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## CORPORATE GOVERNANCE AND EARNINGS QUALITY EFFECT: EVIDENCE FROM NIGERIAN MANUFACTURING INDUSTRY

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### ABSTRACT

*The study examined the effect of corporate governance mechanisms on earnings quality of manufacturing companies in Nigeria. The study specifically examined the effect of board composition, audit committee independence, institutional ownership and executive compensation on earnings quality of manufacturing companies in Nigeria. The study adopted the Agency theory as the anchor theory while panel data was extracted from the annual financial statements of the companies for the period 2012 to 2022. Regression analysis was used for test of hypotheses. The study found that: board composition significantly and positively affect earnings quality of manufacturing companies in Nigeria ( $\beta=0.38$ ,  $z=2.42$ , and  $p=0.005$ ); there is no significant effect of audit committee independence on earnings quality of manufacturing companies in Nigeria as results revealed  $\beta=-0.32$ ,  $z=-0.84$ , and  $p=0.402$ ; institutional ownership has no significant effect on earnings quality of manufacturing companies in Nigeria ( $\beta=0.42$ ,  $z=1.02$ , and  $p=0.310$ ); and there is significant positive effect of executive compensation on earnings quality of manufacturing companies in Nigeria ( $\beta=0.42$ ,  $z=3.96$ , and  $p=0.000$ ). The study concluded that good corporate governance practice has a significant effect in reducing earnings manipulations which by extension improves on quality of earnings. Companies that have more non-executive directors in their board composition and high executive compensation in terms of shareholding and remuneration would have quality financial reports than firms whose boards of directors do not contain reasonable number of independent and directors their executive do not enjoy executive compensation. It recommended that manufacturing companies in Nigeria should ensure that more non-executive directors are included in their board composition in order to enhance effective monitoring, and that; managers of manufacturing and other companies should be encouraged to own shares in the companies they are managing as managers with shares are less susceptible to manipulative accounting practices.*

**Keywords:** agency, board composition, earning quality, manufacturing, audit committee

## 1. Introduction

Unethical accounting behavior by board members of major corporations has led to the collapse or takeover of many companies, raising questions about the credibility of the accounting profession and the effectiveness of governance structures. High-profile companies like Enron, WorldCom, Parmalat, Hollinger, Adeptia Communications, Global Crossing, and Tyco International have collapsed due to unethical and illegal operations. Nigerian corporate scandals highlight inefficient governance mechanisms, leading to increased attention to corporate financial reporting in both developing and advanced economies. The Sarbanese-Oxley Act, enacted in 2002 in the U.S., aims to improve corporate governance practices and has been adopted by many countries, Otuya, Donwa and Egware (2017).

In Nigeria, the Securities and Exchange Commission (SEC) in October, 2003 set up the Peterside Committee on corporate governance in public companies. The Bankers committee also set up a sub-committee on corporate governance for banks and other financial institution in Nigeria in the same year (Akano, 2016; Epor, Yua, Nwakoby, 2023). Also Mahmoud Abubakar Balarabe's national committee was inaugurated in September 2008 by Security and Exchange Commission for the review of the 2003 code of corporate governance for public companies in Nigeria to tackle its shortcomings and develop the system for its implementation which the new code took effect in April 2010. This is in recognition of the critical role that corporate governance plays in the success or failure of companies (Olaoye&Adewumi, 2020; Yua, Yua,& Ogbonna, 2021).

Corporate governance involves managing institutions' business to improve long-term shareholder value, enhance performance, and ensure accountability. It builds credibility, maintains transparency, and fosters good performance. It limits insider abuse, monitors manager behavior, and provides investor protection, (Okougbo&Okike, 2015; Yua, Okonkwo, Okaro,& Ogbonna, 2020; Mensah & Boachie, 2023). A good corporate governance structure is essential due to the separation of ownership from the firm and stakeholders, such as managers, employees, creditors, government, and the public. Modern business sophistication redefines the relationship between owners and managers as an agent and principal, compromising the firm's integrity. Transparency is crucial for a company to disclose financial information properly. (Soomiyol, Teghtegh, & Yua, 2023; Iyobosa, 2023).

Corporate governance is crucial for ensuring high-quality financial reporting, as it influences capital providers and stakeholders in investment, credit, and resource allocation decisions, enhancing market efficiency. Earnings quality is essential as it serves as a summary measure of a firm's performance, used in contracting and investment decisions, and forms the basis for effective or defective resource allocation. (Ityavyar, Yua, 2023; Dong, Wang, Zhang, & Zhou, 2020). Earning quality is crucial in financial reporting systems, enhancing capital market efficiency. Standard setters develop standards to improve earnings quality, with recent changes in auditing, corporate governance, and enforcement. Extant literature such as Anderson, Deli, & Gillan, (2003), Anderson, Deli, & Gillan, (2005), Al-Thuneibat (2006), Jaggi, Leung, & Gul, (2009) Torkwase, Mike, Yua, (2022). and Mashayekhi and Bazaz (2010) suggests several corporate governance attributes that enhance the quality of reported earnings. Popular among these attributes are board composition, audit committee independence, institutional shareholding and executive compensation.

A board with more non-executive directors may enhance earnings quality by reducing managerial self-interest and controlling financial statement production, thereby promoting greater monitoring and adherence to earnings quality. (Yua, Kazeem, Temitope, 2024; Tenggono, Lasdi, & Kristina, 2023). An independent audit committee ensures the credibility of financial statements provided by management. Institutional investors exert more control over company management, leading to increased earning quality. Managers' stock holdings foster a sense of ownership, aligning their interests with stockholders, resulting in improved decision quality and company value, (Yua, Kazeem, Temitope, 2024; Jensen & Meckling, 1976). In line with the above perception, the broad objective of the study is to examine the effect of corporate governance mechanisms on earnings quality of manufacturing companies in Nigeria. The specific objectives are to: examine the effect of board composition, audit committee independence, institutional ownership and executive compensation on the earnings quality of manufacturing companies in Nigeria.

## 1. Literature Review

### 2.1 Conceptual Review

The code of corporate governance provides a number of mechanisms in order to enhance effective control of companies. For the purpose of this study however, board composition, audit committee independence, institutional shareholding and executive compensation will be considered.

#### 2.1.1 Board Composition

The purpose of considering board composition is to identify the proportion of non-executive directors on the board and to assess its impact on the earnings quality made through financial reports. According to Marjen and Rashidah (2013) board composition is the proportion of outside directors to the total number of directors on the board. Thus, who the board should comprise of is another very important tool for efficient governance, and the board comprising of outside directors have the tendency of reducing agency conflict as they provide effective monitoring tool to the board (El Diriet *et al.*, 2020). The proponents of non-executive directors on the board based their arguments on agency theory. The premise of agency theory is that boards are needed to monitor and control the actions of directors due to their opportunistic behaviour (Jensen & Meckling, 1976). Marjen and Rashidah (2013) argued that the inclusion of outside directors increases the board's ability to be more efficient in monitoring the top management and to ensure there is no involvement of top managers to expropriate stakeholder's wealth as the incentive to develop their reputation as experts in decision control.

Also, then non-executive directors are expert managers from other larger organisations and with expertise and independence, objectivity and legal power (Ejuvbeokpo & Esuiké, 2013). The non-executive directors become potentially powerful governance mechanism to mitigate agency costs and protect shareholder's wealth (Ejeagbasi & Nweze; 2015). An important question of board composition concerns the ideal combination of outside and inside members. Outsiders are more independent of a firm's Chief Executive Officer, but are potentially less informed regarding firm projects than insiders. Insiders are better informed regarding firm projects, but have potentially distorted incentives deriving from their lack of independence from the firm's Chief Executive Officer (Egbunike *et al.*, 2015).

### 2.1.2 Audit Committee Independence

The concept of audit committee differs according to the goals, functions and responsibilities assigned to them. Dou *et al.* (2018) defined it as the committee that is composed of non-executive directors in the establishment. The major goal behind forming the audit committee is to increase auditing quality and questioning of board of directors. Arens *et al.* (2009) defined it as a group of persons selected from members of the board of directors who are responsible for retaining independence of the auditor. Azzoz and Khamees (2016) defines the term independence in the Malaysian context as independence from management and independence for significant shareholders. The revised Malaysian Code on Corporate Governance 2007 reinforces the desirability of audit committee independence by excluding executive directors from membership. Meanwhile, the Sarbanes-Oxley Act of 2002 requires firms to have audit committees comprised solely of independent directors who are not affiliates of the firm and not accepting any compensation from the firm other than director's fees.

Companies establish audit committees to improve quality of financial reporting practices and earning (Abbadiet *al.*, 2016). The board of directors generally delegates financial reporting responsibilities to the audit committee and hence the committee is the mechanism most likely to provide shareholders with the greatest protection in maintaining the quality of a company's financial statements and ensuring the entity's compliance with mandatory disclosures (Alhadabet *al.*, 2015). The search for mechanisms to ensure reliable, high quality financial reporting has largely focused on the structure of audit committees, whose function is to oversee the financial reporting process, as well as, the audit of financial statements. Quite understandably, expectations will be high on the audit committees that are independent to be more active and participative in ensuring the proper management of their companies. Audit committees are expected to resolve the agency conflicts and thus enhance the quality of financial reporting. The existence of an independent audit committee is likely to indicate a commitment to sound corporate governance and a high quality financial reporting. The effectiveness of an audit committee is related to the extent to which the committee is dependent, whether members have accounting and financial expertise, the frequency of its meetings and its size (Guillamon-Saorin *et al.*, 2017).

### 2.1.3 Institutional ownership

This ordinarily represents the proportion of shares owned by institutions to total number of shares issued by a firm. Institutional investors are organizations which pool large sums of money and invest those sums in securities, real property and other investment assets. They can also include operating companies which decide to invest their profits to some degree in these types of assets. Typical investors include banks, insurance companies, retirement or pension funds, hedges funds, investment advisors and mutual funds. Their role in the economy is to act as highly specialized investors on behalf of others (Fodio *et al.*, 2013).

Institutional investors, comparatively to individual's investors, have additional capability of gathering, interpreting financial reports and detecting managerial opportunism over earnings figures. Isamet *al.* (2020) noted that considering the importance of corporate governance in firm's management, shareholder's active participation in monitoring function is important to ensure good corporate governance practices. To date, institutional investors participation has

emerged as important force in corporate monitoring to serve as mechanisms to protect minority shareholders interest. The significant increase in the institutional investors shareholdings has led to the formation of a large and powerful constituency to play a significant role in corporate governance. Earnings quality, as part of accounting information, provides investors with relevant information that would help them in making correct asset pricing and investment decisions (Ali,Nwakoby,Ikeotuonye, Yua, 2020; Kankanamage, 2016). The active monitoring hypothesis views institutional investors as long-term investors with raving incentives and motivations to closely monitor management action (Isamet *al.*, 2020).

Furthermore, Lennoxet *al.* (2016) stated that institutional investors and earnings quality play a very important role in making investment decision so they insist on high quality of earnings but if they find any decline in earnings quality then they engage in monitoring activities to enhance the quality of financial report. Higher quality of financial reporting indicates lower use of discretionary accruals and vice versa. So presence of large institutional ownership helps in restraining the use of discretionary accruals.

#### 2.1.4 Executive Compensation

Agency theory aims at curbing the agency cost that arises as a result of the conflict of interest between owners (shareholders) and controllers (managers) of today's complex business setting. According to Hassan and Ahmed (2012), one of the means of reducing the agency cost is executive compensation, which is the settlement to the manager for the commitment towards the success of the firm. This settlement could be either by cash compensation or stock options (bonus plan) or the combination of both. In order to achieve the objective of shareholders' wealth maximization by converging the interest of the managers with that of the shareholders, it only makes sense that executive compensation should be based on firm performance. However, this explicit and implicit executive compensation contracts also serve as an incentive for managers to use accounting judgement to increase earnings-bonus awards (Okougbo&Okike, 2015). Thus CEO pay-for-performance can have a significant influence on the manipulation of reported earnings.

The efficient market hypothesis postulates that capital market mechanisms affect the value and executive pay directly (Olaoye&Adewumi, 2020). This in effect implies the absence of a positive link between executive compensation and performance if the market is inefficient. Suyono&Farooque (2018) assert that company executives may apply earnings management to signal to the market, to increase executive compensation and investment. They maintain that in a setting where information asymmetry is prevalent, top executives may use earnings management to increase short-run stock prices, which is closely linked to their reward packages. Conversely, earnings management raise the expectations of the outside shareholders for higher dividends based on manipulated earnings figures on the financial statements. Shin and Kim (2019) opines that corporations with high executive-equity ownership interest are less likely to manage earnings for short term private gains at the expense of outside shareholders and that corporate management whose interest is consistent with shareholders is more likely to report earnings that reflect the underlying economic value of the firm.

### 2.1.5 Earnings Quality

Some authors relate earnings quality to the accurate representation of underlying economic transactions and events. Solikhahet *al.* (2022) present the value relevance viewpoint, and an economic-based concept of income, examining attributes which specify earnings qualify, such as time series properties of earnings, including persistence, predictive ability and variability, the qualitative characteristics of a conceptual framework, the relationships between income, cash, and accruals, and the implementation of decisions. Muradet *al.* (2022) consider earnings quality as the degree to which reported income reflects operating fundamentals. Tenggonoet *al.* (2023) considered that earnings quality has two guises, first as a fundamental attribute and second as a financial reporting attribute. Fundamental earnings are the accounting profitability measure that gauges a firm's ability to make future dividend payments. Reported earnings are the imperfect signal of the fundamental earnings a firm announces. Therefore, earnings quality refers to how quickly and precisely reported earnings reveal fundamental earnings. Kankanamage, A. C. (2016) thinks that high earnings quality should be stable, predicted and reflect the trend of the income level in the future. Meanwhile, the earnings quality not only involves the income, financial activity, management characteristics but also consider income quality as a sequence creation influence. Moreover, the outside factors such as the economic environment, tax policy etc. also play important roles in deciding the company's earnings quality. Hemdanetal. (2023) note that three conditions should be satisfied before a company is considered to have high earning quality. Firstly, it reflects current operating conditions. Secondly, it as well predicts future operating condition. Thirdly, it really reflects the company's intrinsic value. Hence, they define earnings quality as a measure of how well earnings reflect the actual performance of a firm.

Eze (2017) define earnings quality to mean that reported earnings, before extraordinary items that are readily identified on the income statement, are of good quality if they are good indicator of future earnings. Thus we consider high- quality earnings to be sustainable earnings. Correspondingly, when an accounting treatment produces unsustainable earnings, we deem those unsustainable earnings to be of poor quality. The financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) did not define earnings quality in their common Conceptual framework, but list a number of qualitative characteristics that should achieve a high quality, including relevance, faithful representation, comparability, verifiability, timeliness and understandability.

The long term value of the firm requires that investors should not be after how much money the business is making but how it makes the money, because companies in the winners table generate a lot of sustainable cash from their operations and as such have the best earnings quality, while companies in the losers table keep reporting with tricks as unexpected stock options, low tax rates, assets sales, off balance sheet financing, differed maintenance of pension funds.

From the above postulations, the present study conceptualize earnings quality as a measure of how reliable a company's earnings are for assessing it's current and future performance. High earnings quality would usually suggest that the earnings are free from manipulation by management and a good predictor of future earnings/cash flows that will be generated by the company. Earnings quality drives expectations of future earnings and cash flows and as such low earnings quality will generally result in lower expectations.

## 2.2 Theoretical Framework

### 2.2 Agency Theory

The agency theory developed by Jensen and Meckling in 1976 is concerned with the nature of principal-agent relationship. The agency theory is a management and economic theory that attempts to explain relationships and self-interest in business organisations. It describes the relationship between principals/agents and delegation of control. It explains how best to organise relationships in which one party (principal) determines the work and which another party (agent) performs or makes decisions on behalf of the principal (Jensen &Meckling, 1976). An agent is somebody who officially represents somebody else in business. In practice the two persons; the one who represents and the one that is represented are referred to as the agent/manager and principal/owner, respectively. The agent is expected to represent the owner. Nguyen *et al.* (2024) describes an agency relationship as one in which the principal party makes use of the second party for the purpose of utilizing the specialized skills or knowledge of the second party.

The objective of agency theory is, precisely, to reduce the agency costs derived from the principals' internal controls to keep the agents self-serving behaviour in check (Jensen &Meckling, 1976). Agency theory prescribes several governance mechanisms to protect shareholders' returns and facilitate principal-agent interest alignment. Some of those mechanisms are the design of an appropriate governance structure for the company, such as increasing the number of outside board members on the board, number of outside board members to perform audits and evaluation and ownership structure with regards to accounting information. It has been argued that managers tend to increase the amount of information provided to the owners as a means of reducing the owners' interference and to improve their position, especially when they carried out their work properly. One established way of implementing this is through qualitative financial information which significantly mitigates agency problems associated with information asymmetry (Jensen &Meckling, 1976).

Agency theory is based on the idea that in a modern corporation, there is a separation of ownership and management, resulting in agency costs associated with resolving the conflict between the owners and the agents (Jensen &Meckling, 1976). This implies that management cannot be trusted, thereby calling for strict monitoring by the board in order to protect shareholders' interest. The main concern of agency theory therefore, is effective monitoring which is achieved when board have majority of outside and ideally independent directors.

### 2.3 Review of Empirical Studies

Nguyen, Kim, & Ali,(2024) A study on corporate governance and earnings management in Vietnamese listed firms found that quality restrains earnings management. The negative association was more pronounced in private firms, firms with high foreign ownership, and high growth firms. The study concluded that corporate governance strongly influences earnings management, but failed to consider the various aspects of corporate governance collectively.

Tenggono, Lasdi, & Kristina,(2023) A study on the impact of corporate governance mechanisms on company value, focusing on manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2018-2020, found that earnings quality mediates the size of the board of directors and managerial ownership on firm value. However, earnings quality did not mediate

institutional ownership and independent commissioners on firm value. The study recommends that the board of directors maintain its supervisory function to limit the opportunity for managers to practice earnings management. However, the study's short duration of three years limits the robustness of the findings.

Hemdan, Rehman, & Khan,(2023) The study examines the impact of CEO power dynamics, corporate governance mechanisms, and earnings quality on Egyptian listed firms. It found that CEO power dynamics negatively affect earnings quality, and corporate governance's weakening or substitution role is examined. Board-independence significantly weakens the impacts of CEO-ownership and CEO-tenure on earnings quality. However, the results do not support the weakening or substitution role of board-independence for CEO-duality and CEO-political connection. Board gender diversity is not significantly associated with earnings quality, but gender critical mass serves as a substitution mechanism. The study's findings are relevant to the Nigerian setting, but the study's three-year duration may limit the robustness of the data.

Mensah and Boachie (2023) evaluates the relationship between corporate governance mechanisms and earnings management practices in sub-Saharan Africa found that board gender diversity significantly moderates the relationship between these factors. The study, the first African multi-cross-country study to introduce gender diversity as a moderating variable, recommends competent female representation on corporate boards to benefit from their superior monitoring abilities. However, the study's focus on board gender diversity may detract from other corporate governance aspects, potentially resulting in different findings.

Murad, Abdul, Obada, & Ala, (2022) examined the impact of corporate governance mechanisms on earnings management in Malaysian manufacturing companies found that board of directors' characteristics positively affect earnings management, audit committee characteristics negatively affect it, ownership structure negatively affects it, and external auditor factors do not affect it. The study recommends policymakers develop new corporate governance instructions and stakeholders to improve earnings management and financial reports, enhancing a comprehensive picture of the firm and future decision-making.

Solikhahet *al.* (2022) the study analyzed the influence of independent commissioners, audit committees, managerial ownership, and institutional ownership on earnings quality in Indonesian manufacturing companies. The research found that managerial ownership positively affects earnings quality, while firm size strengthens the influence of these ownership types. The study concluded that good corporate governance is required by the government, but the supervisory function is not fully effective. However, the study was conducted in Indonesia, which may differ from Nigeria due to economic conditions and industry factors.

Shahroor and Ismail (2022) A study conducted in the UAE banking sector examined the impact of corporate governance mechanisms (CGMs) on earnings management. Data from 2009-2020 was collected from national banks. The study found that audit committees and ownership structures were ineffective in mitigating managers' opportunistic earnings management activities. Board characteristics also had a diminishing effect on earnings management. The study suggests that policymakers should strengthen CGMs and enforce strict adherence to measures to reduce earnings management activities.

Akporien (2021) The study examined the relationship between corporate governance mechanisms and earnings management practices of Nigerian listed consumer goods companies. Data from secondary sources from 2019 to 2020 showed a negative but not significant relationship between board size and board independence and audit committee independence. The study concluded that good corporate governance minimizes earnings management practices and recommended companies adopt manageable board sizes to improve financial reporting quality. However, the study's limited data robustness made the findings less reliable.

Iyobosa (2021) A study on corporate governance and earnings management in Nigerian manufacturing companies found no significant effect of corporate governance on earnings management. The research used a sample of 49 listed firms and analyzed data using descriptive and inferential statistics. The results showed no significant effect of board meeting frequency, board gender diversity, or board size on earnings management. The study recommends companies adhere to corporate governance codes to increase positive perception among investors and users. However, the study did not consider important aspects of corporate governance, such as institutional ownership and executive compensation. The findings highlight the need for companies to adhere to ethical practices.

El Diriet *al.* (2020) A study on corporate governance and earnings management in concentrated markets found that firms in concentrated markets use more accrual and real earnings management than those in non-concentrated markets. Quality corporate governance, such as tenured, qualified, and independent boards, is more effective in mitigating earnings management in non-concentrated markets. The study recommends regulators and auditors work on preventing real earnings management in concentrated markets, emphasizing the role of independent board members in evaluating management choices and economic decisions.

Olaoye and Adewumi (2020) A study on corporate governance and earnings management in concentrated markets found that firms use more accrual and real earnings management. Board size, independence, and gender diversity significantly impact earnings quality, especially with discretionary accruals. The study recommends more board independence and diversity for non-concentrated markets and suggests regulators and auditors prevent real earnings management.

A study by Shin and Kim (2019) The study explores the impact of corporate governance on earnings quality and market reaction to low-quality earnings. It found that earnings accuracy is crucial for a firm's sustainability and cost of capital. The study found that firms with independent board of directors and foreign ownership had lower earnings gaps, suggesting better governance. Investors' reactions to the earnings gap varied, with less negative returns for firms with independent board of directors and more negative ones with foreign ownership. The study highlights the importance of effective corporate governance mechanisms for maintaining high-quality earnings.

Suyono and Farooque (2018) The study investigates the influence of corporate governance mechanisms on earnings management practices and CSR disclosure in manufacturing companies listed on the Indonesian Stock Exchange. Results show that institutional ownership, managerial ownership, and independent boards deter earnings management, while institutional ownership and board of directors positively impact CSR. The study also finds a strong moderation effect of earnings management and a positive link between governance and CSR.

Eze (2017) The study explores the impact of corporate governance mechanisms on earnings management in Nigerian food product companies. Data from six firms from 2003 to 2014 was analyzed using descriptive statistics and correlation techniques. Results showed that board meetings negatively affect earnings management, while audit committee meetings positively affect it. The study also found that size of the firm positively affects earnings management. The findings support the application of corporate governance principles to ensure adequate supervision of earnings management practices. However, the study's limitations include its limited focus on a 12-year period and the use of earnings management instead of earnings quality.

Otuya *et al.* (2017) The study examines the relationship between earnings management and corporate governance quality in Nigeria. Data from financial statements of companies listed on the Nigeria Stock Exchange was analyzed. Results showed a significant negative relationship between quality of corporate governance, audit committee strength, and executive compensation. The study recommends strengthening audit committees by emphasizing independence and active member participation.

Akano (2016) The study examined the influence of corporate governance mechanisms on earnings management in non-financial firms in Nigeria. It analyzed data from 159 firms listed on the Nigerian Stock Exchange between 2006 and 2014. The results showed a non-linear trend with a fluctuating direction, with the computer and office equipment sector having the highest trend. Board sex ratio and return on assets positively influenced earnings management, while board independence and managerial ownership negatively impacted it. However, the study did not directly focus on earnings quality.

Bukar *et al.* (2016) The study examined the impact of institutional ownership on earnings quality of Nigerian listed food/beverages and tobacco firms from 2005-2013. The data was analyzed using descriptive statistics, Pearson correlation, and panel data regression. Results showed that institutional shareholding is a crucial monitoring and control device, preventing abuses, improving earnings quality, preventing fraud, and maximizing shareholder wealth. The study recommends mandating institutional shareholders to have stakes in most firms to reduce opportunistic behavior.

Hussaini and Gugong (2015) The study analyzed the relationship between audit committee characteristics and earnings quality of listed food and beverage firms in Nigeria from 2007 to 2014. Results showed that audit committee independence positively and significantly correlated with earnings quality. The study recommended that firms in Nigeria comply with the Companies and Allied Matters Act (CAMA), 1990, and SEC Code of Corporate Governance regarding audit committees with six members, three shareholders, and three directors.

Okougbo and Okike (2015) A study in Nigeria found a positive relationship between CEO duality, board size, and earnings management in the private sector. The study found that return on assets is the only control variable with a significant positive relationship with earnings management. The study suggests policymakers should encourage firms to maintain increasing profits to prevent downward earnings management.

Lawal (2014) The study examined the impact of ownership structure on earnings quality of Nigerian listed Deposit Money Banks. It found that institutional shareholding significantly correlated with earnings quality. The study used a purposive stratified sampling technique and secondary data from 2006-2012. The findings suggest that investors should consider institutional shareholding when making investment decisions, as it ensures the reliability of reported earnings.

Kurawa and Saheed (2014) This study examines the relationship between corporate governance and earnings management in Nigerian petroleum and petroleum products distributors. Data from annual reports and accounts from 2003 to 2012 was collected. Results showed a significant positive relationship between board composition and management equity holding, while board size, CEO duality, and ownership concentration showed an insignificant negative relationship. The study recommends separating the Chairman and Managing Director positions, encouraging a competent board size of 8 to 15 members, and upholding ethical accounting standards to prevent going concern problems.

Alves (2014) examined effect of board independence on earnings quality; evidence from Portuguese listed companies using ordinary least square and two stage least squares techniques to control potential simultaneity problems between board composition and earnings quality on a sample of 33 Euronext Lisbon non-financial firms over a period of 8 years (2003 to 2010). They found evidence that non-executive board members improve earnings quality by reducing earnings management. This finding suggests that strengthening the independence of boards by appointing more non-executive board members is a positive step towards improving earnings quality.

Hassan and Ahmed (2012) A study on Nigerian manufacturing firms found that corporate governance significantly impacts both adjusted and unadjusted firm performance. Board composition is inversely related to true performance, while executive compensation positively interacts with firm performance, regardless of performance specification. The study used univariate OLS multiple regression analysis.

Mashayekhi and Bazaz (2010) A study on corporate governance in Iran aimed to examine the relationship between governance mechanisms and accounting earnings quality. The research focused on the impact of a strong, religious-based central government and the influence of factors such as board size, independent directors, board leadership, and board meetings. The study found that larger board sizes resulted in weaker earnings quality, while increasing independent directors and frequency of board meetings strengthened earnings quality. However, leadership structure did not significantly affect earnings quality. The study recommends further improvement in corporate governance and the transfer of ownership from government to the public. However, the study's focus on Iran and the period 2005-2008 may result in varying findings.

### 3.0 METHODOLOGY

#### 3.1 Research Design

The study is concerned with documentary investigation of the effect of corporate governance mechanisms on earnings quality of manufacturing companies in Nigeria. The research design adopted for this study is ex-post facto research design.

#### 3.2 Population of the Study

The population of the study is forty three (43) manufacturing companies listed on the Nigerian Stock Exchange as at December, 2023. The Nigerian Exchange group (NGX) regulates the Nigerian Capital markets and as such all legally qualified companies have their securities listed on the NGX.

#### 3.3 Sample Size and Sampling Procedure

The sample size for the study is 20 industrial and consumer goods manufacturing companies listed on the Nigerian Exchange Group (NGX) as at December, 2023. The study focused on the impact of corporate governance mechanisms on earnings quality of Nigerian listed manufacturing companies using purposive sampling. Only companies that fully adopted these mechanisms and consistently published their annual accounts were selected, avoiding companies that became public or liquidated mid-study.

#### 3.4 Method of Data Collection

Secondary data was adopted for the study which was collected from the annual reports of the sampled listed 20 manufacturing companies obtained through the Nigerian Exchange group as at December, 2023. The data for the study were extracted from the financial statements of listed manufacturing companies for the period 2013 – 2023. In addition, relevant literature on creative accounting as it relates to profitability was extracted from journal articles. The collection was mainly done through the internet as the researcher visited relevant websites including that of the Nigerian Stock Exchange on several occasions to ensure adequate data capture.

#### 3.5. Model Specification

This study examines the effect of corporate governance mechanisms on earnings quality of manufacturing companies in Nigeria. Earnings quality is the dependent variable measured basically by Discretionary Accruals (DACC) used by management. Consistent with contemporary studies in earnings management (such as Dechow *et al.* 1995, and Jaggiet *al.*, 2009), a cross-sectional regression of the modified Jones Model is used to obtain the discretionary component of accruals. The choice of the modified Jones model is informed by the argument of Dechow *et al.* (1995) who note that the model is more powerful in detecting earnings management among the existing models. Total accruals (TACC) is defined as the difference between net income, which is the earnings before taxation and extraordinary item and cash flow from operating activities.

$$TACC_i = NI_i - OCF_i \dots\dots\dots(i)$$

$$TACC_{it} / A_{it-1} = \alpha_t [1/TA_{it-1}] + \alpha_{1i} [(\Delta REV - \Delta REEV) / A_{it-1}] + \alpha_{2i} (PPE_{it} / A_{it-1}) + \varepsilon_{it} \dots(ii)$$

Where TACC = total accruals (NI – OCF),  
 $\Delta$ REV = change in revenue,  
 $\Delta$ REC = change in receivables,  
PPE = property, plant and equipment and  
 $\varepsilon$  = the residual.

Al-Fayoumi, Abuzayed and Alexander (2010) noted that change in revenue is included to control for economic circumstances of each firm in the sample, while gross plant, property and equipment are included to control for the total proportion of accruals relating to non-discretionary expenses. Earnings management is measured by the discretionary accruals, which is obtained by making the error term from equation (ii) the subject of the formula. Discretionary accruals is therefore estimated as:

$$DACC_{it} = TACC_{it}/A_{it-1} - \alpha_0[1/A_{it-1}] + \alpha_1[(\Delta REV - \Delta REC)/A_{it-1}] + \alpha_2[PPE_{it}/A_{it-1}] + \varepsilon_{it}$$

The above relationship suggests that the larger the value of the discretionary accruals, the higher the presence of earnings manipulation and vice-versa.

Similarly, corporate governance mechanisms constitute the independent variable proxied by board composition, institutional ownership, audit committee and executive compensation; and it is measured as follows:

**Table 1: Independent Variable Measurement**

VARIABLE ACRONYM	VARIABLE NAME	VARIABLE MEASUREMENT	SOURCES
BC	Board composition	Proportion of non-executive directors on the board to total number of board members expressed in percentage.	Alves (2014)
AC	Audit committee independence	Proportion of non-executive directors on the audit committee to total number of the audit committee, expressed in percentage.	Hussaini and Gugong (2014)
IO	Institutional Ownership	Proportion of shares owned by institutional investors to total number of shares issued, expressed in percentage.	Hassan and Ahmed (2012)
EC	Executive Compensation	Ratio of shares owned by managers to total number of shares issued, expressed in percentage.	Hassan and Ahmed (2012)

**Source: Alves (2014), Hussaini & Gugong (2014), Hassan & Ahmed (2012)**

Hence the model adopted is based on the following functional relationship.

$$EQ = F(BC, IO, AC, EC)$$

The above relationship can be established by regression model as follows:

$$EQ = \beta_0 + \beta_1 BC + \beta_2 IO + \beta_3 AC + \beta_4 EC + \varepsilon$$

Where,

EQ = Earnings Quality (Discretionary Accruals)

$\beta_0$  = Parameter constant

$\varepsilon$  = Error Term

Apriori expectation:

$$\beta_1 > 0, \beta_2 > 0, \beta_3 > 0, \beta_4 > 0$$

### 3.6 Techniques of Data Analysis

Both descriptive statistics and multiple regression analysis were used to investigate the relationship between the variables with the aid of STATA 15 software. The choice of these analysis techniques is considered ideal because both the independent and dependent variables used in determining the correlation, for example, are continuous variables and can only be analysed using a parametric statistics. Panel data was used to account for individual heterogeneity of the sampled companies. Two steps regression was used in determining the quality of financial reports of the Nigeria listed manufacturing companies. To carry out statistical analysis using regression technique, some diagnostic econometric tests were done to avoid spurious regression results.

The tests included heteroscedasticity, multicollinearity and normality tests. Heteroscedasticity is performed to find out whether the disturbances appearing in the population regression function are homoscedastic (same variance). Also, multicollinearity test was carried out to ascertain whether or not two or more of the predictor variables were moderately or highly correlated with one another. Lastly, normality test was conducted to determine if the data used followed normal distribution so as to enhance the goodness of fit of the regression model.

The residuals for the model after inserting the sampled companies' data represents earnings quality in the second regression model specified for the study. The residual determines the accrual quality, that is, the larger the residuals, the lower the quality of accrual and vice versa. All the four hypotheses were tested at five percent (5%) level of significance (0.05).

## 4.0 RESULTS AND DISCUSSION

### 4.1.1 Normality Test

In order to determine the normality or otherwise of the data the shapiro-Wilk normality test was carried out as shown in table 2 above. A normal distribution provides a reliable basis for data analysis and the regression assumes that data is normally distributed for statistical analysis. The results have showed that the data for most of the variables were normally distributed as three of the variables have insignificant values.

### 4.1.2 Correlation Matrix

In order to ascertain the statistical moving relationship between and amongst the variables, a correlation test was carried out between the dependent variable and each of the independent variables as well as among the independent variables. The result is presented below:

**Table 3: Correlation Matrix**

pwcorr eqbc ac is ec

	<b>Eq</b>	<b>Bc</b>	<b>ac</b>	<b>io</b>	<b>ec</b>
<b>Eq</b>	1.0000				
<b>Bc</b>	0.4039	1.0000			
<b>Ac</b>	-0.0592	0.0898	1.0000		
<b>Io</b>	-0.0456	-0.2734	0.0361	1.0000	
<b>Ec</b>	0.3635	0.3485	-0.0817	-0.3247	1.0000

**Source: STATA Output, 2023.**

In order to determine the relationship between the dependent and independent variables, the result from the correlation matrix in Table 3 above indicates that EC and EQ, BC and EQ are positively correlated. The implication of this is that the paired variables move in similar direction, as one is increasing, the other is also increasing. On the other hand, AC and EQ as well as IO and EQ are negatively correlated. This means that the paired variables move in opposite direction. Amongst the independent variables, the table shows that AC and BC, IO and AC, EC and BC are positively correlated while IO and BC, EC and AC, EC and IO are negatively correlated. The above table also shows that the highest value of correlation among the independent variables is 0.34 that is between BC and EC which is far below the regression threshold of 0.7 which is considered injurious to regression analysis. This indicates that there is no problem of multicollinearity among the independent variables.

### 4.1.3 Robustness Tests

Despite the correlation found among the independent variables, robustness tests were carried out using variable inflation factor and tolerance inflation factor to examine the results of the study.

### 4.1.4 Test for multicollinearity

Multicollinearity is examined using tolerance and variance inflation factor (VIF) values. The result of multicollinearity test is shown in the table 4 below:

**Table 4: Tolerance and variance inflation factor values**

Variables	VIF	1/VIF
EC	1.23	0.811326
BC	1.20	0.836294
IO	1.16	0.865683
AC	1.02	0.975958

**Source: STATA Output, 2023.**

Table 4 shows the VIF values of the variables as being less than 10 and tolerance values being greater than 0.10. Going by the ‘rule of thumb’ (Gujirati, 2005), this reveals that the variables used do not pose multicollinearity problem. This, therefore, goes in agreement with the assumption of classical regression model which states that there should not be multicollinearity among the regressors included in the model.

#### 4.1.5 Test for heteroscedasticity

In order to find out whether the disturbances appearing in the population regression function are homoscedastic (same variance), Breusch-Pagan's test for heteroscedasticity was performed. The Breusch and Pagan Lagrangian multiplier for random effects provides the following output:  $\text{var}(u) = 0$ ,  $\text{Chi2}(1) = 2.72$  and  $\text{Prob} > \text{chi2} = 0.0990$  (STATA Output, 2023). This result shows the value of chi square of 2.72 while its probability is 0.09 which is not significant at 5%. This indicates that there is no problem of heteroscedasticity.

#### 4.1.6 Fixed and random effect tests

Fixed effect and random effect regressions were also carried out on the dataset given its panel attributes. The results of the fixed effect (F) test show that  $F(4, 205) = 27.18$  and  $\text{Prob} > F = 0.0000$ . The random effect test had an output of  $\text{allu}_i = 0$ :  $F(10, 205) = 2.07$  and  $\text{Prob} > F = 0.0287$  while the Hausman Specification test revealed  $\text{Chi2}(4) = (b-B)'[(v_b - v_B)^{-1}](b-B)$  and  $\text{Prob} > \text{chi2} = 0.6107$  (STATA Output, 2023). The result is not significant at 5% indicating that the individual effects of the predictor variables are strictly uncorrelated with the regressors and therefore the random effect result was selected.

The result was further subjected to random effect robust test to determine its reliability and it proved that the random effect was reliable as follows:  $\text{Wald chi2}(4) = 144.11$  and  $\text{Prob} > \text{chi2} = 0.0000$  (STATA output, 2023).

## 4.2 Regression Analysis and Results

**Table 5: Regression Analysis**

VRA	COEFF	Z	P>(Z)
BC	0.382194	2.42	0.015
AC	-0.3204532	-0.84	0.403
IO	0.427579	1.02	0.310
EC	0.427579	3.96	0.000
C	-02007733	3.96	0.000
R-Square:	0.2810	-0.95	0.340
Wald	144.11		
Chi2	0.0000		
Prob			

**Source: STATA Output, 2023.**

Summary of the random effect regression model result in table 5 above shows an  $R^2$  value of 0.28 and Wald  $\chi^2$  value of 144.11. The  $R^2$  value of 0.28 which is the multiple coefficient of determination signifies that 28% of variation in EQ of manufacturing companies in Nigeria is explained by BC, AC, IO and EC while the remaining 72% is caused by other factors not captured in the model. The Wald  $\chi^2$  high value of 144.11 shows the cumulative result is significant at 1 %. This means that the model is well fitted with the study variables.

## 4.3 Discussion of Findings

Test of hypothesis one which sought to establish the relationship between board composition and earnings quality revealed that there is positive relationship between the variables with regression coefficient of 0.38. This implies that for any increase in the number of non-executive directors on the board, the earnings quality of manufacturing companies would improve by 38% while any reduction in the number of non-executive directors would reduce the quality of earnings quality of manufacturing companies in Nigeria by the same percentage. This can also be deduced from the z-value of BC which is 2.42 with a probability of 0.05 significant at 5%. This implies that the relationship between board composition and earnings quality is positive and significant. Consequently, the study rejected the first hypothesis of the study which states that board composition does not significantly affect earnings quality of listed manufacturing companies in Nigeria. This finding corroborates the findings of Man and Wong (2013), Alves (2014), and Muradet *al.* (2022) which found that non-executive directors have a significant influence on earnings quality. The findings are also in line with the agency theory which postulates that the interest divergence between the owners and the managers may lead to losses for the principal,

who ends up imposing control structures upon the agent to mitigate the potential abuse of delegation and information asymmetry.

Test of the second hypothesis shows that there is a negative relationship between audit committee and earnings quality as determined by the random effect result of -0,33. Also, the z-value of AC is -0.84 with a p-value of 0.40 which is not statistically significant at 5%. This means that a unit increases in AC will lead to a 0.33 drop in earnings quality of listed manufacturing firms in Nigeria. It further implies that audit committee independence may not serve as a means of increasing earnings quality by managers. This is because; members of the audit committee might not be financially literate enough and may not have the industry experience which allows for monitoring effectiveness. The study thus accepted the second hypothesis which states that audit committee has no significant effect on earnings quality of listed manufacturing companies in Nigeria. The finding corroborates the findings of Anderson *et al.* (2003) who found that audit-committee independence does not have a greater correlation to earnings quality over board independence in the period 2001-2002. On the contrary, the findings disagreed with Husaini and Gugong (2015) who found that the proportion of non-executive directors in the audit committee, which measure audit committee independence, has positive and significant relationship with earnings quality of firms.

Furthermore, the regression coefficient of 0.12 for institutional ownership implies a positive relationship between institutional ownership and earnings quality of manufacturing companies in Nigeria. The z-value of 1.02 and the probability of 0.31 however imply that the positive relationship between institutional ownership and earnings quality is not significant. The third hypothesis which states that institutional ownership does not have significant influence on the earnings quality of manufacturing companies in Nigeria is therefore rejected. This finding supports the findings of Bao and Lewellyn (2017), and Dong *et al.* (2020) who found that institutional ownership does not significantly affect earnings quality of firms. However, this result contradicts the finding of Bukaret *et al.* (2016), Kurawa and Saheed (2014), and Okougbo and Okike (2015) who submit that institutional ownership significantly affect earnings quality of firms.

Lastly, the result shows that executive compensation has a positive coefficient of 0.43 and a Z-value of 3.96 with a p-value of 0.00. This shows that the higher the compensation value the higher the earnings quality of the company. That is a unit increase in EC of the companies will lead to 0.43 increases in the earnings quality of the firms. Thus, the p-value of 0.00 which is significant at 1 % signifies that EC positively affects earnings quality of manufacturing companies in Nigeria. Consequently, the fourth hypothesis which states that managerial ownership does not significantly affect the earnings quality of listed manufacturing companies in Nigeria is rejected. This position supports the theoretical assumption of aligning the interest of the executives with that of shareholders to reduce agency problems and ensure convergence of interests. In effect, with a higher executive remuneration, the directors would be less opportunistic, reducing the tendency to manipulate the company's financial results. The finding is also consistent with that of Waidi and Johnson (2013) who reported significant relationship between managerial ownership and earnings quality of firms. The result is however contrary to the findings of Marjen and Rashidah (2013) who found no significant relationship between managerial ownership and earnings quality of firms.

## 5.0 SUMMARY, CONCLUSION AND RECOMMENDATIONS

### 5.1 Summary of Findings

The study examined effect of corporate governance mechanisms on earnings quality of manufacturing companies in Nigeria and found that corporate governance mechanisms constitutes 28% of changes in earnings quality. The study specifically examined the effect of board composition, audit committee, institutional ownership and executive compensation on earnings quality and found that:

- i. Board composition significantly and positively affect earnings quality of manufacturing companies in Nigeria ( $\beta=0.38$ ,  $z=2.42$ , and  $p=0.005$ )
- ii. There is no significant effect of audit committee independence on earnings quality of manufacturing companies in Nigeria as results revealed  $\beta=-0.32$ ,  $z=-0.84$ , and  $p=0.402$
- iii. Institutional ownership has no significant effect on earnings quality of manufacturing companies in Nigeria ( $\beta=0.42$ ,  $z=1.02$ , and  $p=0.310$  which is more than 0.05)
- iv. There is significant positive effect of executive compensation on earnings quality of manufacturing companies in Nigeria ( $\beta=0.42$ ,  $z=3.96$ , and  $p=0.000$ )

### 5.2 Conclusion

Based on the findings, the study concludes that good corporate governance practice has a significant effect in reducing earnings manipulations which by extension improves on quality of earnings. Board composition significantly affect earnings quality of companies as independent non-executive directors play a prominent role of monitoring, management to reduce their opportunistic behaviour in managing earnings. The presence of high proportion of non-executive members on corporate board is likely to enhance the earnings quality reported by the companies. Thus, efficient monitoring from non-executive directors that are free from managerial influence is capable to improve the quality of financial information conveyed to the users of financial statement. Also executive compensation tends to reduce the chances of earnings manipulation by management. Thus companies that have more non-executive directors in their board composition and high executive compensation in terms of shareholding and remuneration would have quality financial reports than firms whose board of directors does not contain reasonable number of independent directors their executive do not enjoy executive compensation.

### 5.3 Recommendations

The study recommended as follows:

- i. Manufacturing companies in Nigeria should ensure that more non-executive directors are included in their board composition in order to enhance effective monitoring.
- ii. Audit committee independence should be strengthened and maintained by manufacturing companies in order to guarantee earnings quality.
- iii. Manufacturing companies in Nigeria should focus more on corporate governance mechanisms other than institutional ownership as it does not play a significant role in enhancing earnings quality.

- iv. Executives of manufacturing and other companies should be encouraged to own shares in the companies they are managing as this will make them less susceptible to manipulative accounting practices thereby enhancing earnings quality.

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