Board Dynamics and Financial Reporting Quality in Nigeria

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Abstract

The code of corporate Governance code (2011) in Nigeria was ushered with a target to enhance the monitoring function of board of directors and audit committees. This study investigates the ability of certain board dynamics to influence management attitude in relation to reporting quality in Nigerian listed firms. Accruals, a proxy for financial reporting quality is estimated using the Dechow and Dichev model. Using a panel data obtained from annual reports of 69 listed Nigerian firms from 2008 to 2012, the study documents that board independence, board tenure, gender diversity and directors' shareholding are significant predictors of financial reporting credibility in Nigeria. The board size was found to have a neutral effect on financial reporting quality. This study extends existing literature by contributing to knowledge on how board traits influence financial reporting quality in emerging economies such as Nigeria.

Keywords: *Financial Reporting Quality, Board of Directors, Earnings Management, Corporate Governance*.

JEL classification: M4, G3.

1. Introduction

Fluctuating economic climate, accounting scandals and eventually the collapse of several corporate giants such as Enron, WorldCom and Maxwell which were believed to be the pacesetters in business performance have propelled the need for good corporate governance both in developed and developing countries. This has also led to international movement towards adopting corporate governance dynamics to address opportunistic dispositions that have undermined investors' reliability in financial information. The collapses of some of these corporate giants were as a result of failures in financial reporting due to fraudulent practices by the board of directors and weak governance mechanisms in place.

The duty of monitoring the quality of the information in the financial reports of corporate firms is delegated to the board. Several studies have shown that sound governance by board of directors reduces the adverse effects of earnings management as well as the likelihood of creative financial reporting arising from fraud or errors. (Beasley, 1996; McMullen & Raghunandan, 1996).

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The integrity of financial reporting and how this links to board dynamics has been a consistent and serious concern among investors, regulators, market participants and the academic community, most especially after high-profile accounting scandals of some big firms. The collapse shook investors' faith in the capital markets and the efficacy of existing board structures in promoting transparency and stewardship. It continues to receive attention due to recent corporate failures that has brought about doubts in the minds of stakeholders on the credibility of financial reports being prepared by board of directors. The quality of financial reporting expectedly promotes accountability and transparency through comprehensive disclosures. This is due to the fact that financial reporting has been a principal means of communicating financial information to outside users (Zhou & Chen, 2004; Kajola, 2008).

Previous studies have examined some specific boards' characteristics that could enhance better financial reporting quality. But this is a unique study in the sense that a variety of boards' characteristics are being examined on different sectors of the economy in order to ascertain their overall effect on financial reporting quality. Moreover this study envelopes firms representative of all sectors of the Nigerian Stock Exchange since earnings management practices and creative financial reporting are not attributed to a few firms; rather it is a widespread phenomenon in Nigeria.

Most importantly, unlike most prior studies, this study uses an extensive dataset of boards' information from five consecutive years for the tests rather than a single year with a view to obtaining a trend.

2. Theoretical Issues

Agency theory provides a natural background of the study analysis because financial reporting concerns arise when there is a conflict of interests between managers and owners (shareholders) coupled with information asymmetries. Without this agency problem, financial reporting credibility is a non-issue since managers do not have any incentive to hide information. The purpose of boards' structure in its various dimensions is to reduce this agency problem thus initiating a natural link between boards' characteristics and financial reporting. Thus according to Hassan (2011), an effective board should result in high financial reporting quality. Weak board structures may provide an opportunity for managers to engage in behavior that would eventually result in a creative financial reporting through earnings manipulation. This opportunistic behavior of managers is better explained by the agency theory. Going by existing separation between ownership and control in a firm, managers may act to maximize their own wealth at the expense of shareholders' wealth (Jensen & Meckling, 1976).

The board of directors is an agent of the shareholders in ensuring transparent financial reporting that reflects the true and fair view of the financial position of companies. In other words, board structure is an internal governance mechanism put in place by the firm to counter managerial opportunistic behaviors as such serving as an effective tool in meeting the aspirations and needs of the stakeholders.

2.1 Prior Research and Hypotheses Development

Corporate finance literature has pointed out four major characteristics of board of directors. These include board composition, board size, directors' shareholdings and directors' tenure. The extent to which these characteristics affect earnings manipulation and creative accounting is still under debate. Agency theory suggests that the board should be dominated by outside directors in order to increase the board's independence from management. Moradi et al. (2012) demonstrate that independent directors in the board and their supervisory performance as independent individuals are seen to reduce divergence of interests between shareholders and managers.

Several studies have reported a positive link between higher proportion of independent non-executive directors sitting on the board and financial reporting quality (Peasnell, Pope & Young, 2000; Davidson, Godwin & Kent, 2005). As these independent directors do not play a role in the management of the company, their existence possibly provides a potent monitoring tool to the board and thus produces higher quality financial reports (Peasnell, Pope & Young, 2000). Jaggi, Leung & Gul (2007) in their research find significant negative relation between earnings management and a higher proportion of outside directors in Taiwan and Hong Kong. Findings from these studies suggest that the inclusion of larger proportion of outside members on the board of directors provides improved oversight of management to mitigate earnings management activity. Gulzar & Wang (2011) however did not find empirical evidence on the association between earnings management and board independence.

Based on the above arguments, the following hypothesis is proposed:

H_{1} – There is no significant relationship between financial reporting quality and board independence.

Is the size of the board of directors associated with the quality of financial reporting? From the perspective of agency theory, it can be argued that a larger board has a greater likelihood to tackle agency problems simply because a greater number of people will be assessing and monitoring management decisions (Bugshan, 2005). Monks and Minnow (1995) show convincing proofs that larger boards are able to commit more time and effort while smaller boards commit less time and effort in overseeing management. Klein (2002) lends support to this argument by suggesting that board monitoring is positively associated with larger boards due to their ability to share the work load over a greater number of observers. Existing corporate finance supports this argument by documenting that larger boards are strongly associated with lower levels of earnings management (Yu, 2008). Yu (2008) in his study found that small boards are more likely to fail in detecting earnings management. The likely implication of this effect is that smaller boards may be more likely to be dominated by management or institutional investors.

Gulzar & Wang (2011) find a positive relationship between the size of the board and earnings management. Contrarily, Moradi et al., (2012 find no significant relationship between size of the board and earnings management. This study however hypothesizes that:

H_2- Board size does not significantly impact financial reporting quality

The tenure directors serve on the board will provide an opportunity for them to obtain corporate experience and ability to control the company's activities. This translates to procedural knowledge which helps them in performing their oversight functions and which is the most essential part of corporate governance that ensures accountability (Eko & Nugroho, 2011). In a nutshell, directors' tenure impacts on board experience and expertise and consequently will help in monitoring the financial reporting process. Canavan, Jones & Potter (2004) find a positive relationship between financial reporting quality and board tenure. However, there is the likelihood that over time, directors with longer tenure are more likely to be unequally yoked with managers and thus become compromised monitors thereby losing some of their independence if they stay on the board too long. Xie, Davidson & Dadalt (2003) find a positive association between directors' tenure and level of earnings management.

Although it is argued that a reasonable period on the board can give directors a profound grasp of the company's business, it is however important to reinforce the board by continually injecting new energy and ideas. Based on these premises, this study hypothesizes that:

H_3 – There is no significant impact of board tenure on financial reporting quality

The agency theory suggests that the level of ownership can have a positive effect on the incentives of directors in monitoring the financial reporting ecosystem (Kuang, 2007). Short & Keasey (1999) document that those directors that have financial interest in the firm will be motivated to expend more time and effort to ensure the integrity and reliability of the financial reports. Sharma & Iselin (2006) report a positive association between directors' shareholding and quality of financial reporting. This suggests that when directors have an equity stake in the firm, there is a greater tendency for them to be concerned about the governance of the firm. As such, they would without hesitation challenge management for poor financial reporting and also encourage better disclosure in the firm's financial reports.

However, a contrary view argues that director shareholding can lead to conflicts of interest which could likely threaten directors' effectiveness in monitoring the financial reporting process (Mangena & Pike, 2005). In this vein, directors could support or even collude with management to manipulate financial reports just to protect their own interests (Sharma & Iselin, 2006). Carcello & Neal

(2003) in their study corroborate this position. They find that directors' shareholdings are negatively related with financial reporting quality. This study however proposes a hypothesis that:

H_4 – Directors' shareholdings has no significant effect on the quality of financial reports

Gender diversity has been a growing area of corporate governance research in recent years. The concept of gender diversity implies that the board of directors should be reflective of societal structure and show gender backgrounds. Mason & Mudrack (1996) demonstrate that men, longing for earnings and cherishing career success are more likely to violate the law to reach competitive success than women are while women are less likely to transgress business ethics. This study hypothesizes that:

H_5 – Gender diversity has no significant impact on financial reporting quality

3. Methodology

3.1 Population and Sample

The population of this study is made up of all quoted firms on the floor of the Nigerian Stock Exchange from year 2008 to 2012. This period is considered important due to the fact that this period under review witnessed a lot of outcry for effective board dynamics and sound financial reporting framework. As at 2012, 219 companies were listed on the exchange. The Yaro Yamane formula was used to determine the sample size as follows:

$$n = N/1 + N\,(e)^{2} \qquad (1)$$

Where n = the sample size

N = Population

E = level of precision (error limit) (for this study, 0.10 on the basis of 90% confidence level).

$n = 219/\ 1 + 219\ (0.10)^{2} = 68.65$

Thus a total of 69 firms were randomly selected from all the existing sectors of the stock exchange.

3.2 Model Specification / Measurement of Variables

This study utilizes the Dechow & Dichev (2002) model for estimating accruals. The measure is based on the idea that accruals are estimates of future cash flows, and that earnings will be more representative of future cash flows when there is lower estimation error embedded in the accrual process (Mc Nichols, 2002). The model is a regression of working capital accruals on lagged, current and future cash flows plus the change in revenue, and property, plant and equipment (PPE). It is stated as follows:

$$Accruals_{it} = b_0 + b_1\ cashflow_{it} + b_2\ cashflow_{it+1} + b_3\ \Delta Revenue_{it} + b_4\ PPE_{it} + e_{it} \quad (2)$$

Where

Accruals = (ΔCA – Δcash) – (ΔCL - ΔSTD) – Dep (3)
ΔCA = change in current assets
Δ cash = change in cash/ cash equivalents
Δ CL = change in current liabilities
Δ STD = change in short-term debt
Dep = depreciation and amortization expenses
Cash flow = net income before extraordinary items minus accruals
Δ Revenue = change in revenue
Δ PPE = gross property, plant and equipment

A cross sectional regression model to examine the association that exists between board dynamics and financial reporting quality by sample firms is as follows:

$$Accruals_{it}\ (FRQ) = b_0 + b_1\ BIND + b_2\ BSIZ + b_3\ BT + b_4\ DS + b_5 GD + e_{it} \quad (4)$$

Where accruals is the estimate of future cash flows proxied by a vector of major conditioning variables. Note that accruals are a proxy for financial reporting quality in this study.

BIND (board independence) represents the independence of the board
BSIZ (board size) is measured as the total number of directors on the board
BT (board tenure) is the period directors occupy on the board
DS (directors' shareholding) is measured as the percentage of shares owned by directors
GD (gender diversity) is measured as the proportion of female executives in the board

4. Results and Discussions

Table 1. Estimation of Accruals

Constant	**Cashflow**	**Cashflowit$_{+1}$**	**Gross earning**	**Property, plant and equipment**	**R_2**	**F stat**
5476.132	.769**	0.013*	.199**	.081*	.761	3472.15**
(1.787)	(-77.913)	(.615)	(1.947)	(-5.26)		

The t-values are in parenthesis
*, ** indicate 5% and 1% levels of significance respectively
Source: SPSS output

Table 2. Descriptive Statistics for Dependent and Independent Variables

STATISTIC	BIND	BSIZ	BT	DS (%)	GD
Mean	0.46	8.5	4.0	69.26	2.24
Median	0.5	9.0	4.0	76.30	2.01
Maximum	1	13.0	6.0	92.50	4
Minimum	0	6.0	2.0	4.70	0
Std. Dev.	0.137	1.12	1.05	18.67	0.82

Source: SPSS output

Table 3. Regression Results

Variable	Coefficient	t-statistic	Prob
(constant)	-5.25	-7.305	0.000
BIND	-3.71	-2.48	0.002
BSIZ	8.14	6.53	0.713
BT	3.63	2.84	0.015
DS	6.55	4.97	0.000
GD	1.65	5.85	0.024
Fstatistic R^2	430.65 0.769	Durbin Watson Prob (F statistic)	1.94 0.010

As reported in table 1, the coefficient of determination (R^2) is 0.761. This implies that about 76% of the changes in accruals are explained by the combined effect of the four independent variables: cash $flow_{it}$, $cashflowit_{+1}$, gross earnings and property, plant and equipment (PPE). This suggests that the model is well fitted and thus justifies the use of the equation in estimating the value of accruals in the model of the study. Descriptive statistics in table 2 shows the mean, median, and standard deviation, minimum and maximum values of the variables used in the study.

The maximum board size in the sample is 13 while the minimum is 6 members. 46% of the directors in the investigated sample firms are independent directors while 69% of the shares are held by directors.

Table 3 displays the regression results of the nexus between board dynamics and financial reporting quality. Results provide evidence for the rejection of the first null hypothesis which states that board independence has no significant effect on the quality of financial reporting. Findings reveal that board independence significantly and negatively impacts on discretionary accruals. In other words, the more the independent directors on the board, the better the quality of financial reports. This result lends support to the findings of Kao & Chen (2004) who in their study of the Taiwanese market documented a negative significant link between earnings management and a higher proportion of independent directors.

The results also show that board size has a neutral effect on the quality of financial reporting. This reaffirms the second hypothesis of this study that there is no significant relationship between financial reporting quality and board size. This finding contravenes assumptions of the agency theory that a larger board has a tendency to be more vigilant, commit more time and effort to reviews and decision making and thereby improving accountability. The finding also confirms the work of Moradi et al., (2012) who in their research find no significant relationship between the size of the board and earnings management.

Results on table 3 show that board tenure has a positive significant impact on discretionary accruals. As such, the longer the tenure of a board, the greater the potential for earnings manipulation. The coefficient is significant and its sign is positive contrary to expected results. This result is coherent with the results of Xie, Davidson & Dadalt (2003) who find a positive association between directors' tenure and level of earnings management. The result also leads to the rejection of the 3rd hypothesis and thus highlight the fact that the longer the tenure of the directors, the more likely they are to compromise with management.

For the variable DS (directors' shareholding), its coefficient is positive (contrary to the expected sign) and significant. This corroborates the arguments of Mangena & Pike (2005) that director shareholding can lead to conflicts of interest which could eventually threaten their effectiveness in monitoring the financial reporting process. As far as the variable GD (gender diversity) is concerned, our findings document positive significant impact on discretionary accruals. This study finds that the higher the proportion of women in a board, the more the earnings management. In other words, financial reporting quality is threatened with a higher number of female board executives.

This confirms the findings of Peni & Vahamaa (2010) that provide considerable evidence that female chief financial officers are associated with income-decreasing discretionary accruals, thereby suggesting that they follow more conservative earnings management strategies. This could probably be explained by their efforts to overturn prejudiced and popular perception of their socio-psychological weakness by trying to impress stakeholders with 'celebrated' bottom lines.

Conclusions

The major interest of this study is that it contributes to accounting literature to the extent to which board mechanisms interact with the quality of financial reporting. The corporate setting of Nigeria is of core interest because it is characterized by a poorly developed corporate governance system and low level of investor protection. Results of this study according to the test statistics highlight that board dynamics in aggregate affects the quality of financial reporting which of discretionary accruals is a proxy.

The paper demonstrates that the independence of a board as measured by the number of independent directors improves financial reporting quality while board tenure, director shareholding and gender diversity negatively impact on the credibility of financial reporting. This study has also shown convincing proof that the size of a board has no effect on the extent of earnings management.

This study has both theoretical and practical implications. From a practical point of view, the study offers novel insights to management in evaluating the efficacy of governance control systems in organizations and considers these findings while drafting a governance policy. It also offers important platforms for capital market regulators in developing more efficient guidelines in improving quality of reported information. Theoretically, the research documents a significant relationship between specific board dynamics and earnings management and by so doing contribute to existing literature. Future works in this direction could examine the extent to which other board characteristics like the CEO duality structure and other board demographic factors impact on financial reporting credibility while other proxies of the quality of financial reporting are also incorporated for empirical investigation.The paper conclusions will follow the numbered list which was began before, similar to the rest of the sections.

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