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Financial Reporting Quality, Does Regulatory Changes Matter? Evidence from Nigeria

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Abstract: The aim of the study is to investigate the effect of revised Code of Corporate Governance 2011 for public companies in Nigeria and how these changes affect the quality of financial reporting in the nonfinancial firms in Nigeria between 2010 and 2014. The study employed McNichols (2002) accrual quality measure on pooled panel data with 505 firm-year observations. The findings revealed that the revised code brought changes that impacted positively in providing effective mechanisms for monitoring and control which decreases earnings management practices that enhanced the quality of financial reports in Nigerian nonfinancial listed firms. However, specific variables contribution in improving the quality of firms' earnings were found to be inadequate in enhancing the quality of financial reports. Thus, mandatory disclosure of equity and financial expertise of shareholders representatives on the audit committee in the governance reports would improve oversight monitoring functions of the board and audit committee.

Keywords: Corporate governance, audit Committee, earnings quality, financial reporting quality, Nigeria

1.1 Introduction

The global financial crises that resulted in a passionate demand for best practices in the management of corporations called for the review of how public companies are managed in Nigeria. The Nigerian Companies and Allied Matters Act (CAMA) 1990, as amended in 2004, was saddled with the responsibility of providing a corporate governance framework for public companies in Nigeria (Abdulmalik and Che-Ahmad 2015). Consequently, three statutory bodies are shoulder with the responsibility of regulating accounting and financial reporting in Nigeria, which is the Corporate Affairs Commission (CAC) (2012), Nigeria Stock Exchange (NSE) and Securities and Exchange Commission (SEC), Nigerian Financial Reporting Council (NFRC). The CAC is vested with the responsibility of supervising and registering company formation, management, and winding up. However, SEC handles regulating the capital market while the Nigerian Stock Exchange is charged with the responsibility of making sure that firms comply with listing rules, as well as the reporting requirements of the firms. While the NFRC established in 2011, is vested with the responsibility for developing and publishing financial reporting standards for public companies.

In 2003, SEC developed a code of the best practice for public companies in Nigeria. The code was made to be voluntary and designed to establish good business practice and standard for directors, CEOs, Boards, and auditors of listed companies (Wilson, 2006). Given the lack of enforcement of the SEC, 2003 rules that rendered it ineffective and unobservable by the companies (World Bank, 2004, 2012). Then, SEC set up another review committee that was mandated to recommend ways of improving the enforcement mechanisms required to make CCG 2003 more effective and enforceable. The recommendations of the review committee gave rise to the release of SEC CCG, 2011. Therefore, does the revised CCG, 2011, provides significant changes that improve the quality of financial reporting in the nonfinancial listed companies in Nigeria? This amongst other questions is what this study seeks to answer.

2.1 Materials and Methods

The quality of the financial report is fundamental to investors, shareholders, creditors and other stakeholders which provide them with financial information about an entity. However, the quality of the report depends on its reliability that translates into investment decision (Wilson, 2006). Thus, emphasise the need to provide relevant information, which is crucial for efficient markets, the absence of which encouraged market manipulation. Accordingly, corporate governance mechanisms

are set to impact positively on the quality of earnings, as a result, discourage motivation for earnings manipulation. However, the consistent reported cases of fraud related cases, distress and bankruptcy cases particularly in deposit money banks, caused much public concern about the quality of firms financial reporting (Miko & Kamardin, 2016; Olowokure, Tanko, & Nyor, 2016).

Accordingly, the Code made provisions aim at strengthening internal control mechanism through the audit committee (AC). Thus, AC is required to be established by section 359 (3) and (4) of (CAMA) Cap. C20 Law of the Federation of Nigeria (LFN) 2004. Where the Board is required to nominate three of its members, while three members are appointed by the shareholders' making an audit committee of six. Further, at least one financially literate non-executive director (NED) with knowledge of accounting or financial management should serve on the board audit committee. Consequently, prior studies (Hayes, 2014; Badolato, Donelson, & Ege, 2014; Nuraddeen Usman Miko & Kamardin, 2015) document that, board and members of audit committee need financial sophistication. Moreover, that, presence of at least one financial or accounting expert is associated with a decrease in discretionary accruals.

Abdulmalik and Che (2015) examine the relationship between the establishment of risk management, corporate governance committees (required by CCG, 211) and audit fees, using a sample of 94 non-financial listed firms in Nigeria, between 2008 and 2013. The study finds corporate governance committee to have an insignificant relationship with audit fees. Although the study could not establish significant relationships, it provides evidence of an increase in scope and effective monitoring roles of external auditors.

Similarly, Miko and Kamardin (2016) study the development vis-a-vis the challenges of corporate governance in the pre and post 1960 independence of the Nigeria. The study provided an overall assessment of relevant laws governing corporate governance mechanisms and concluded that, despite the multiplicity of CCG Codes, there is a continued non-compliance, corporate failures that lead to the bankruptcy of many companies, particularly in the financial sector of the economy. Similarly, Miko and Kamardin (2015) examined the effect of SEC, 2011 changes in the pre and post implementation period on the earnings management of Consumer Goods Industry in Nigeria. Using a sample of 20 listed companies, it reveals that the pre-implementation period encourages earnings management practices, contrary to the post-implementation period. Thus, revised CCG 2011, introduced changes that effectively enhanced the earnings quality of the Nigerian consumer goods industry. Given the sample size, it would be difficult to make a generalisation of its findings. However, it has provided an insight into the impact of those changes in that industry which could be extended to other industries or the entire listed firms in Nigeria.

Some of the significant changes observed in the revised Code of CG 2011 are contained in Sec.4.1, p.9 provisions. Where the Board of Directors are required to be of sufficient size with a membership of not be less than five that should consist of a mixture of the executive (ED) and non-executive directors (NED) to be chaired by NED. Prior literature argue that board size requires expertise and experience to handle board related responsibilities and [14–19] found a significant positive association between board size and earnings management. Also, (Xie, Davidson, & DaDalt, 2003) found that EM is unlikely in firms with larger boards. In line with that, SEC Code 2011, requires that the NED's should constitute the majority of the Board membership. Moreover, at least one (1) of NED should be an independent director. The Code emphasised independence of the Board from the management. Hence, provides that not more than two family members at the same time sit on the Board. This study is consistent with (Firth, Fung, & Rui, 2007; Magnan & Cormier, 1997; Erena & Tilahun, 2012; Rubin & Segal, 2014) that document high proportion of INED's presence on the board improves the quality of earnings. Further (Erena & Tilahun, 2012) argue found that the larger the percentage of INED the lesser the income-increasing accruals. Besides, NED is concerned with restraining income increasing accruals.

Furthermore, the two positions of CEO and Chairman are required to be separated and held by different individuals to allow for checks and balances in the discharge of Board's duties.

This lent support to the agency and stewardship theory (Kim, Al-Shammari, Kim, & Lee, 2009; Lin, 2005). Furthermore, the existence of CEO duality in an organisation would jeopardise board independence, impair its oversight governance role (Central Bank of Nigeria, 2014; Dey, Engel, & Liu, 2011; Elsayed, 2010; Petra, 2005). Therefore, independence of the board would be maintained and more desirable when the two roles are separated (Fama & Jensen, 1983). Other changes introduced include mandatory setting up of the whistleblowing unit to assist AC in its oversight functions, and to establish risk management committee, governance committee. While, these changes are to take effect and strengthen and provide effective CG practices, industries within the economy began to set specific corporate governance codes. For instance, the banking sector has CCG, (Central Bank of Nigeria, 2014). The National Insurance Commission (Naicom, 2009) published Codes of Corporate Governance to guide the Insurance Industry. Also, the (Nigerian communication commission, 2014) Code of Corporate Governance was issued. Similarly, Code of Corporate Governance for licensed pension operators (National Pension Commission, 2008) was released exclusively for pension fund administrators. Thus, resulting to non-compliance of the SEC CCG which incapacitated its operation. Consequently, with the establishment of Financial Reporting Council (FRCN, 2011) that seeks to introduce its code of corporate governance, the financial/capital market operators, the professionals and investors agitate for harmonisation of these Codes.

2.2 Hypothesis Development

The review of Nigerian SEC CCG 2011 is designed to ensure good governance in public companies, through the well-established board of directors. Moreover, that the BOD's of each company ought to guarantee that the firm's annual report incorporates a CG report that passes on to stakeholders, contains an unambiguous information on the quality of the company's CG structures, practices, and policies. Therefore, the following hypothesis is set thus:

H1: The revised SEC Code of Corporate Governance 2011 has significantly improved the quality of financial reporting in the Nigerian nonfinancial listed firms.

2.3 Research Design

The population of the study is all Nigerian listed non-financial companies trading on the floor of Nigerian Stock Exchange from 2010 to 2014. Furthermore, a total of 101 companies emerged as the sample size. Multivariate regression using pooled panel balanced data was employed in the analysis. Thus, (McNichols, 2002) accruals quality model was used in predicting FRQ, depicted in Equation [1]:

Δ**WC**= change in working capital, Δ**AR**= Change in account receivables, Δ**INV** = Change in inventory, Δ**AP**= Change in account payable, Δ**TP**= Change in tax payable, ΔOther assets (Net) = Change in other assets. The model is specified thus:

[1] $$\Delta WC\_ACC = \beta 0 + \beta_1 CFO_{it-1} + \beta_2 CFO_{it} + \beta_3 CFO_{it+1} + \beta_4 \Delta REV + \Delta\ \beta_5 PPE_{it} + \varepsilon_{it}$$

While, $CFO_{it-1=}$ Lag of cash flow from operations, CFO_{it} = current year cash flow from operations, $CFO_{it+1=}$ following year's cash flow from operations, Δ**REV** = Change in revenue, **PPE**= Property Plant and Equipment, ε = Residuals, $\beta_{0=}$ Intercept, β_{1-} $\beta_{5=}$ Coefficients of Independent Variable.

The corporate governance variables were collected from the website of SEC and companies' websites as well as hand collected from sample companies annual reports respectively. The control variables were leverage, profitability, firm age, and firm size. Also, a linear regression model was used for measuring the power of the association between the predictor variables. Whereas, the financial reporting quality (FRQ) is the outcome variable using abnormal accruals (discretionary) as its proxy.

Below is the model used to test the association between the FRQ and explanatory variables in [2]:

[2] $$FRQ_{it} = \beta_0 + \beta_1 BIND_{it} + \beta_2 BS_{it} + \beta_3 MOS_{it} + \beta_4 CEODit + \beta_5 BGD_{it} + \beta_6 ACIND_{it} + \beta_7 ACFEX_{it} + \beta_8 ACSO_{it} + \beta_9 FAit + \beta_{10} FSZ_{it} + \beta_{11} PRAT + \beta_{12} LEV_{it} + \varepsilon_{it}$$

2.4 Variables Measurement

Financial reporting quality=**FRQ**= Discretionary accruals, Board independence=**BIND**=

Percentage of the non-executive director or outside directors by the total number of directors on the board, Board size=**BS**= Total the number of directors' on the board, Chief executive officer Duality=**CEDU**=Dummy variable indicating "1" if CEO is the chairperson of the firm, otherwise "0", Board Gender Diversity=**BGD**=Proportion of female directors to the total number of board members, Managerial share ownership=**MSOW**= The percentage of the number of shares owned by executive directors divided by the total number of company shares, Audit Committee independence=**ACIND**= Measured by "1" with presence of at least one independent non-executive director on the AC, if otherwise "0";Audit Committee Financial expertise=**ACFE**= Measured by "1" with presence of at least one member with financial literacy, if otherwise, "0"; Audit Committee share ownership=**ACSOW**=Proportion of shares held by non-executive directors on the AC divided by fully paid company's shares; Leverage=LEV= Proportion of total long-term debt over a total asset of a firm; Profitability=**PRAT**= Measured by the ratio of profit after tax, to total assets; Firm Size=FS= Measured by the natural logarithm of total assets; Firm Age=FA= Number of years of firm's incorporation

3.1 Results

Table 3.1 shows the descriptive statistics of financial reporting quality for the SEC pre and post-CCG, 2011. The pre-period comprise of two years (2010-2011) as the period from the effective date of implementation and post period of equivalent years (2013-2014) as the period after the effective date of implementation. Therefore, the study used two sample t-statistics with an equal variance to examine whether a significant difference exists between the mean of the two groups (period). Similarly, the groups are categorised into group 1=pre-period and denoted "0" while group 2= after the revised Code denoted "1". The study anticipates the higher quality of earnings during the post-implementation period.

Accordingly, Table 4.2 presents the results of the two sample means (pre-period has a mean value of 0.1410, the standard deviation value of 0.4263, while the post-period has a mean value of 0.2270, the standard deviation value of 0.3954. This indicate that the average of 0.1410 of the pre-period is lower than the average of 0.2270 of the post-period, implies that on the average, FRQ increases by 9 per cent. Furthermore, the result is supported by its significance at 5 percent (t-statistic is -2.1004, *p*-value = 0.0363) level. Thus, the *t*-statistics of -2.1004 is sufficient to reject the null hypothesis of no difference between the mean of the pre and post-CCG 2011. Consequently, the revised code of corporate governance 2011 brought about new regulatory changes that effectively enhance the quality of financial reporting, hence, decreases managerial self-motivation for earnings manipulations

Table 3.1. Test of The Differences of DA Between Pre- and Post- CCG, 2011

	Mean	SD	t-statistics	Significance
Pre-Period	0.1410	0.4263	-2.1004	0.0363**
Post-Period	0.2270	0.3954		
Difference	-0.0859			

Note: Significant levels at ***1% **5% & *10% respectively. SD=standard deviation.

3.1.1 Diagnostic Tests

Model specification test was conducted using Ramsey specification test (Ramsey, 1969) that provides *p*-value=0.34521 and *F*-statistics (1.09) which justify the fitness of the study model and correctly specified. Thus require no additional variable(s). Also, Table 3.2 indicates IM Heteroscedasticity Test of $\chi 2$ = 29.46, with *p*-value=1.0000 that justifies the earlier result and further evidence of constant variance among the error terms.

Table 3.2 *Model Specification, Selection, and Fitness test*

Tests	χ^2	*p*-value	Coefficients
Ramsey Test	1.09	0.3452	-
Breusch-Pagan / Cook-Weisberg	0.10	0.7494	-
IM Heteroscedasticity Test	29.46	1.0000	-

Test for Skewness and Kurtosis were conducted, using (Cameron & Trivedi, 1990) decomposition of IM-test. The result in Table 3.3 indicates skewness χ^2 =7.06 with *p*-value=0.8538 and kurtosis χ^2=1.01 with *p*-value=0.3143. Thus, proved the normality of the data. Additional normality test using Mardia (1970) as in Table 3.3 provides χ^2= 2.492 with *p*-value =0.1145 that proved that the data is normally distributed. This indicate that skewness and kurtosis posed no threat to the variables of the study.

Table 3.3 *Normality Test*

Tests	χ^2	*p*-value
IM Skewness	7.06	0.8538
IM Kurtosis	1.01	0.3143
Mardia Kurtosis	2.492	0.1145
Henze-Zirkler	2.522	0.1123

Furthermore, a Chow test was conducted to analyse whether intercept and slopes (parameters) of one group in the regression model are different from other groups. A regression model was estimated using interaction method on group variables. The null hypothesis for this statistical test stated that the before (group 2) and after (group 1) the revised Nigerian SEC CCG 2011 have corresponding parameters for the selected groups' variables, ACSOW, CEDU, ACIND, BGD and ACFE and their intercepts. As such, deviations of the slopes and intercepts are not statistically different from zero. However, the result of the Chow tests for the selected variable (ACSOW, CEDU, ACIND, BGD, and ACFE) provides that χ^2= 23.47 with *p*-value=0.0000, which is significant at 1 percent level. The result indicates that the coefficients of the explanatory variables are not statistically the same between the two groups. It further explained that there is evidence of policy change in the SEC CCG 2011 that impacted positively on the quality of financial reporting in the non-financial listed firms in Nigeria. Therefore, the study did not support the null hypothesis and concluded that the coefficients of these variables are statistically different across the two different samples.

3.2 Impact of Corporate Governance Mechanisms on Pre and Post-CG Code 2011

Table 3.4 presents a comparison between the earnings management (proxy) of FRQ and independent variables of the study in the pre and post-CCG 2011 period. The analytical comparison is aimed at examining whether the revised CCG 2011 has a significant impact on CG practices in enhancing FRQ of the non-financial listed firms in

Nigeria compared with the CG code, 2003. Further, the analyses would indicate the consistency of the results of the two periods (pre and post 2011).

Table 3.4 shows that the pre-period R^2 is approximately 32 percent, while the post-period R^2 is approximately 33 percent, providing evidence of an increase in the strength of the model in the CG post code 2011 period that fully explained the relationship between IV's and dependent variable in the earnings management model. However, both models are well fitted by the significance at 1 percent level. However, the regression results show that ACSOW, CEDU, BIND are positive but statistically insignificantly associated with earnings management during the pre-NGSEC 2011 CG Code. Similarly, LEV, MSOW, BIND are positive but statistically insignificantly related to EM in the post-period. However, LEV, ACFE, FA, FS, and MSOW are positive and statistically significantly related to EM at 10 percent, 1 percent, 1 percent, 1 percent, and 5 percent respectively, during the pre-CCG 2011 period, thereby enhancing EM practices as well as reducing the quality of financial reporting of the listed firms.

Accordingly, results in Table 4.4 indicate that ACSOW, CEDU and ACFE, are statistically positive and significant at the conventional level, post-NSEC CG Code 2011. While the control variables FA and FS are both positive and significantly related with EM. Conversely, ACIND appears negative and significant before and after the revised CCG 2011, signifying an inverse association with earnings management. This suggests that the changes in the revised code impacted positively on the earnings quality of the non-financial listed firms in Nigeria. Hereafter, earnings management practices in the non-financial listed firms are on the decrease. Therefore, quality of earnings is higher in the post-period SEC, CCG, 2011 than in the pre-period SEC, CCG, 2011. Thus, Nigerian SEC, Code of CG 2011 impacted positively in providing effective mechanisms for monitoring and control of earnings management practices in Nigerian non-financial listed firms. Hence, provided support for the study hypothesis H1.

Table 3.4 Regression *Result of Discretionary Accruals on Pre and Post CCG 2011*

	Pre-Code 2011			Post-Code 2011		
Variables	**Coeff.**	**t-stat**	***p*-value**	**Coeff.**	**t-stat**	***p*-value**
ACSOW	0.053	0.76	0.224	0.032	5.34	0.000***
LEV	0.001	1.51	0.067*	0.002	0.73	0.233
MSOW	0.105	1.88	0.031**	0.127	0.78	0.219
CEDU	0.119	0.87	0.193	0.265	1.74	0.041**
ACIND	-0.240	-2.61	0.005***	-0.185	-2.15	0.017**
BGD	-0.051	-1.00	0.160	-0.076	-1.19	0.118
BIND	0.286	1.11	0.133	0.137	0.62	0.269
BS	-0.004	-0.42	0.339	-0.018	-1.74	0.041**
ACFE	0.182	3.17	0.001***	0.231	4.30	0.000***
FA	0.007	3.39	0.000***	0.005	2.16	0.016**
FS	1.899	7.37	0.000***	2.159	9.38	0.000***
PRAT	-0.000	-0.11	0.460	-0.019	-0.31	0.380
Group observations	202			202		
R-Squared	0.32			0.33		
Sig.	0.000***			0.000***		

***, ** and * indicate a significant level at 1%, 5%, and 10% respectively**.** Significant at one-tailed. The dependent variable is financial reporting quality, BIND is board independence, CEDU is chief executive officer duality, MSOW is directors shares ownership, BS is the board size, and BGD is the board gender diversity. ACFE is the audit committee financial expertise, ACIND is audit committee independence, ACSOW is audit committee share ownership, LEV leverage (long-term debt), FS is firm size, FA is firm age, and PRAT is the profitability.

4.1 Conclusion

The revised SEC Code 2011 was aimed at changing the way corporations are managed. Though believed to have been mimicked from the Anglo-Saxon countries, it has been adjudged to have impacted positively in enhancing the performance of the board of directors and managers in Nigeria. Aside, the proliferation of code of corporate governance in Nigeria that lead to its weakened and non-compliance. However, the regulatory changes introduced in the SEC 2011 Code, indeed improved the financial reporting quality of the non-financial listed firms in Nigeria in the post-2011 period. The findings of this study have some implications for both theory and practice. Even though the evidence in the improvement affected specific board and audit committee characteristics, further review is required to increase and provide quota for female board membership, provide a ceiling for share ownership of executive directors. Also, in line with the agency theory, audit committee share ownership and audit committee financial expertise has proven to be of significance in oversight monitoring functions. It requires the mandatory disclosure of equity as well as the financial expertise of the entire audit committee membership not only for the non-executive board members on the committee but the three shareholders representatives on the audit committee. It would be of both investors' and regulators' interest to have a simplified and harmonised code of corporate governance issued by a particular regulatory body, which enables immediate implementation and compliance.

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