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Board Composition and Financial Reporting Quality of Deposit Money Banks in Nigeria

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ABSTRACT
The management of public liability companies in Nigeria is responsible for the preparation of annual financial statement of which the auditor is to attest. Thus, financial report is one of the instruments used by stakeholders in assessing the board of directors' performance. This study therefore, explored the extent at which the board composition (measured with three variables: Board size, board meeting and board independence) influence the financial reporting quality of Banks in Nigeria. The study used a sample of 15 Deposit Money Banks listed on the Nigeria Stock Exchange between 2005 and 2016. The data were analyzed and results estimated using Ordinary Least Square (OLS) Regression which was complimented with the panel data estimation technique. It was found that discretionary accrual as a proxy for financial reporting quality is positively related to Board size and board independence but relate negatively to board meeting. This study has established the fact that board composition is a key component of the quality of financial reporting quality of the listed Deposit Money Banks in Nigeria. . It is recommended that the board size of banks in Nigeria should not be too large and must meet regularly to carry out their oversight function.

Keywords: Discretionary Accrual, Board Composition, Board Independence, Deposit Money Banks, Financial Reporting Quality.

1. INTRODUCTION

Shareholders invest in the corporate governance system as a way of getting the directors to pursue their interest (maximizing returns) in a fair manner. Such investments are evident in the structure of the board (i.e. its size and independence), versatility of the board (i.e. directors' qualification and experience) and audit quality. Shareholders invest in these key areas of the corporation in order to add value to the corporate governance system which is expected to improve performance and also improve the quality of financial reports as proposed by the regulators (Mehrani & Safarzade, 2011). However, when the quality of information in the financial report is high, then shareholders' confidence on these reports is also assumes to be high and vise-versa.

Financial reporting is the means of communicating information on the activities of the company to the users of accounting information; and the quality of financial reporting is a function of the quality of accounting standards and the corresponding regulatory enforcement of the standards. Financial reporting quality can be influenced by three variables namely, standard setters' decision; accounting method used by management; and management judgment and estimates in applying the selected substitutes. Therefore, enforcement is an important mechanism of enhancing financial reporting quality whose absence will make the best accounting standards incapable of providing credible and reliable accounting information to various users (Aliyu & Ishaq 2015).

Corporate governance (CG) is a concept where management supervision takes place in the decision making process of an organization. The leadership (board) quality plays a vital role in the implementation of corporate governance as they are responsible in deciding the means to direct, control and manage resources in accordance with the company's objective.

The management of public liability companies in Nigeria is responsible for the preparation of annual financial statement of which the auditor is to attest. Thus, financial report is one of the instruments used by stakeholders in assessing the board of directors' performance. However, through specific methods, the board of directors often manipulates the financial report in the recordings of the company's book keeping activities which are referred to as earning management in accounting.

As observed by Aliyu and Ishaq (2015), following high profile accounting scandals at the turn of the century involving corporate firms such as Xerox, Enron, WorldCom, Adelphia, Tyco, Parmalat, One-Tel, HIH, and Cadbury Nigeria PLC, serious concerns have been raised about corporate governance practices in general and sharp focus have been given to the issues relating to quality of financial reporting and the weak internal control systems in corporate firms. The collapses of such large corporations in the past have highlighted the intentional misconduct of managers. There is also concern about the weakness of CG in the past, as it was not effective enough to protect investors from expropriation. These problems are envisaged to be much more significant in emerging markets where many market imperfections continue to persist.

In Nigeria, concerns have been expressed about the large scale malpractices and abuse of the system by capital market operators in the past, especially following the recent incidence on the sale of forged shares of publicly quoted companies (Aliyu & Ishaq 2015). Companies have gone into liquidation for reasons bordering on ineffective or non-existing system of CG. Examples are Onwuka Hitech, Abacus Merchant Bank and others (Dabor & Tijjani 2010).

In response to calls for strengthening corporate governance mechanism to enhance the oversight function of the Board of Directors and to restore public confidence in the integrity of financial reporting, the Security and Exchange Commission promulgated the Nigerian Code of CG in 2003 which was later reviewed in 2011 to enhance its effectiveness. This Code requires companies listed on the Nigerian Stock Exchange to appoint independent directors and supervisors, including at least one financial expert, and to establish an audit committee. This study therefore, explores the extent at which the provisions, especially in relation to board composition, influence the financial reporting quality of firms in Nigeria with particular focus on the Deposit Money Banks in Nigeria. To accomplish this, the paper is divided into five sections namely introduction, literature review, methodology, results and discussions, and finally conclusion and recommendations.

2. LITERATURE REVIEW AND THEORETICAL FRAMEWORK

Board comprises both executives and non-executive directors. Non-executive directors act as mechanism that enhances efficient monitoring. Non-executive directors help to curtail managerial excesses that are capable of lowering the quality of accounting information conveyed to the users of financial statements (Higgs, 2003).

Board composition (usually measured as the proportion of non-executive directors on a board) indirectly reflects the independence of board and monitoring role of non-executive directors. An effective board should monitor financial discretion and should ensure that accounting choices made by the management are valid (Kent & Stewart, 2008). The ability of the board of directors to act as an effective monitoring mechanism is dependent upon its independence from management (Beasley, 1996). From an agency perspective, independent directors are expected to provide shareholders with greater protection in monitoring management. This superior monitoring ability can be attributed to the incentive to maintain their reputation in the labour market.

Nigerian and international CG guidelines recognized the importance of the monitoring by non-executive directors in ensuring the quality of financial report (Organization for Economic Cooperation and Development (OECD), 1999; Australian Securities Exchange (ASX) Corporate Governance Council, 2007; SEC, 2011; FRCNA, 2011). These guidelines suggest that the best practice regarding board composition is the one having majority of non-executive or independent directors.

Prior studies on the association between CG and financial reporting quality documented mixed results between the presence of outside directors and financial reporting quality (Klein, 2002; Xie, Davidson & DaDalt, 2003; Abdul Rahman, & Ali 2006; and Rubin and Segal, 2012) . In board composition, this study examined the size of the board (i.e. the number of directors on the board) and the independence of the board (i.e. the percentage of independent directors on the board) in relation to the quality of financial report. Prior studies have revealed contradictory results on the relationships between board size, board independence and financial reporting quality.

Board Size and Financial Reporting Quality

Fama and Jensen (1983) view the board as the firm's highest-level control mechanism, with ultimate responsibility of overseeing the activities of the firm. The literature on restatement, fraudulent financial statements, and financial reporting quality in general indicates that the composition and characteristics of the board influence its effectiveness in this regard. Board size is another determinant of financial reporting quality, the larger the board the more complex it will be as regard decision making. The size of the board of directors is often used by some scholars to measure the quality of corporate governance. Many scholars argued that the assertion that larger board size connotes viable governance is a misconception. On the contrary other scholars debunked the assertion that larger size boards are better off. Extant literature shows that board size play a significant role in directors' viability to check on managers. Lipton and Lorsch (1992) and Jensen (1993) argue that large board gives room for rowdiness which in turn lowers the monitoring function of the board. Contrary to this Adams and Mehran (2002) argue that some organizations need larger boards for effective monitoring. This is also supported by Chaganti et al. (1985) who opine that large boards are useful for the breadth of their function. Klein (2002) finds that disintegration of board members into different committees largely depends on the size of the board. Monks and Minow (1995) further suggest that larger boards are able to commit more time and effort to monitor management.

Beasley (1996) reports that board size has positive relationship with the likelihood of financial statement fraud while Carcello and Nagy (2004) and Farber (2005) found negative relationship between financial quality and board size. Jensen (1993) and Lipton and Lorsch (1992) report that large boards of directors are less amenable to effective monitoring and easier to be controlled by the CEO. Xie, Davidson and Dalt (2003) document an inverse relationship between the size of the board and the quality of financial reporting. On board size, Jensen (1993) among other early studies revealed that a small number of directors will foster a high degree of coordination and communication between them and managers, which is expected to increase the quality of financial reports. Bradbury, Mark and Tan (2006) argued through their findings that a large board size may awaken elements of managerial entrenchment. It also increases coordination and communication problem, hence, declining directors' ability to oversee management. The studies of Vafeas (2005) also found that a large board size tends to reduce the information content of income and also increases earnings management.

Board Independence and Financial Reporting Quality

Klein (2002) revealed through their findings that an independent board mitigates earnings management. Bushman and Vafeas (2005) concluded that information quality increases with the increase in percentage of outside or independent directors. In other contexts, Firth, Fung and Rui (2007) indicated that the presence of independent directors improves he earnings quality of Chinese firms. Dimitropoulos and Asteriou (2010) also confirmed this finding using a sample of Greek firms. While Nesrine and Abdelwahid (2011) concludes that although board independence improves earning quality, but in the case of Tunisian firms, this may not be possible given the limited number of independent directors and the high frequency of CEO duality. However, the studies of Petra (2007) established that the independent directors are not competent enough to control the managers, and that their presence on the board have no effect in ensuring financial reporting quality.

Many scholars are of the opinion that independence board has impact on financial reporting quality. Fama and Jensen (1983) opine that one of the key functions of non-executive directors is to ensure that the board does not collude with management. Prior studies (Klein; 2002, Davidson et al., 2005) documented a positive relationship between board independence and financial reporting quality. Kao and Chen (2004) report negative relationship between financial reporting quality of firms in Taiwan and Hong Kong. Park and Shin (2004) on the other hand, did not find any significant relationship between reporting quality and independence board for Canadian firms. Abdullah and Mohammed (2004) did not also find any significant association between board independence and financial reporting quality of Malaysian firms.

Peasnell, Pope and Young (2005) document a positive relationship between the size of the board of directors and the accounting quality.

Board Meeting and Financial Reporting Quality

Another board characteristic is frequency of meeting. Board of directors need to be active to meet their CG commitments, particularly in ensuring high quality, transparent reporting in annual reports. Boards that meet frequently are more likely to perform their duties diligently and effectively. Diligent boards are also likely to enhance the level of oversight of the financial reporting process directly and indirectly through the choice of external auditor and the composition of the audit committee (Yatim, Kent & Clarkson 2006).

Xie, Davidson and DaDalt (2003) argued that board that meets rarely may only have time for signing of management plans and listening to presentations; hence, they may not have time to focus on issues such as earnings management or financial statement fraud. In other words, they found that earnings management was significantly negatively related to the number of board meetings. On the other hand, Adams, Hermalin and Weishback (2008), found that directors who primarily monitor management perceives that they participate less in boardroom discussion than other directors and that the CEO often asks them for advice.

3. METHODOLOGY

The population of the study consists of all the 20 Deposit Money Banks in Nigeria. However, all the 15 Deposit Money Banks that are quoted on the Nigeria Stock Exchange were selected for the study. These banks were considered because they are listed on the Nigerian Stock Exchange market which therefore enabled researcher to have easy accessibility to their annual reports which is the major source of the secondary data. Financial reports of the banks for the period 2005-2016 were considered. This 12 year period allows for a significant lag period for banks to have reviewed and implemented the recommendations by the CBN post consolidation code.

For the purpose of this study, three sets of variables were considered namely the independent, the dependent and control variables. The independent variables were board composition attributes (board size, board independence and board meetings); financial reporting quality is the dependent variable and was proxy by the discretionary accounting accrual. Bank size was used as control variable.

Model Specification

The implicit economic model used in this study is given as: $Y = f(x_i) + \varepsilon$

Where, Y is the dependent variable; f(x) comprises β0 (constant) and a set of β_i's which are the coefficient of the explanatory variables (board composition characteristics), and ε is the random effect (assumed to have zero mean and independent across time period).

Explicitly, the regression model is specified as:

$$FRQ_{it} = \beta_0 + \beta_1 BRDSIZ_{it} + \beta_2 BDIND_{it} + \beta_3 BDMTG_{it} + BNKSIZ_{it} + \varepsilon_{it}$$

Where;

FRQ_{it} represents quality of financial reporting measured by discretionary accruals for bank *i* in year *t*

$BRDSIZ_{it}$ represents board size measured by the number of directors on the board

$BRDIND_{it}$ represents board independence measured by the proportion of independent non-executive directors on the board

$BRDMGT_{it}$ represents frequency of board meetings measured by Number of times the board met during the financial year

$BANKSIZ_{it}$ represents Bank size is measured as the log of total assets of each bank

4. RESULTS AND DISCUSSION

The Relationship between Board Composition and Quality of Financial Reporting

This section establishes the correlation and regression result of the relationship between board composition and the quality of financial reporting of listed deposit money banks in Nigeria.

Table 1: Pearson's Correlation Coefficients Matrix for Model

	DAC	BRDSIZ	BRDIND	BRDMTG	BKSIZ
DAC	1				
BRDSIZ	0.1267	1			
BRDIND	-0.0221	0.3879	1		
BRDMTG	-0.2177	-0.2294	-0.0278	1	
BKSIZ	0.1911	0.3387	0.1249	-0.0917	1

Source: E-views result extract, 2017.

From the correlation result in Table 1, bank size and board size are positively correlated while board independence and board meeting are negatively correlated to the financial reporting quality of deposit money banks in Nigeria. In the same vein, all the variables; board size, board independence, board meeting and bank size are statistically and significantly related to the financial reporting quality of the listed deposit money banks in Nigeria as indicated in Table 1 and 2. The Pearson correlation matrix however, depicts that the variables are weakly correlated because their values are not closer to 1 as indicated in Table 1

Hypothesis:

There is no significant relationship between board composition and quality of financial reporting

Model:

DAC = 0.7 + 0.009*BRDSIZ +0.02*BRDIND+0.03*BRDMTG + 0.15*BKSIZ

The model above is derived from Table 2 below.

Table 2: Regression Result for the Model

	OLS				RE			
Variable	Coefficient	Std. Error	t-Statistic	Prob.	Coefficient	Std. Error	t-Statistic	Prob.
C	0.676798	0.4766	1.4202	0.1579	0.62173	0.452	1.377	0.1709
BRDSIZ	0.008555	0.0157	0.5455	0.5863	0.00816	0.015	0.554	0.0502
BRDIND	0.01643	0.0218	0.7525	0.0453	0.01622	0.021	0.789	0.0418
BRDMTG	0.026664	0.012	2.2208	0.0281	0.02508	0.011	2.194	0.0313
BKSIZ	0.150903	0.0823	1.8346	0.0069	0.13993	0.078	1.798	0.0244
R-squared	0.815291	Mean dependent var		0.0226				
Adjusted R-squared	0.053268	S.D. dependent var		0.421				
S.E. of regression	0.409659	Akaike info criterion		1.0894				
Sum squared resid	21.81667	Schwarz criterion		1.197				
Log likelihood	-68.5312	Hannan-Quinn criter.		1.1331				
F-statistic	2.884893	Durbin-Watson stat		1.9842				
Prob(F-statistic)	0.025035							

Source: E-views result extract, 2017.

Note: **, * significant at 1%, and 5% respectively

The OLS regression results displayed in Table 2 reveal the cumulative R^2 (0.82) which is the multiple coefficient of determination gives the proportion or percentage of the total variation in the dependent variable explained by the explanatory variable jointly. Hence, it signifies 82% of total variation in FRQ of Nigerian listed deposit money banks is caused by their board size, board independence, board meeting and the size of the bank. Similarly, the result of the F- statistic value of 2.88 implies that the model is well fitted and significant at 5% considering the rule of thumb of 2. Therefore, the model is fit and the explanatory variable are properly selected, combined and used as substantial value of the reporting quality is accounted for by the explanatory variables. The regression results as shown in Table 2 indicate that board size in both OLS and RE have positive relationship and statistically significant at 5% level of significance. This implies that as the value of board size increase, the quality of financial reporting rises. This implies that board size improves the quality of financial report. This is consistent with the findings of Adams and Mehran (2002)

The regression results in Table 2 reveals that board independence is positively related and statistically significant at 5% level of significant with FRQ. Expectedly Board Independence has a positive coefficient in both OLS and RE estimations. This implies that the independent director has the ability to monitor and control the excesses of the executive directors, thereby protecting and defending the interests of the shareholders and other stakeholders. The board independent is therefore free from managerial influence and capable of monitoring them efficiently which improve the quality of financial information conveyed to the users of financial statement in the bank. In addition, this study finds that the increase in the percentage of independent director in the board has a positive role in determining the quality of earnings of Nigerian banks. This may be as a result of outside members not playing a direct role in the management of the bank. Their existence may provide an effective monitoring tool to the board and thus produce higher quality financial reports. Besides, outside directors have incentives to carry out their monitoring tasks more effectively, not collude with top management in expropriating shareholder wealth and objectively question and evaluate management performance.

Board meeting has a significant positive relationship with FRQ of the listed banks in Nigeria in both OLS and RE regressions. This implies that frequency of meeting increases the level of earning management which in turn increases the quality of financial reporting as established in Yatim, Kent & Clarkson (2006) contrary to the submission of Xie, Davidson and DaDalt (2003). The positive relationship between board meetings and the quality of earnings in the bank industry can be attributed to the inclusion of financial expert as one of the variables of the study.

Bank size has a significant positive relationship with FRQ of the listed banks in Nigeria in both OLS and RE regressions. This implies that as the size of the bank increases, the quality of financial reporting equally increases. The positive relationship between bank size and the quality of earnings in the bank industry can be attributed to the large number of available banks in Nigeria.

The OLS regression results reveal the cumulative R^2 of 0.82. The R^2 of 0.82 implies that about 82% of total variation in the dependent variable is accounted for by the independent variables jointly. This further shows that the model is a good fit. Table 2 also shows that board size and board meeting in the RE estimates have negative and insignificant ($p < 0.05$) influence on financial reporting quality of listed deposit money banks in Nigeria.

Therefore, the results provide premise not to accept the hypothesis that there is no significant relationship between board composition and quality of financial reporting of listed deposit money banks in Nigeria.

5. CONCLUSIONS AND RECOMMENDATION

This study concluded that board composition is a key component of the quality of financial reporting quality of the listed deposit money banks in Nigeria. This implies that consideration should be given to the board size, board independence, board meeting and bank size in an attempt to x-ray the relationship between earnings quality and board composition.

Every study has its own limitations; this study is not an exemption. The possible limitations of this study include the proxy used for reporting quality in this study which has its own defect and therefore cannot guarantee a perfect result and the study was restricted to banking sector of the economy. However, these limitations have not affected the result of our findings.

It is recommended that the board size of banks in Nigeria should not be too large and must be meeting regularly to efficiently carry out their oversight functions.

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