resulted from influencing earnings. The first corporate governance code is the Securities and Exchange Commission (SEC) Code 2003, and the others are Central Bank of Nigeria Code 2006, Pension Commission (PENCOM) Code 2008, National Insurance Commission (NAICOM) Code 2008, Securities and Exchange Commission (SEC) Code 2011 and financial reporting council of Nigerian FRCN Code 2013. Although SEC Code (2011) and 2003 are for listed firms while Financial Reporting Council of Nigeria Code (FRCN Code, 2013) is general for the listed and non-listed firm in Nigeria. Managers use earnings management to increase or decreasethe volume of reported earnings for example, managers use different earnings management method in order to meet the target to avoid reporting losses annually (Cohen & Zarowin, 2010). Usually, this kind of earnings management lasts for a short time, subsequent period will go down which cause negative effect to the owners of businesses. Among the negative effects are the bankruptcy, capital shortage and fraud of the corporations, for example, the case of Lever Brothers plc, and Cadbury Nigerian plc(Ajibolade, 2008). In 2009, CBN revealed that most of the banks were about to collapse (Afribank, Finbank, Intercontinental Bank, Oceanic Bank, Union Bank, namely BankPHB, Equitorial Trust Bank, Spring Bank and Wema Bank) because they failed audit test and CBN had veiled them(Njanike, Dube, & Mashayanye, 2009).

The introduction of governance mechanisms (Code, 2003) in Nigeria is expected to mitigate corporate scandals and other associated problems. However, corporate failures and scandals are increasing. For example the cases of Wema Bank plc and Spring Bank plc in Nigeria (the case of mismanagement of capital) suffered from the poor corporate governance practice (Demaki, 2011). A committee was inaugurated to review the CG code 2003 for further improvement. After the review, some new issues were raised; for example, differentiating between independent director and executive director, training of directors, evaluations of the board performance by an independent outside consultant, separation of functions of chairperson of the board and chief executive officer, and etc. Furthermore, the new amendments fixed in the new code (2011) to improve the quality of reported earnings. Due to the short-comings and inconsistencies of the Code 2011, for example, CG code 2011 did not considerunquoted and private firm etc. Another similar codewas launched in 2013 by the Financial Reporting Council of Nigeria (FRCN) which harmonized all corporate governance code in Nigeria. This new code is applicable to all firms whether quoted or unquoted, private or public. The corporate governance code of FRCN 2013 is introduced to strengthening earnings quality of financial reporting and previous' CG codes shortcomings. Corporate governance and earnings managements have been widely discussed in literature(Dechow, Ge, & Schrand, 2010; Dechow & Dichev, 2002; Dechow, Sloan, & Sweeney, 1995; Klein, 2002).Board of directors as a mechanism of corporate governance is set to oversee the manager's activities of the firm. Board of directors' control increase transparency and reduce earnings management behavior of managers (Hunton, Libby, & Mazza, 2006). The revised code 2011 shows the regulators' intention to shape up the role of the audit committee by providing independent audit committee. Ownership structure is also believed to increase

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transparency and reduce conflict of interest to the minimum level. This study tends to measure the effectiveness of corporate governance Code 2011 in relation to minimization of earnings management by comparing the pre- and post- period of the code. The sections of the study include literature review, method of conducting the study, presentation and discussion of the result, and conclusion and recommendations.

II. LITERATURE REVIWEW

2.1 Earnings Management

Earnings management is considered as adjustments of financial transactions to suit the interest of mangers and to mislead investors(Healy & Wahlen, 1999). Firms use opportunistic behaviors by involving in manipulation of earnings to meet investors expectations(Rahman & Ali, 2006) and subsequently have negative effects to the investors capital. This study consider some corporate governance factors that will reduce the opportunistic behaviours.

2.2 Board of Directors

Board functions can be seen as a dynamic process which involves a strategy that leads to policy making and planning, monitoring and supervising executive performance, providing accountability which forms the basis for reviewing strategy (Tricker, 2012).According to the SEC Code (2011)the main function of the board is to set company's goals and ensure that set objectives are achieved, i.e. to make sure that human and financial resources are properly utilized toward achieving the overall strategic goals of the firm effectively. The structure and composition of the board of directors should have diversity of directors. The number of the directors in the board should not be less than five directors and the majority should be non-executive with at least one independent director. Some of the board characteristics considered are boards size and boards independence.

2.2.1Board Size and Earnings Management

The relationship between board size and earnings management is guided by the agency theory. Some studies like Monks and Minow (2004)established the relationship between board size and earnings management. They disclosed that larger board committed more time and resources to monitor management activities in the corporations. Yu (2008) submitted that small size of the board cannot detect earnings management. Rahman and Ali (2006) revealed that board size increases earnings management. It is hypothesized that: H_1: *Board size has a significant negative relationship with discretionary accruals in the pre- and post- code 2011.*

2.2.2 Board Indepedence and Earnings Management

Board independence means majority of the board of directors are non-executive. SEC Code (2011) states that board must comprise executive and non-executive directors. For any board to be independent, majority of the directors must be non-executive or independent directors. One of the most important factors influencing the integrity of the financial accounting process involves board of directors whose responsibility is to provide independent oversight of management performance and to hold management accountable to shareholders for their actions (DeFond & Jiambalvo, 1994; Dichev & Skinner, 2002). Peasnell, Pope and Young (2005) and Marra, Mazzola and Prencipe (2011)find that board independence provides an essential tool to reduce the magnitude of earnings management. Osma and Noguer (2007) find a positive relationship between board independence and lower earnings management. Jaggi *et al.* (2009)find that independent boards provide effective monitoring of earnings management. Fodio *et al.* (2013)find that board independence has a negative association with discretionary accruals. In contrary, findings by Abdullah and Nasir (2004), Rahman and Ali (2006), Saleh and Iskandar (2005) find that board independence has no impact on constraining earnings management. It is hypothesized that:

H_2: *Board independence has a significant negative relationship with discretionary accruals in the pre- and post- code 2011.*

2.3 Audit Committee

Audit committee is a committee with members selected by the shareholders to verify director's reports (Tricker, 2012). According to the SEC Code (2011), every public compay is mandated under section 359(3) and (4) of the CAMA'90 to form an audit committee. It is the duty of the board of directors to ensure that audit committee is formulated and discharge its responsibility effectively. The audit committee charcteristics considered by this study are audit committee independence and audit committee size.

2.3.1 Audit Committee Independence and Earnings Management

After the events of the financial scandals of giant companies (such as Enron, WorldCom, and Xerox), investors require firms to provide truthful and reliable financial information (Fodio *et al.*, 2013). For the audit committee to be fully independent and effective, the majority of the members must be non-executive directors (SEC Code, 2011). Carcello and Neal (2000)find a positive relationship between audit committee independence and the quality of financial reports. Abbott, Parker, Peters and Raghunandan (2003) and Klein (2002) find that audit committee independence has a negative relationship with misstatement and earnings management. Bryan *et al.* (2004)posit that an efficient audit committee enhances the credibility of reported earnings. Osma and Noguer (2007) find that audit committees with greater independence are associated with lower earnings management levels. However, Fodio *et al.* (2013)reveals that audit committee independence has a positive relationship with discretionary accruals. Based on the agency theory it is hypothesized that: H_3: *Audit committee independence has a significant negative relationship with discretionary accruals in the pre- and post- code 2011.*

2.3.2 Audit Committee Size and Earnings Management

SEC Code (2011) provides no fixed number of the audit committee members and the audit committee size should be based on the company size. Audit committee size is the number of directors in the audit committee. Ghosh, Marra and Moon (2010)find that audit committee size influencing

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discretionary accruals at the pre- period. Fodio *et al.* (2013) report that audit committee size is significant and negatively associated with discretionary accruals. Vafeas (2005) reports that audit committee performance are determined by committee size. Xie *et al.* (2003) reveal an insignificant relationship between audit committee size and discretionary accruals. Musa, Oloruntoba and Oba (2014) find that audit committee size has no significant impact on the quality of financial reporting. It is hypothesized that: H_4: *Audit committee size has a significant negative relationship with discretionary accruals in the pre- and post- code 2011.*

2.4 Ownership Structure

Ownership structure is expected to have vital relatioship with earnings management in corporations. Most of the companies in developing and developed countries are owned by the a group of ownership (e.g. istitutional owners, family owners and managerial owners) (Siregar & Utama, 2008). Ownership of a groups are expected to limit earnings management for example, institutional owners find to constrain earnings management (Koh, 2003; Mitra & Rodrigue, 2002).

2.4.1 Directors Ownership and Earnings Management

Agency theory highlights that executive directors' stock ownership might reduce the level of conflict of the goals between the management and the shareholders (Jensen & Meckling, 1976). For aligning the interest, owners of the firm should make sure managers undertake risk-bearing strategies that will enhance stock value of the firm (Hutchinson, Percy, & Erkurtoglu, 2008). Hunton and Rose (2012) find that board increases transparency that can reduce directors' incentives to act in their own self-interests. The finding of the study suggests that the directors' alliance with management will decrease due to the directors' interest to protect their investments. Rose *et al.* (2013)find that directors who own stock were less likely to agree with management's aggressive reporting.Bolton (2014) finds that firms with the highest levels of directors in audit committee stocks' ownership have higher operating performance than firms with smaller level of ownership. It is hypothesized that: H_5: *Directors' shareholdings have a significant negative relationship with discretionary accruals in the pre- and post- code 2011.*

2.4.2 Institutional Ownership and Earnings Management

Institutional investors always try to protect their investment by not allowing managers to report unrealistic earnings; for instance, Charitou, Lambertides and Trigeorgis (2007) indicated that the management of distressed firms with lower (higher) institutional ownership have greater (lesser) tendency to manage earnings down wards. Bushee (2001)reported that institutional non-block-holders are more interested in short-run earnings. Koh (2003) find that the relationship between instructional ownership and aggressive earnings management was positive at lower level of institutional ownership and negative at higher level of institutional ownership. Hsu and Koh (2005) suggested that the transient and long-term institutional investors co-exist and have differential effects on earnings management. Siregar and Utama (2008)found that institutional ownership does not significantly encourage managers to improve earnings. It is hy pothesized that: H_6: *Institutional investors have a significant negative relationship with discretionary accruals in the pre- and post- code 2011.*

III. RESEARCH METHODS

The study uses 27 consumer goods listed firms in Nigerian Stock Exchange as the population of the study. A sample of 20 firms with available datawithin the two periods,- Pre-period (2009-2010) and Post- period (2012-2013), was used for the study.

3.1 Earnings Management Measurement

This study used modified Jones Model 1995 to measure earnings management as it is the most powerful model to detect earnings management (Dechow *et al.*,1995). The model is as follows: $DA_{it} = TA_{it-1} - [\alpha_1 (1/TA_{it-1} + \alpha_2 (\Delta REV_{it} - \Delta REC_{it}) / TA_{it-1} + \alpha_3 (PPT_{it-1})]$. Where: Total accruals (TA) is measured by net income before extraordinary items minus cash flows from operation.

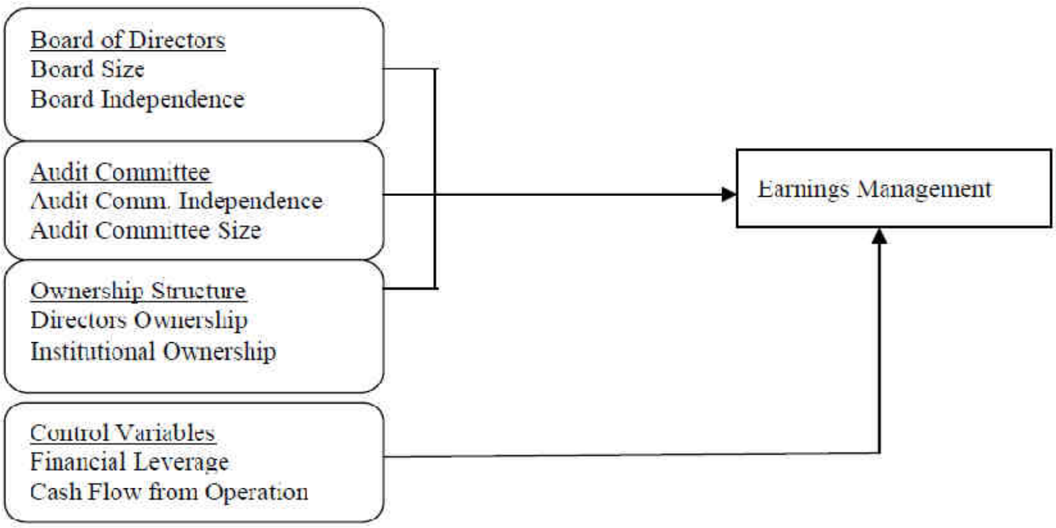

Figure1. Research Framework

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3.2 Model specification

Model specification of the study is shown below:

$DA_{it} = \alpha + \beta_1 BO_{it} + \beta_2 BOID_{it} + \beta_3 ACIN_{it} + \beta_4 ACS_{it} + \beta_5 DH_{it} + \beta_6 IO_{it} + \beta_7 FL_{it} + \beta_8 CFO_{it} + \varepsilon_{it}$

Descritionary accruals (DA) is the dependent variable, while board size (BO), board indpendence (BOID), audit committee indpendence (ACIN), audit committee size (ACS), directors shareholding (DH) and institutional ownership (IO) serve as independent variables. Financial leverage (FL) and cash flow from operation serve as control variables. The definations and measuments of the variables of the model are outline in table 1 as follows:

Table. VariablesMeasurements

Variables	Definition	Measurements	Expected Sign
DA	Discretionary Accruals	Modified Jones 1995	
BO	Board Size	Number of Directors in Board	-
BOID	Board Independence	Ration of Non-executive in Board	-
ACIN	Audit Committee. Independence	Ration of Non-executive in Audit Committee	-
ACS	Audit Committee Size	Number of Directors in Audit Committee	-
DH	Directors Shareholding	Ratio of Directors Shares	-
IO	Institutional Ownership	Ratio of Institutional Shares	-
FL	Financial Leverage	Total Debt to Total Asset	+
CFO	Cash Flow from Operation	Cash Flow from Operation	+

IV. RESULTS AND DISCUSSIONS

This study centered on the impact of some corporate governance mechanisms on earnings management in the pre- and post- code 2011 period. The pearson correlation matrix for panel A and panel B are presented in Tables 3 and 4. The result shows that there is no high correlation between the variables. Subsequently, test of multicollinearity is carried out which indicated that the mean of VIF is 1.66 and 1.32 forpanels A and B respectively comfirming the absence of multicollinearity. Levene's test shows that the variance is homoscedasticity. Descriptive statistics as presented in Table 5 reveals that the average earnings management (EM) is 0.000 and 0.100 for the pre- and post- code 2011 period respectively. The EM ranges from -1.812 to 1.750 for the pre- period and ranges from -0.992 to 0.855 for the post- period. Board size in the pre- period has the average of 10 directors with the mininum of 5 and maximum of 13 directors while in the post- period board size has the average of 10 directors with minimum of 5 and the maximum of 14 directors. Board independence have the ratio ranges between 0.417 to 0.923 with the average of 0.730 of non-executive directors in the pre- period while in the post- period the ratio ranges between 0.500 to 0.929 with the avearage of 0.714. The ratio of audit committee independence have ranges from 0.333 to 0.500 with the the average 0.426 of non-executive directors in the pre- period while in the post- period the ratio of non-executive directors ranges from 0.333 to 0.750 with the average of 0.438. Audit committee size ranges from 4 to 6 directors for both periods with averages of 5.850 and 5.200 for pre- and post- periods respectively. Directors' ownnership ranges from 0.001 to 0.464 with the average of 0.060 in the pre- period while in the post- period it ranges from 0.000 to 0.311 with the average of 0.057. Institutional ownership ranges from 0.000 to 1.000 for both periods with the average of 0.520 and 0.558 for pre- and post- periods respectively. Financial leverage ranges from 0.936 to 1.248 with the average of 0.985 in the pre- period while in the post- period it ranges from 0.941 to 1.271 with the average of 0.986. Cash flow ratio ranges from 0.418 to 0.979 with the average of 0.839 in the pre- period while in post- period ranges from 0.485 to 0.954 with the average 0.815. The skewness of the study variables data ranges between -0.803 to 1.338 in the pre- period and -0.595 to 1.788 in the post- period which show that the data is normally distributed.

Table 3 Panel A: Pearson correlation matrix for pre- code 2011 data

	DA	BO	BOID	ACIN	ACS	DH	IO	FL	CFO
DA	1.000								
BO	0.014	1.000							
BOID	0.156	-.348*	1.000						
ACIN	0.073	0.068	.419**	1.000					
ACS	0.181	.507**	-0.176	-0.027	1.000				
DH	-.586**	0.054	-0.118	-0.049	0.121	1.000			
IO	-0.150	0.115	0.115	0.254	-.080	0.138	1.000		
FL	0.228	-0.112	0.195	-0.183	-.021	-.044	-0.222	1.000	
CFO	0.202	-0.001	0.009	0.218	0.145	-.124	0.257	-.665**	1.000

*. Correlation is significant at the 0.01 level (1-tailed), **. Correlation is significant at the 0.05 level (1-tailed).

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Table 4 Panel B: Pearson correlation matrix for post- code 2011 data

	DA	BO	BOID	ACIN	ACS	DH	IO	FL	CFO
DA	*1.000*								
BO	-0.148	1.000							
BOID	-.272*	-.209	1.000						
ACIN	0.258	-.121	.328*	1.000					
ACS	-.320*	0.167	-.401**	-.314*	1.000				
DH	-0.246	0.152	-0.183	-0.065	0.257	1.000			
IO	-0.017	0.017	0.103	0.071	0.039	-0.101	1.000		
FL	0.254	0.140	0.112	-0.215	-0.085	0.066	-.339*	1.000	
CFO	0.192	-.060	0.001	-0.084	-0.059	0.016	0.006	-0.069	1.000

*. Correlation is significant at the 0.01 level (1-tailed), **. Correlation is significant at the 0.05 level (1-tailed).

Table 5 Descriptive Statistics

	Mean		SD		Minimum		Maximum		Skewness	
Variables	pre	post	pre	post	pre	post	pre	post	pre	post
DA	0.000	0.100	0.961	0.483	-1.812	-0.992	1.750	0.855	-0.315	-0.293
BO	9.880	9.750	2.015	2.169	5.000	5.000	13.000	14.000	-0.355	-0.073
BOID	0.730	0.714	0.163	0.137	0.417	0.500	0.923	0.929	-0.803	-0.200
ACIN	0.426	0.438	0.081	0.110	0.333	0.333	0.500	0.750	-0.212	0.933
ACS	5.850	5.200	0.533	0.992	4.000	4.000	6.000	6.000	-1.354	-0.424
DH	0.060	0.057	0.113	0.094	0.001	0.000	0.464	0.311	1.308	1.762
IO	0.520	0.558	0.239	0.227	0.000	0.000	1.000	1.000	-0.242	-0.595
FL	0.985	0.986	0.059	0.065	0.936	0.941	1.248	1.271	1.338	1.785
CFO	0.839	0.815	0.107	0.113	0.418	0.485	0.979	0.954	-1.796	-1.302

The study used residuals of the modified Jones model for detecting earnings management.The relationship between corporate governance and earnings management as presented in Table 6 shows that the model fitness (R^2) is 44 percent (44%) and the F-statistics is 3.070 which is significant at 5 percent in the pre- period. While the model fitness (R^2) is 56 percent and the F-statistics is 4.950 which is significant at 1 percent in the post- period.

Table 6 Multiple Regression Result

	Pre- code 2011				Post- code 2011			
Variables	Coeff.	t-value	Sig	VIF	Coeff.	t-value	Sig	VIF
BO	0.011	0.150	0.440	1.760	0.054	1.720	0.048*	1.080
BOID	0.098	0.110	0.457	1.650	-0.113	-0.320	0.375	1.680
ACIN	0.704	0.410	0.342	1.450	1.685	2.440	0.011*	1.370
ACS	0.309	1.140	0.132	1.600	-0.045	-0.590	0.280	1.340
DH	-4.356	-4.020	0.000**	1.140	-1.598	-2.160	0.019*	1.150
IO	-0.371	-0.690	0.247	1.260	-0.343	-2.280	0.015*	1.150
FL	8.201	2.890	0.004**	2.160	2.469	1.940	0.031*	1.650
CFO	4.132	2.580	0.008**	2.250	1.306	2.160	0.019*	1.100
R2			0.442				0.561	
Adj R2			0.298				0.447	
F value			3.070				4.950	
Sig			0.012				0.001	

**, *. Regression is significant at the 0.01, 0.05 percent levels respectively (1-tailed).

The data in Table 6 also indicates that all the variales are not significant at the pre- period except for directors shareholdings (DH) which is signifiantly reducing earnings management at 1 percent level, and control variables which have positive and significance level at 1 percent. The variables including control variables (BO, BOIN, ACIN, ACS, FL and CFO) show positive coefficient indicating that any increase in unit of BO, BOIN, ACS, FL and CFO will increase earnings management with 0.011, 0.098, 0.704, 0.309 8.201 and 4.132 respectively, but IO has negative relationship with earnings management but not significancantly related. For the post- period, almost allvariables including control variables (BO, ACIN, DH, IO, FL and CFO) are sigficant at 5 percent level except for variables BOIN and ACS. The variables BO, ACIN, DH

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and IO have nagative coefficients of -0.054, -1.685, -1.598 and -1.343 respectively indicating that any unit increase in BO, ACIN, DH and IO will reduce eanings management with -0.054, -1.685, -1.598 and -1.343 units respectively. FL and CFO have positive and signifiant relationship with earnings management. This evidence shows that corpiorate governance reforms in 2011 has positive impact by reducing the level of earnings management in Nigerian consumer goods industry.

V. CONCLUSION AND RECOMMENDATIONS

The study set to examine the effect of corporate goverance reform of 2011 on reducing earnings management in the consumer goods industry. The study showsthat some corporate governance mechanisms has play significant role in reducing earnings management in Nigeria after the reforms, which provides justification that the reform has contributed a lot in strengthtening the corporate governance variables to meet up the expectation; unlike prior to the reforms, the results indicated that all the variables have positive relationship with earnings except directors shareholding which shows that instead of reducing earnings management, they end up increasing earnings management.However, after the 2011 reform, there was a switch to the expectation. It is recommended that periodical review of the code of corporate governance should be carried out in order to ensure full control of financial reporting quality. The study has some limitation: limited to sample of 20 firms withsome misssing data and the period of study which only covers two years in each period. Further studies may consider other variables apart from the variables used by this study to test the reform effect.

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