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## **MONITORING CHARACTERISTICS AND EARNINGS QUALITY OF LISTED BUILDING MATERIALS FIRMS IN NIGERIA**

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### **Abstract**

*The existing literature provides mix of results on the relationships between governance mechanisms and earnings quality. Hence, the nature of their relationships remains to be controversial. This paper is aimed at investigating the relationship between board characteristics and earnings quality of listed Building Materials Firms in Nigeria for the period of 2005 to 2012. The data*

was obtained from the sample of seven firms out of the population of 13 firms through their annual report and accounts. The independent variable Board characteristic was proxied by the board size, board composition, managerial shareholding and institutional shareholding, while the residuals from the modified Dechow and Dichev (2002) was used to proxy earnings quality. The study adopts multiple regression in analyzing the data with the aid of SPSS. The findings reveal that managerial shareholding have a negative significant impact on earnings quality, while the other independent variables were found to be not significantly impacting on the earnings quality of Nigerian Building Materials Firms. It is recommended that Nigerian Building Materials Firms should have more percentages of its shares to be owned by the management in order to improve their financial reporting quality.

**Keywords:** Board Size, Board Composition, Managerial Ownership, Institutional Ownership, and Listed Building Materials in Nigeria

## 1.1 Introduction

Corporate organizations are governed by the board of directors which is one of the legal requirements for incorporation. Boards play an important role as independent scrutinizers of management action, and as protectors of shareholders' wealth. Peasnell, Pope and Young (2005) emphasized the role played by independent boards in reducing agency problems arising from the divergent interests of the shareholders and the management of the company through monitoring of managerial behavior. Fama (1980) argued that independent directors had incentives to protect shareholders' wealth in order to protect the value of their reputational capital. Ebrahim (2007) and Peasnell *et al.* (2005) found that companies with a high proportion of non-executive directors on the board tend to have lower abnormal accruals.

Policy makers are of the view that board of directors can promote persistence in financial markets, encourage investment and also leads to economic growth (Shiri, *et al.* 2012). Another important tasks of corporate board is to ensure the quality of financial reporting which can reduce agency costs, filtering through limiting opportunistic behavior of management, which can lead to improve quality and reliability of financial reports and also increases the value of the firms. Reliability refers to the quality of information which assures that information is reasonably free from error and bias and faithfully reflects the true and fair view of the firms operations.

The quality of financial reporting is to promote transparency and deliver high quality financial statement through adequate disclosure (Hassan, 2013). The quality of financial information always is an issue of interest among the users. This is because; the financial reporting is a means of communicating financial information to both internal and external users. The use of financial reporting assist in determining the economic performance and condition of a firm in monitoring management's actions and assist making investment decision (Koh,2003). Investors, financial analysts and portfolio managers relayed on the firms reported earnings as an indicator of a firms future performance. Their main interest is to assess a firm's ability to generate future cash flows using reported financial information.

High quality accounting information earnings is a good indicator of current and future operating performance and is useful for assessing firm's value. The rules of financial reporting have managerial discretion attached to it. This discretion manifests itself with numerous opportunities to make critical estimates of variables that can affect reported earnings. These estimates made by management can bring both unintended and neutral errors as well as intended or strategic errors in the financial statements of firms. Managers have numerous incentives to meet and the discretion to manipulate earnings. This discretionary behavior can lead to observable and measurable systematic biases in reported earnings, ultimately deteriorating the earnings quality of firms.

Therefore, the study generally seeks to evaluate the relationship between board characteristics and earnings quality of listed building materials firms in Nigeria. It was also hypothesized that board characteristics proxy by board size, board composition, managerial shareholding and institutional shareholding has no significant impact on earnings quality of listed building material firms in Nigeria.

## **2.1 Literature Review and Theoretical Framework**

The board is accountable and responsible for the performance and affairs of the company. It is defined the company's strategic goals and ensure that its human and financial resources are effectively utilized towards achieving those goals. The primary objective of the board is to ensure that the company is properly managed. It is the responsibility of the board to oversee the effective performance of the management in order to protect and enhance shareholders value and to meet the company's obligations to its employees and other stakeholders (Nigerian SEC Code of Corporate Governance 2011). Ball and Brown (1968) are of the view that investors, creditors and other users of accounting information are interested in

reporting quality of earnings. Boards with a higher proportion of non-executive directors are more likely to report quality informative earnings (Redhwan & Ismail 2013).

Empirical evidence on the mechanisms that help to reduce the agency problem abstracting from board characteristics and earnings quality can be reviewed on the composition of board size, board composition, managerial shareholding and institutional shareholding.

### **Board Size and Earnings Quality**

The board should be of a sufficient size relative to the scale and complexity of the company's operations and be composed in such a way as to ensure diversity of experience without compromising independence, compatibility, integrity and availability of members to attend meetings and with membership, of at least 5 members (Nigerian SEC code of corporate governance 2011). A reasonable size of the board is expected to be effective in monitoring the activities of firms management (Sanda, Mikailu & Garba, 2008). A large size of board of directors can improve monitoring mechanism effectively and prevent managers to engage in earnings restatements (Feng & Shiao, 2009).

Larger boards with competent directors having diverse educational and technical knowhow, have multiple perspectives to improve the quality of firm's value and more likely to represent the interests of shareholders thereby preventing managers from earnings management. Jian and Ken (2004) found that active boards are associated with less earnings management and improved the quality of firms accounting information. Nugroho and Eko (2011) discovered that board size do not affect earnings management of firms listed in the Indonesian stock exchange. Firms with small board size have more quality accounting information (Vafeas, 2000) Earnings are of good quality if it can be used in predicting future earnings of a firm (Penman & Zhang, 2002). Jensen (1993) stated that streamlined boards can operate more effectively in maintaining management.

### **Board Composition and Earnings Quality**

This is the proportions of non-executive directors on the board to the total board size, non-executive directors should be the key members of the board. They should bring independent judgment as well as necessary scrutiny to the proposals and actions of the management and executive directors especially on issues of strategy, performance evaluation and key appointments (Nigerian SEC code of corporate governance 2011). The higher the proportion of non-executive directors

in the firms has more impact on earnings quality of listed Korean firms (Yun & Jung, 2008).

Maria and Francisco (2010) investigated the relationship between board of directors' characteristics and forward looking information disclosure strategies, their results shows that more independent boards of directors influence positively on the quality of accounting information. Independent directors knew that increasing quality of financial information would help to improve analyst's forecasts and hence, market transparency. To improve the earnings quality of a firm the proportion of independent directors need to increase in the board size (Mahdi & Azaden,2013).Earnings quality is the extent to which reported earnings faithfully represent the actual operating income of a firm( Schipper & Vincent, 2003).

#### **Managerial Shareholding and Earnings Quality**

Managerial shareholding represents the interest of managers in the firm's equity shareholding. Managers' equity holdings encourage them to operate in a way that maximizes the firms value (Hassan, 2013). Nugroho and Eko (2011) documented that the incentives for the management to act in line with the investors' interest is influenced by the level of firms' equity owned by the management. If the management of a firm owned some percentage of the firms' equity, they will not engage themselves in earnings management and any other type of manipulation of earnings. As a result of that the quality of firm accounting information can be improved. Beasley (1996) reveals that managerial ownership increases the quality of financial statement and decreases earnings manipulation. Moh'd *et al.* (2005) found that discretionary accruals is negatively related to managerial ownership. Dechow and Schrand (2004) viewed earnings quality as persistent and hence the best predictor of future long-run sustainable earnings.

#### **Institutional Shareholding and Earnings Quality**

This is the proportion of firm's share owned by the institutional investors. Institutional investors can act as a monitoring mechanism in assisting company in reducing earnings management, this can be done only when their ownership level is high (Malakian & Daryayi, 2011).They have the abilities to monitor and control the management of companies, they highly influence financial and operating policies of companies. They have greater access to information and also having the authority and power in decision makings, they can participate in monitoring the company's performance. Managers of firms with institutional investors must disclose more information in order to satisfy the interest of the owners (Mehrami,

Moradi & Eskandar, 2010). Institutional shareholders can influence the firms accounting and financial reporting practices (Koh, 2003).

Institutional shareholders as monitoring mechanism makes managers to less time to manage earnings and this increases the quality and reliability of their financial reporting (Heirany, Sadrabadi & Mehrjordi, 2013). Ramadan (2012) confirmed the monitoring role of the institutional shareholders alleviate the practices of earnings management which increase the quality of earnings. Investors are concerned with earnings quality and become more cautious in considering net earnings of a firm. Balhaj (2006) argued that earnings is considered as an important factor in the financial statement and is used as guidance for investment decision making.

### **Theoretical Framework**

Managers may have different motives to shareholders. Brennan (1995) view that managers can be influenced by some factors such as financial rewards, labour market opportunities and relationship with other parties that are not directly relevant to the interest of the shareholders. This can result to a tendency for managers to be more optimistic about economic performance of an entity than the reality. As a result of these different interests, managers may have incentives to bias information flows (Agrawal & Knoeber, 1996). Shareholders may also express concerns about information asymmetries where managers are in possession of information to which shareholders do not have access to it.

Different motivation and information asymmetries lead to concern about the quality and reliability of information, which impact on the level of trust that shareholders will have in their managers (Fama, 1980). There are various mechanisms that can be used to align the interest of managers with shareholders and to allow shareholders to measure and control the behavior of their managers and reinforce trust in them. Board of directors provides and independent check on the activities of managers and of the information provided by the managers, which helps to maintain confidence and trust on them.

Therefore the theoretical framework underpinning this study is agency theory. This is because Jensen and Meckling (1976) argue that where ownership and management are separated, the accounting function is affected by the agency problem. An agency relationship exists when one or more principal (shareholders) engage another person as their agent (managers) to perform a service on their behalf (Fama & Jensen, 1983). Performance of this service results in delegation of

some decision-making authority to the managers. This delegation of responsibility by the owners and the resulting division of labour are helpful in promoting an efficient and productive economy.

However, such delegation means that the principal needs to place trust in an agent to act in the principal's best interest. As a result of information asymmetries and personal interest of manager, shareholders lack reasons to trust their agents and will seek to resolve these concerns by putting in place mechanisms to align the interests of managers with shareholders and to reduce the extent for information asymmetries and opportunistic behavior (Donaldson & Davis, 1991).

### **3.1 Methodology and Model Specification**

The research design used for this study is correlation, because it describes the statistical relationship between two or more variables. Board characteristics and earnings quality are the variables of the study. A board characteristic is the independent variable which is proxied by board size, board composition, managerial shareholding and institutional shareholding, while the dependent variable is earnings quality represented by the residuals from the modified Dechow and Dichev (2002). The population of this study comprises of all the 13 listed building materials firms in the Nigerian stock exchange as at 31<sup>st</sup> December, 2012. Filter is used to eliminate some of the firms that do not have complete records of all the data needed for measuring the variables of the study within the period of 2005 to 2012. The sample of the study consists of 7 firms that have complete records to be used for the study. The data used for this study is secondary which was obtained from the annual reports of listed building materials firms in the Nigerian stock exchange within the period under study. Multiple regression is used to examine the model of the study. Two steps regression is used in determining the earnings quality of listed building materials firms in Nigeria, by adopting the modified Dechow and Dichev (2002). The residuals of the model are given below:

$$\Delta WC_{it} = \beta_0 + \beta_1 CFO_{it-1} + \beta_2 CFO_{it} + \beta_3 CFO_{it+1} + \varepsilon$$

Where:

$\Delta WC$  = change in working capital

$\beta$  = parameters for estimation

$CFO_{it-1}$  = past cash flows

$CFO_{it}$  = current cash flows

$CFO_{it+1}$  = future cash flows

$\varepsilon$  = error terms

**Model Specification**

$$EQ = \beta_0 + \beta_1 BS + \beta_2 BC + \beta_3 MS + \beta_4 IS + \epsilon$$

Where:

- EQ= earnings quality
- BS= board size
- BC= board composition
- MS= managerial shareholdings
- IS= institutional shareholdings

**Variables Definition and Measurement**

Variable	Definition and Measurement
Earnings quality	Measured by the residuals from the modified Dechow and Dichev (2002)
Board size	Is the total numbers of board members in the board
Board composition	Is the proportion of non-executive directors in the board
Managerial shareholding	Is the proportion of firm’s shares owned by the management
Institutional shareholding	Is the percentage of firm’s shares owned by the institutional investor

**4.1 Result and Discussion**

This section presents the results of the descriptive statistics, followed by the correlation matrix and regression results of the study.

**Table4.1: Correlation Matrix**

VARIABLES	DAC	BS	BC	MS	IS
EQ	1				
BS	0.340	1			
BC	0.007	0.438	1		
MS	-0.193	0.498	0.053	1	
IS	0.261	0.055	-0.426	-0.126	1

*Source: SPSS Output*

The table above shows that three proxies of the independent variables board size board composition and institutional shareholding are positively related with earnings quality listed Building Materials Firms in Nigeria, while managerial

shareholding is negatively related with earnings quality of listed Building Materials Firms in Nigeria. The tolerance values and the variance inflation factor are good measures of evaluating multicollinearity between the independent variables of the study. The results shows that tolerance values were less than 1.00 and the variance inflation factor were less than 10 showing complete absence of multicollinearity problem. This shows that the model of the study is suitably fit with the four independent variables used in the study.

**Table 3: Regression Result**

<b>Variables</b>	<b>Coefficient</b>	<b>P-Values</b>	<b>Tolerance</b>	<b>Vif</b>
<b>Constant</b>	-57.52908	0.405	0.976678	1.04
<b>BS</b>	4.140574	0.000	0.967771	1.03
<b>BC</b>	-6.439653	0.099	0.907271	1.10
<b>MS</b>	-111.6291	0.000	0.809481	1.24
<b>IS</b>	55.72232	0.752	0.867431	1.15
<b>R</b>	0.60			
<b>R<sup>2</sup></b>	0.36			
<b>F-statistics</b>	7.02			
<b>Sig</b>	0.000			
<b>DW</b>	1.89			

**Source: SPSS Output**

Table 3 above, shows the summary of the estimated regression model  
 $RESD = -57.5291 + 4.1406BS + -6.4397BC + -111.6291MS + 55.7223IS$

The model shows that board size has positive significant impact on earnings quality of listed Building Materials Firms in Nigeria at 1% level of significant. This implies that smaller board sizes are better at improving the quality of accounting information of Building Materials Firms in Nigeria. This is in line with work of Abdul Rahman and Ali (2006) and Kao and Chen (2004) who found significant positive association between board size and earnings management. On the contrary, Xie *et al.* (2003) found a negative association between board size and earnings quality. This may be as a result of different types of earnings management measures adopted or different markets and corporate governance Practice. The result therefore produces a basis for rejecting the first null hypothesis formulated which presumed that board size has no significant effect on earnings quality of listed Building Materials Firms in Nigeria.

Again, there is a negative significant relationship between board composition and earnings quality of listed Building Materials Firms in Nigeria at 10% level of significant. This means that board independence is associated with lower levels of earnings management which serve as a by-product of a better financial reporting quality. This is in line with the works of Davidson, Goodwin-Stewart, and Kent (2005) who found an inverse relationship between board independence and earnings quality and, Fama and Jensen (1983) who documented that independent directors on boards make boards more effective in monitoring managers and exercising control on behalf of shareholders. This gives the justification for the rejection of the second null hypothesis which stated that board composition has no significant impact on earnings management of listed Building Materials Firms in Nigeria.

Additionally, managerial shareholding is also negatively and significantly impacting on earnings of listed Building Materials Firms in Nigeria. This indicates that higher rate of managerial shareholding signifies better monitoring, which therefore improves the quality of financial information. This is consistent with the agency theory which predicts that low levels of insider ownership imply a poor alignment of interests between management and shareholders (Jensen & Meckling, 1976); that is, managers with little ownership may have incentives to manage accounting numbers so as to increase earnings-based on compensation, relax contractual constraints, or avoid debt covenants (Healy, 1985; Holthausen et al., 1995). This serves a yardstick for rejecting the third null hypothesis that was formulated as managerial shareholding has no significant effect on earnings quality of listed Building Materials Firms in Nigeria.

Finally, institutional shareholding is found to be positive but not significantly related with earnings quality of listed Building Materials Firms in Nigeria. This is in line with the findings of Siregar and Utama (2008) who found that institutional shareholding has no significant effect on earnings quality. Consequently, the study fails to reject the last null hypothesis which was stated that institutional shareholding has no significant effect on earnings quality of listed Building Materials Firms in Nigeria. The relationship between the dependent and independent variables of the study is represented by R at 60% which shows strong positive relationship. The coefficient of determination  $R^2$  at 36% constitutes the proportion of the total variation in the dependent variable explained by the independent variables. Therefore, it signifies that 36% of the total variation in earnings quality of listed Building Materials Firms in Nigeria is caused by board size, board composition, managerial shareholding and institution shareholding,

and the remaining 64% is caused by other factors. The F statistic is 7.02 at 1% level of significant. This shows that the model is well fitted.

Therefore, board size, board composition and Managerial shareholding as proxies of board characteristics have significant impact in improving the earnings quality of Nigerian Building Materials Firms in Nigeria.

### **5.1 Conclusions and Recommendations**

This study investigates the relationship between board characteristics and earnings quality of listed Building Materials Firms in Nigeria. Board size, board composition and managerial shareholding and institutional shareholding were used as proxies of board characteristics, while the residuals from the modified Dechow and Dichev (2002) was used to represent earnings quality as a dependent variables of the study. It was therefore found that Board size, board composition and managerial shareholding have significant impact on earnings quality of listed Building Materials Firms in Nigeria. As such the existence of positive significant effect between board size and earnings quality of listed Building Materials Firms in Nigeria was due to the fact that smaller board sizes are better at improving the quality of accounting information. Again, the presence of negative significant impact between board composition and earnings quality was as result of the believed that independent directors on boards make boards more effective in monitoring managers and exercising control on behalf of shareholders. The appearance of negative significant effect between managerial shareholding and earnings quality of listed Building Materials Firms in Nigeria was due to the fact that insider ownership constrains the opportunistic behavior of managers there reducing earnings manipulations. It is recommended that Nigerian Building Materials Firms should have reasonable number of members on the so that they can operate more effectively in maintaining management operation. Additionally, they should also have independent directors to be the majority of the board members because it was indicated in our findings that more independent directors signifies better monitoring. And finally, they should also provide more percentages of its shares to be owned by the management in order to improve their financial reporting quality.

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**Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation
WK	56	1344291	2E+009	2E+008	399129489.7
BS	56	3.00	13.00	8.9643	2.41182
BC	56	.33	.78	.6537	.12595
MS	56	.00	.11	.0200	.03107
IS	56	.01	.82	.4362	.25234
Valid N (listwise)	56				

**Correlations**

		WK	BS	BC	MS	IS
WK	Pearson Correlation	1	.340*	.007	-.193	.261
	Sig. (2-tailed)		.010	.961	.154	.052
	N	56	56	56	56	56
BS	Pearson Correlation	.340*	1	.438**	.498**	.055
	Sig. (2-tailed)	.010		.001	.000	.687
	N	56	56	56	56	56
BC	Pearson Correlation	.007	.438**	1	.053	-.426**
	Sig. (2-tailed)	.961	.001		.700	.001
	N	56	56	56	56	56
MS	Pearson Correlation	-.193	.498**	.053	1	-.126
	Sig. (2-tailed)	.154	.000	.700		.355
	N	56	56	56	56	56
IS	Pearson Correlation	.261	.055	-.426**	-.126	1
	Sig. (2-tailed)	.052	.687	.001	.355	
	N	56	56	56	56	56

\*. Correlation is significant at the 0.05 level (2-tailed).

\*\*. Correlation is significant at the 0.01 level (2-tailed).

.01 level (2-tailed).

**Regression**

**Model Summary<sup>b</sup>**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df 1	df 2	Sig. F Change	
1	.596 <sup>a</sup>	.355	.304	332879019	.355	7.018	4	51	.000	1.887

a. Predictors: (Constant), IS, BS, MS, BC

b. Dependent Variable: WK

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**ANOVA<sup>b</sup>**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	3.1E+018	4	7.776E+017	7.018	.000 <sup>a</sup>
	Residual	5.7E+018	51	1.108E+017		
	Total	8.8E+018	55			

a. Predictors: (Constant), IS, BS, MS, BC

b. Dependent Variable: WK

**Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-3E+008	3E+008		-.840	.405
	BS	1E+008	3E+007	.715	4.393	.000
	BC	-8E+008	5E+008	-.260	-1.681	.099
	MS	-7E+009	2E+009	-.530	-3.763	.000
	IS	7E+007	2E+008	.044	.317	.752

a. Dependent Variable: WK

**Residuals Statistics<sup>a</sup>**

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	-2E+008	7E+008	2E+008	237812329.0	56
Residual	-6E+008	1E+009	.00000	320545856.0	56
Std. Predicted Value	-1.325	2.113	.000	1.000	56
Std. Residual	-1.934	4.032	.000	.963	56

a. Dependent Variable: WK