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Corporate Governance, Quality of Earnings and Future Stock Returns: Nigeria Experience

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Abstract

The purpose of this study is to examine the quality of earnings, corporate governance and future stock returns. The study employed a longitudinal research design by sampling 25 companies from the non-financial quoted companies in the Nigerian Stock Group for the period of 2015 to 2020. The study conducts descriptive Statistics, Pearson correlation matrix, variance inflation factor and multivariate regressions technique for the empirical analysis. The empirical results show that earnings quality has a significant positive effect on stock returns and board independence has an insignificant negative effect on stock returns while board size has an insignificant positive effect on stock returns. The study recommends that earnings quality should be given priority by management because it positively enhances future stock returns.

Keywords: Board independence, board size, corporate governance, earnings quality and stock returns.
JEL Classification: G26, G28, M30

1. Introduction

Earning is regarded as key fundamental and prominent accounting variable which influences the movement in the market of share of listed quoted firms in Nigeria (Abiodun, 2012). A stock market is a financial asset that will fluctuate and influence through political, social, or economic distress and company’s performance and investors invest in bond market to diversify the risk of losses. Investors and analysts look to earnings to determine the attractiveness of a particular stock (Sonia, et al, 2013). The movement in market value of share of quoted firms is influenced by changes in the firm’s fundamental factors such as financial performance and macroeconomic variables (Kehinde, 2012). In addition, Agrawal (2011) opines that the earning of a firm influences the financial performance and macro economic variables that cause a change in the movement of market value of share in the capital market. Meanwhile, “the market value of share of listed firms in the capital market is determined by the forces of market supply and demand is highly volatile due to its dependent on the expectations of the buyers and sellers (Menaje, 2012).

The market will look out for both cash flow and net book value if the earnings numbers are perceived to be inadequate (Abiodun, 2012). The importance of a company’s income is shown by the fact that the value of a company’s shares represents the value of its future earnings. The Corporate scandals like Enron, Ahold, and WorldCom have again raised the questions about the financial reporting quality, earnings management and corporate governance. Whether does the better governed firm report more credible earnings numbers? Previous literatures have presented evidence that mechanisms of corporate governance have impacts on the earnings quality (Imeokparia, 2013; Wildatunjanah & Suparningsih, 2019). The board structure in any listed firms gives it the overview of the standard of such organization, which influences its public image (Obigbemi, *et al,* 2016).

There has been debate about the need for strong corporate governance (Adeyemi & Fagbemi 2010; Dennis & Ogoun, 2018; Anichebe *et al,* 2019; Akrawah, *et al,* 2020) with countries around the world drawing up guidelines and codes of practice to strengthen governance (Cadbury 1992; Corporate Governance Code of Nigeria 2005). Because this behavior may have a significant effect on the quality of information provided to investors, the security and exchange commission is more concerned with earnings management behavior of firms' managers (Zikra *et al,* 2018). Stock prices already reflect not only historical information but all published information about the company whose securities are under consideration. Hence, the peculiar nature of the study is a strong motivation for empirically examining the effect of quality of earnings, corporate governance and future stock returns among some selected non-financial quoted companies in Nigeria. To bridge the gap in knowledge, the study made use of multivariate regression technique to test the formulated hypotheses.

1.2 Research Objectives

The broad objective is to examine the quality of earnings, CG and future stock returns. The specific objectives are to:

(i) examine the effect of earning quality on future stock returns.
(ii) ascertain the effect of board independence on future stock returns.
(iii) assess the effect of board size on future stock returns.

1.3 Research Hypotheses

The following hypotheses were formulated in a null form:

H_{O1}: Earnings quality has no significant effect on future stock returns.
H_{O2}: Board independence has no significant effect on future stock returns.
H_{O3}: Board size has no significant effect on future stock returns.

2. Literature Review

2.1 Stock Returns

According to Sukesti (2021) stock returns is the current stock price of traded and listed share on the stock exchange influences by the forces of demand and supply of the relevant shares in the capital market. Khanagha, *et al* (2011), identify earnings per share (EPS) and book value per share (BVPS) as the two most important accounting measures that have a significant positive association with market value of a firm, proxy by share prices in relevant literatures. Stock market returns are the fundamental metrics for measuring firm values of corporate organisation. The stock market is to provide an exchange in which buyers and sellers interact for the purpose of trading in shares and other securities issued by publicly traded companies (Monther & Kaothar, 2010). Omura (2005) claims that stock would be considered undervalued if its market value is well below book value, which means the stock is trading at a deep discount to book value per share. However, stock is overvalued if it is trading at a premium to book value, as this again depends on the sector and the extent of the premium in relation to the stock's peers (Omura 2005).

Researchers bring distinct opinions regarding managerial stake. Those managers with more stock in organization may tend to take decisions which go for their self interest to maximize their wealth, job tenure or to elevate their reputation and value. These types of decisions create a conflicting situation. To overcome such pitfalls, good corporate governance is needed to keep check and balance that all activities are managed and decisions are effectively taken by managers to enhance the value of stakeholders' wealth (Omoregie *et al,* 2018). In this study, stock market returns are defined as the movement of stock price controlled and regulated by the forces of demand and supply in a free market economy.

2.2 Earnings Quality

Earnings quality is defined by Istianingsih, *et al* (2020) as the timing and quality of management's decision-making for proactive investment decisions for increasing the performance of the firm. The practice of earnings quality and management has created more attention in the whole financial market and its presence distorts the true and fair view of the financial position of companies, and may cause serious corporate failure (Mahmia, 2017). The Cadbury and Akintola Williams Delloite (AWD) case of fraudulent financial reporting also demonstrates the relationship between audit quality and earnings management manipulation (Eriabie & Dabor, 2017). Mamo and Aliaj (2014), claim that manipulations of financial reports had a large asymmetry of information for readers of financial statements and affect their decision making and impaired earnings quality". Auditors, who are indirect stakeholders, are blamed by the public for the failure of most organizations on the ground that financial statements of a company with a going concern issue had unqualified report. The issue of auditor's involvement has raised the following questions: First, do auditors play a key role in the preparation of the reports? An attempt to resolve the above question generated two alternative situations when the functions of auditors and the requirements of good corporate governance by client management are matched against one another (Eriabie & Dabor, 2017). In this study, earning is seen as the power influential of share price in the capital market that immensely improves performance of quoted firms.

2.3 Corporate Governance Characteristics

Corporate governance has become a great global concern because of the rising frequency and widespread pattern of deliberate accounting deceits and fraud, as well as growing number of consequent corporate failures (Nwachukwu, 2007). Corporate governance is a simple practice of just doing things fairly and rightly (Sudhir, 2017). Corporate governance has gained more prominence due to its promotion of transparency, fairness and honesty in financial reporting, compliance with ethical and regulatory standard, accountability to shareholders and the efficacy of the board of directors regarding its responsibilities for the oversight of the management operations (Ilaboya & Obaretin, 2015). Magdi and Nadereh (2002) argue that that corporate governance is about ensuring that the business is run well and investors receive a fair return and shareholders are happy. Shleifer and Vishny (1997), are of the opinion that corporate governance deals with the ways suppliers of finance to corporations assure themselves of getting a return on their investments. Effective corporate governance reduces control rights shareholders and creditors confer on managers, increasing the probability that managers invest in positive net present value projects (Shleifer & Vishny, 1997)

2.3.1 Board Independence

Board independence is seen as the percentage of independent non-executive directors on the board of directors (Bin & Yi, 2015). Literature on corporate governance suggests that board independence is premised on separation of ownership from control of a company. The inclusion of non-executive directors and independent directors on the board serve as a veritable platform for effective monitoring" (Uadiale, 2012). Kyereboah-Coleman and Biekpe (2006) disclose that firms are supposed to increase the independence of their board in order to overcome poor performance. John and Senbet (1998) are of the view that the independence of a board is more visible with the presence of more non-executive directors. According to Fama and Jensen (1993) for a board to be independent it should have outside directors as the majority and it is believed that independent directors are more vigilant in monitoring behaviours and decision making of the company.

2.3.2 Board Size

Board size is the total number of directors sitting on the board of any corporate organization (Tafamel, Dania & Akrawah, 2016). Omoye and Eriki (2014) claim that the size of the board is fundamental practice of CG in a small and large firm as regards to earning management practices. Ammari, Kadria, and Ellouze (2014) claim that, large board size offers adequate number of people to manage the work load of the board easily, the responsibility is divided among many members and larger size provides more perspectives. A board can be effective if its decision power and influences on the managers is very strong. Ahmadu, Tukur and Aminu (2011) are of the view that a significant board size influences the functions of the board tremendously with help of good CG performance.

2.4 Empirical Review

Morck *et al.* (2000) investigate the information content of stock markets and why do emerging markets have synchronous stock price movements and found out that the presence of more private information contained in stock prices the more efficient the company in terms of performance and such information is impounded into stock prices. Okolie, (2013) studied the effect and relationship between audit quality, earnings management and earnings response coefficients of quoted companies in Nigeria, and documented evidences that are consistent with the relationship and effects which audit quality exerts on earnings management from the perspectives of discretionary accruals manipulations and the manipulations of real economic operations of companies listed on the Nigerian Stock Exchange. Omoye and Eriki (2014), investigated corporate governance determinants of earnings management in Nigerian quoted companies and the study classified Nigerian quoted companies into high and low earnings management levels and also to investigate how corporate governance mechanisms relate to these categories of earnings management levels by sampling 130 companies were drawn from quoted companies on the Nigerian stock exchange over the period of 2005 to 2010. The results also revealed that board independence had a positive and significant influence on the probability of Nigerian companies adopting absolute high earnings management, audit committee independence. Narwal and Jindal (2015) conducted an empirical study on the impact of corporate governance on the profitability of the firm and revealed that board composition as an attribute of corporate governance has a significant negative effect on performance and profitability of the organizations.

Alexander, *et al* (2015) examined the impact of CG on FP in Nigeria quoted companies and the results revealed that BS has a significant negative impact on firm FP. Jayati and Subrata (2018) conducted a study on bank ownership, board characteristics and performance in India and made use of some selected banks for the period of 2003 to 2012 for the empirical analysis. The results showed that board independence has a significant positive correlation with the performance of private banks and a significant but negative correlation with the performance of state-owned banks while CEO duality has a negative relationship in state-owned banks where incidence of CEO duality is high.

Similarly, Cao *et al.,* (2021) examined the relationship between corporate BS and corporate performance in China. The aim of the study is to examine the connection between board size and firm performance measured by Toin Q and ROA. Secondary data were collected from a sample of 372 companies in the US S&P 500 for the period of 2013 to 2017 whereby descriptive statistics, correlation analysis and regression technique in the analysis of data. The empirical findings show that BS exhibit a negative and significant relationship with corporate performance at p-value < 0.05 after grouping the sample into high-tech and non-high-tech industries. In India, Al-Homaidi, *et al.* (2021) sampled 33 to examine the relationship between corporate governance characteristics and firm profitability for the period of 2011 to 2014 and descriptive statistics, correlation analysis and multiple regressions in the analysis of data. The results reveal that board diligence, ACS, audit committee composition, audit committee diligence, company size exert a significant relationship with firm profitability proxied by ROA and with EPS, ACS, audit committee composition, audit committee diligence and company size were significant related and BS and BC exhibit an insignificant relationship with ROA while BS, BC and board diligence were not significantly related with EPS. In a recent study by Ali, *et al.* (2021) research on the effect of CG mechanism on non-financial performance of listed firms in Pakistan. The study period was from 2005 to 2015 and a sample of 524 firms listed on the Pakistan Stock Exchange. It was found that board independence has a significant effect on FP proxy by Tobin's Q.

2.5 Theoretical Review

2.5.1 Stakeholder Theory

Stakeholder theory is a further development on the concept of stakeholder and its relationship to any business corporation. Freeman, Ohlson and Penman (1984) offer a traditional definition of a stakeholder as thus: "any group or individual who can affect or is affected by the achievement of the organization's objectives. Therefore, the general idea of stakeholder theory is a redefinition of the organization. That is, what the organization should be and how it should be conceptualized. Adeyemi, and Fagbemi (2010) equally observe that stakeholders' theory takes account of a wider group of constituents rather than focusing on shareholders. Where there is an emphasis on stakeholders, the governance structure of the company may provide for some direct representation of the stakeholders groups". The theory as noted by Knechel and Willekens (2006) states that the organization itself should be thought of as grouping of stakeholders and the purpose of the organization should be to manage their interests, needs and viewpoints. This stakeholder management is thought to be fulfilled by the managers of a firm.

The underlying assumption is that management tends to be increasingly used when the stakeholders' pressures intensify. Hence, the duty of the management is to maximize the wealth of the owners and not to work for the entire interests of all stakeholder of the company through favourable stock returns (Momanyi *et al,* 2018). The study is relevant to this study because corporate governance has gained more prominence due to its promotion of transparency, fairness and honesty in financial reporting, compliance with ethical and regulatory standard, accountability to shareholders and the efficacy of the board of directors regarding performance of the firm.

3. Data and Methods

The study adopted a longitudinal scope research design which is aimed at studying events or groups over a period of time. The population is made up of companies whose shares are quoted on the floor of the Nigerian Exchange Group and must have finished its obligation in delivery annual reports for the year ended 2020. Each firm in the population must have finished its obligation in delivering annual reports for six consecutive years for the period of 2015 to 2020. The sample size was based on the one-hundred and seventy (170) quoted companies made up of equities listing and mutual fund listing as at 31 December, 2020 in Nigerian Exchange Group (NEG, 2020). The study made use of secondary data which was collected from audited annual report of quoted companies.

However, the filtering method was applied where companies from ICT, conglomerates, services and financial services were excluded from the sample population. The justification for excluding these companies is based on the fact that these companies are service rendering companies as well as conglomerate companies. Therefore, we use the statistical formulae of Ewododhe (2011) to arrive at the sampled size of the remaining total population of 75 quoted companies. This was mathematically expressed as:

$$n=1/3N$$

1/3 x 75 = 25

In order to avoid bias, random sampling techniques was used to select 25 quoted companies out of the sampled population. The econometric technique adopted in this study was multivariate regression technique. Pearson correlation matrix was adopted to measure the relationship between the variables and a Variance Inflation Factor was conducted to check for multicollinearity.

3.1 Model Specification

The study adopted the multivariate regression model of Omoregie, *et al.* (2018) to empirically quality of earnings, corporate governance and future stock returns. The model was re-specified in equation (1) below:

STR = F (ESQ, BIND, BS) ………………………………………………………………… (1)

The multiple regressions with error term (et) is express in the econometric equation below;

$STR = \beta_0 + \beta_1 ESQ + \beta_2 BIND + \beta_3 BS + \varepsilon$ ………………………………………………. (2)

Where:

STR = Stock return. Stock return was measured by stock price earnings ratio.

ESQ = Earnings quality. Earnings quality was measured by change in profit margin (ΔPMt) and the change in asset turnover ($\Delta ATOt$).

BIND = Bind independence. Bind independence was measured by ratio of non-executive to total board size.

BS = Board size. Board size was measured by the number of directors sitting on the board.

β_0 = Constant Coefficient

$\beta_1 - \beta_3$= Explained coefficients of the independent variables

The *a priori* sign; $\beta_1, \beta_2, \beta_3 > 0$

4. Data Analysis and Discussion of findings

4.1 Descriptive Statistics

The descriptive statistics result in Table 1 showed that on the average stock return (STR) was N18.28 and a standard deviation value of 27.51. This means that non-financial quoted companies in Nigeria Stock Exchange had an average stock return of N18. On the average, earnings quality (ESQ) measured by change in profit margin and the change in asset turnover was N1.32 and a standard deviation value of 17.51. This means that there was a positive earnings quality generated on the average. Board independence (BIND) on the average was 60% and a standard deviation value of 15.81. This therefore means that the non-financial quoted firm in Nigeria Stock Exchange had more independent directors sitting on the board. Board size (BS) had an average value 9.24 and a standard deviation value 2.79. This implies that there was a sizeable board of nine (9) on the average was maintained by the sampled quoted companies. Lastly, the Jarque-Bera (JB) statistics showed that stock returns, earnings quality and board size were normally distributed while board independence was abnormally distributed.

Table 1: Descriptive Statistics

Variables	Mean	Std. Deviation	Jarque-Bera	OBS
STR	18.28	27.69	651.15 (0.00)	150
ESQ	1.32	17.51	53149.00 (0.00)	150
BIND	60.42	15.81	2.20 (0.33)	150
BS	9.24	2.79	7.80 (0.02)	150

Source: Authors' Computation (2021)

4.2 Correlation Matrix

The coefficient of the correlation results in Table 2 revealed that stock return (STR) and earnings quality (ESQ) was positive and moderately correlated (0.2712). This there means that stock return might be by influence by earnings quality. Stock return (STR) and board independence (BIND) was negative and weakly correlated (-0.0456). This there means that board independence might influence stock return negatively. Stock return (STR) and board size (BS) was positive and weakly correlated (0.0789). A careful look at the correlation coefficient revealed that a positive association exists between the variables. To test for the presence of muiticolinearity in the correlation result, a Variance Inflation Factor was conducted and the mean aggregate value of 1.07 revealed the absence of multicolinearity. This means that there is the absence of multicolinearity problem in our model. Multicollinearity between explanatory variables may result to wrong signs or implausible magnitudes, in the estimated model coefficients, and the bias of the standard errors of the coefficients.

Table 2: Correlation Matrix Result

Variable	STR	ESQ	BIND	BS
STR	1			
ESQ	0.2712	1		
BIND	-0.0456	0.0402	1	
BS	0.0789	-0.0314	0.3014	1

Source: Authors' Computation (2021)

4.3 Quality of earnings, CG and future stock returns

From Table 4, it would be observed that the coefficient of determination (R^2) value of 0.088825 that about 9% of the systematic variations in the dependent variable (stock returns) were jointly explained by the independent variables (earning quality, board independence and board size. This means that the model overall is good for statistical prediction. The F-statistic value of 4.744206 and it associated p-value of 0.0003460 showed that there was a significant linear relationship between the given variables. The empirical results showed that earnings quality (ESQ) a significant positive effect on stock returns (STR) at 1% level of significance. This therefore means that increase in earnings quality would lead to an increase in stock returns but it was statistically significant, and supported by the findings of Morck, *et al,* (2000).

The study therefore suggested the hypothesis should be rejected that earnings quality has no significant effect on stock return. Also, board independence (BIND) has an insignificant negative effect on stock returns (STR) even at 10% level of significance. This therefore means that increase in board independence would lead to a decrease in stock returns but it was statistically insignificant, and supported by the findings of Al-Homaidi, *et al,* (2021) and negates the results of Ali, *et al,* (2021). The study therefore suggested the hypothesis should be accepted that board independence has no significant effect on stock return. In the case of board size (BS), the variable has an insignificant positive effect on stock returns (STR) even at 10% level of significance. This therefore means that increase in board size would lead to an increase in stock returns but it was statistically insignificant. The findings negate the results of Cao, *et al,* (2021). The study therefore suggested the hypothesis should be accepted that board size has no significant effect on stock return.

Table 4: Multivariate Regression Results

Variable	Coefficient	Std. Error	t-test	p-value
C	16.84	9.94	1.69	0.0926
ESQ	0.44	0.12	3.51	0.0006
BIND	-0.16	0.14	-1.10	0.2712
BS	1.14	0.82	1.39	0.1665
R^2-Square = 0.088825				
Adjusted R^2-Square = 0.070102				
F-Statistic = 4.744206				
Prob(F-Statistic) = 0.0003460				

Source: Authors' Computation (2021)

5. Conclusion and Recommendations

The aim of the study was to empirically examine the quality of earnings, corporate governance and future stock returns. Earning is the "power influential of share price" in the capital market that immensely improves performance of quoted firms. The stock market is a financial asset that will fluctuate and influence through political, social, or economic distress and company's performance and investors invest in bond market to diversify the risk of losses. The study concluded from the results that earnings quality has a significant positive effect on stock returns and board independence has an insignificant negative effect on stock returns while board size has an insignificant positive effect on stock returns.

Based on the findings, the study recommended the following:

(i) Earnings quality should be given upmost priority by management for impacting on the performance of the firm and favourable future stock returns.

(ii) Management should be given strong consideration for corporate governance parameters (board independence and board size) in order to bring about favourable future stock returns.

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