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THE EFFECTS OF EARNINGS QUALITY ON THE SHARE PRICES OF QUOTED CONGLOMERATE FIRMS IN NIGERIA

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Abstract

This paper investigated the impact of earnings quality on the share prices of quoted Conglomerate firms in Nigeria. The sample of the study is 100% of the population. The study employed the use of multiple regressions as a tool of analysis to examine the impact of discretionary accruals, earnings persistence

Keywords

Earnings Quality, Accruals Quality, Share Prices, Quoted Conglomerate Firms, Nigerian Stock Exchange and Capital Market

INTRODUCTION

Earnings are firms' specific information provided in the financial statements and this presumption is supported by empirical researches. Liu, Nissim and Thomas (2002) in their study argued that earnings perform the best and investors rely on reported earnings more than other performance measures. Francis, Schipper and Vincent (2003) also concluded that earnings are the preferred metric which dominates cash flows in explaining security returns in industries. Graham, Harvey, and Rajgopal (2005) provided survey evidence indicating that chief financial officers believe earnings, not

and earnings variability on share prices of quoted conglomerate firms in Nigeria. The study revealed a positive and significant impact of discretionary accruals, earnings persistence on share prices. However, the impact of earnings variability on share prices was found to be negatively significant. The study concluded that earnings quality has significant impact on share prices of quoted Conglomerate firms in Nigeria. Therefore, it was recommended that the management of quoted conglomerate firms in Nigeria should make declaration upon the quality of the reported earnings in their annual reports and accounts.

cash flows to be the key metric considered by outsiders, and thus, managers perceive large market penalties if the firm does not reach quarterly earnings targets. DeAngelo (1986) also stated that "earnings are also used by courts to assess fairness, should outside stockholders litigate, as they typically do in buyouts."

The financial analysts and managers of the companies mostly use earnings numbers instead of equity, sales or any other summary measure when they express expectations about the performance of the firms because outsiders heavily rely on earnings. Conversely, recent worldwide accounting scandals have led accounting regulators to provide deeper analysis on the volume and types of fraud in the market. Many of those reports indicated that most of the fraudulent financial reporting cases were those on fraudulent earnings (Securities and Exchange Commission (SEC), 2002). Since earnings as a measure, is crucial for users of company information, assessment of earnings has been a critical task for academics, analysts, investors, standard setters, and regulators for years. Barragato and Markalevich (2003) also discussed with regards to the users of earnings information. They argued that earnings and the varied metrics derived from it are utilized in making contracting and investment decisions. According to them, low quality of earnings may cause defective resource allocation for investment decisions and unintended wealth transfers for contracting decisions. Cormier, Magnan and Morard (2000) discussed that earnings under the contractual perspective are earnings which are posited to be the basis of an implicit contract between investors and managers. Ball and Shivakumar (2005) also emphasized the usefulness of earnings to investors, creditors, managers and all other parties contracting with the firm.

Patell (2014) defined the five broad earnings information using areas of economic activities or markets as follows; (a) Equity capital markets use earnings as a proxy for stock prices, (b) Debt capital markets use earnings while organizing debt covenants, (c) Labor markets use earnings as an instrument for performance measurement, (d) Material and product markets use earnings in supplier-customer transactions, and (e) Political markets use earnings in taxing, tariffing, rate of return regulations, special industry subsidizations. Stock pricing emerged when double entry book keeping was invented in the fourteenth century. This led to company's valuation which was based upon ratios such as price per unit of earnings from income statement, price per unit of net worth of the company from balance sheet, and price per unit of cash flow from cash flow. With the advancement in technology, a price is being attached to individual share rather than the whole company or price per unit of dividend. Thus, discounting cash flow is based on the time value of money in order to estimate the value of stocks (Coleman, 2006).

Lee, Li and Yue (2016) posited that the market uses dividend discounted model to value firm's share. Firms with higher growth rate have higher price responsiveness which triggers larger amount of managed earnings and larger firms are expected to have lower earnings quality. The bed rock of most modern economies is the stock exchange markets serving a critical role of raising fund at a reasonable low cost when compared with other sources such as borrowing. The stock market serves two main functions; linking companies that need funds to set up new business or expand their operations with those that have excess and provide a regulated market where it is governed by appropriate government agent. In the regulated market, conditions of supplying the goods and services as well as the price to be charged is being monitored (Sunde & Sanderson, 2017).

The Nigerian Stock Exchange is a free market where buying and selling of shares at a price determined by supply and demand notwithstanding the other macroeconomics. Quoted Companies do borrow from banks to meet their short term cash requirements. Conversely, when the need for long term fund arises, they sell their ownership interest in the company to the public in form of Public Offerings and also borrow from the public through the means of selling debentures. Shares do exist to enable companies in need of long term financing to sell pieces of their equity securities in exchange for cash. These publicly held shares may later be traded to other investors in the stock market. According to the Nigerian Stock Exchange (2018), almost all the Nigerian formal deposits went through the banking system before 1961, while the then colonial masters invested major capital balances for the country on the London stock exchange. However, the establishment of the Central Bank of Nigeria (CBN) in 1959, paved way to the incorporation of Lagos stock exchange in 1960 which commenced operations in 1961. The Nigerian stock exchange is a private and non-profit organization limited by guarantee. It was incorporated via the support of businessmen and the federal government through the CBN owned by about three hundred (300) members. The members include financial institutions, stock brokers and individual Nigerians of high integrity who contributed to the stock market and the economy at large (The Nigerian Stock Exchange, 2018).

Onyiuke et al (2015) affirmed that the exchange provides an avenue for foreign investors after the replacement of Nigerian Enterprise Promotion Decree of 1989 with the Nigerian Investment Promotion Commission Decree No.16 of 1995. As a result of the window created by the above mentioned Decree and the existence of NSE, foreign investors injected a total of US $654 million in Nigerian banks between 2005 and 2006 during the banking sector consolidation exercise. In 2007 alone, foreign investors account for about 47% of the exchange total capitalization.

This paper is therefore motivated by the fact that accruals are essentially temporary adjustments that shift cash flows across periods. The main benefit of this shift is that the adjusted numbers present a more accurate position of the economic performance of the firm given the managers have no hidden motivation for the adjustment.

STATEMENT OF THE PROBLEM

One of the major objectives of financial statement preparation is to provide information facilitating performance evaluation of a company and to assess the extent to which current performance is indicative of future performance and as well determine whether the current stock prices reflect intrinsic firm value (Dechow & Schrand, 2013). Earnings management compromises of financial reporting system as reported earnings are being impaired by management through the use of their discretion. Different categories of stakeholders (academic researchers, professional accountants and regulatory bodies in accounting among others) in the accounting profession have over the years been working round the clock in an attempt to contain and even eradicate the problem, but little success is recorded. The recent scandals of Enron, WorldCom, Adelphia communications and Fannie Mae in the US, among others are forceful reminders that investors could lose billions of Dollars/Naira by not paying the necessary attentions on how companies reported their earnings. This has drawn the attention of researchers, analyst worldwide to investigate the quality of financial statements of firms.

A quality earnings figure is relevant in measuring company's performance or is one that reflects the company's current and future operating performance and is a useful summary measure for assessing firm value, conversely, can it be evidently ascertained that, it is obtainable in the conglomerate firms? Measuring earnings quality arose out of a need to dig into what managers do hide in financial statement to alter financial reports to mislead some stakeholders about the underlying economic performance of the firm. It is also used to influence contractual outcomes that depend on reported accounting numbers and a desire to recognize differences in quality for valuation purposes over a given period. Management that engages in this practice do create a more risky atmosphere for investors and other users of financial statement, thereby, making them very difficult in decision making processes.

Accruals, as one of the component, of reporting quality are the function of a company's business transactions and any change in company's accruals within periods should be consistent with the change in business transactions. However, if this change cannot be explained by a change in company's business activities, then those accruals can be easily assumed as discretionary. The users of the financial statement hardly figure out this discretionary accruals and therefore assume that the earnings are of quality ones. Where this occurs, the firm value will be mispriced, due to the misrepresentation in the financial statements. Earnings persistence is the degree to which earnings performance persists into the next periods. The ability of earnings to persist into the next periods implies higher auto-correlation in earnings which is one of the features of high quality earnings. Similarly, persistent earnings are meant to improve the ability of earnings to capture value-relevant information. But considering a company that has reported a particular figure of earnings in each of the past few years, the earnings number is persistent and has low volatility, but it may not be relevant for measuring anticipated growth, and by implication reduces its usefulness for valuation.

Moreover, the market is assumed to be efficient and that stock prices quickly reflect all publicly available information. Where investors are fixated on one metric as a means of measuring the quality of earnings and ignore others, then the stronger association (between earnings and stock prices or stock performance) indicates only that, investors and other users of financial statement used a particular number in valuation, not that they should have. The association of earnings and business risk is also another challenging area to managers because, it includes the effect of cyclical and other business forces on earnings level, stability, sources and its variability. Usually, it is normal to realize that earnings varies from one accounting period to another, but the question here, is the variation as a result of the real activities of the firm or by the smoothing from managers to save their interest? Consider smoothing the opposite of variability of earnings, Lev (1989) emphasizes that the role of earnings is to provide investors with information about future securities' returns. Thus, the earnings with higher predictive power of future returns are of higher quality. Smoother earnings stream lowers the expected costs of dealing with shareholders and strengthen the relationship between accounting earnings and market returns, given the extent to which earnings reflects operating fundamentals of firm. Are managers not tempted to artificially smooth the reported earnings?

Unpredictable earnings are seen as a signal of low quality earnings. Managements do employ varieties of techniques to smoothing earnings in order to achieve the predictability goal. Therefore, predictability analysis should not only be considered in order to reveal whether management has intervened to the earnings stream for them to reach smoothed earnings. Having these in mind, investors and other users of financial statements need to consider discretionary aspect of accruals, persistence, as well as smoothness of earnings while pricing stocks. Moreover, the overall quality of the earnings should be ascertained to enable the users achieve their aims. Although, there are research on earnings quality along with other variables, such as consolidation and earnings quality in the Nigerian banking sector, corporate profitability and Earnings quality management, among others. However, to the best of my knowledge, there is no empirical evidence on how discretionary accruals, earnings persistence and earnings smoothing affects the share prices of quoted Conglomerate firms in Nigeria. This study therefore, seeks to investigate the impact of earnings quality on share prices of quoted food/ beverages and tobacco firms in Nigeria.

OBJECTIVES OF THE STUDY

The main objective of this paper is to examine the impact of earnings quality on share prices of quoted food and beverage firms in Nigeria. Therefore, the specific objectives are as follows:

i. To evaluate share prices response to discretionary accruals of quoted food/beverages and tobacco firms in Nigeria
ii. To investigate the impact of earnings persistence on share prices of quoted food/beverages and tobacco firms in Nigeria
iii. To determine the effect of earnings variability on share prices of quoted food/beverages and tobacco firms in Nigeria

LITERATURE REVIEW

Concept of Earnings Quality

Earnings quality is a multi-dimensional concept. The choice of an earnings quality measure will depend on the research question posed and the availability of data and estimation model. Some research questions call for a measure of earnings quality that is linked to investors' perceptions of earnings. For example, research that examines the value relevance of earnings presumes earnings are useful to a particular class of market participants (namely investors) whose aggregate judgments and decisions are summarized by share prices and returns (Francis, LaFond, Olsson, & Schipper, 2005). They argue that, other research questions focus on direct measures of earnings quality constructed using accounting data alone (i.e., without reference to stock prices or returns). Yet another dimension that is important for some research questions is the distinction among total, innate and discretionary earnings quality. Earnings quality refers to the ability of the current earnings to forecast future earnings (Penman, 2007). Earnings are of good quality if no earnings reversals are forecasted. With valuation in mind, the investors are interested in future earnings, that is, they buy future earnings using the current ones. Further earnings are said to be of poor quality if the current reported earnings are not good indicators of future ones.

Schipper and Vincent (2003) assert that earnings are the summary indicator of the economic and institutional forces operating on the financial reporting process. Earnings quality as posit by Okolie (2006) is an important aspect of evaluating firm's financial health, even though, investors and other users of financial often ignore it. Earnings quality refers to the ability of reported earnings to reflect the firms true earnings as well as the usefulness of the reported earnings to predict future earnings.

Dechow and Schrand (2004) provide two definitions, though tend to be similar. Firstly, a high-quality earnings number is one that accurately reflects the company's current operating performance, is a good indicator of future operating performance, and is a useful summary measure for assessing firm value. Secondly, earnings quality refers to a situation when the earnings number accurately annuitizes the intrinsic value of the firm. These definitions by Dechow and Schrand, indicate the absence of impairment of earnings figure.

In all the definitions stated above, quality of earnings could be seen in two ways; firstly, reported earnings would be of quality if it reflects the underlying economic performance of a firm in that particular period. Secondly, earnings quality portrays how well accounting earnings convey information about the phenomenon.

Finally, for the purpose of this study, earnings quality refers to the one that is free from accruals that is not driven by accounting fundamentals or innate factors (Discretionary accruals), but are sustainable and are not being impair in order to artificially reduce the variability in earnings.

Concept of Share Prices

According to Ronen and Yaari (2008), the invention of double entry book keeping in the 14th century led to company's valuation which is based upon ratios such as price per unit of earnings (from income statement), price per unit of net worth (from balance sheet) and price per unit of cash flow (cash flow statement). The next advance was to price individual price shares rather than the whole company. A price per dividend was the next advancement. Analysts find it appropriate to use discounted cash flow that is based on time value of money to estimate the intrinsic value of share (stock) rather than price per dividend of share prices.

Holland and Ramsay (2005) argued that share price is not merely a reflection of accounting fundamentals but the combination of appropriate discount rate and the pattern of cash flow, make the stock market to decide the price (random walk theory). They asserted that higher share price may signal that the company has a good product and induce consumers to adopt its product to start a positive feedback. They conclude that a higher share price can also make the term equity related transactions more favorable. For example it can increase the proceeds received from the equity offerings or increase executives personal wealth.

Empirical Evidence

A number of studies on Share prices, discretionary accruals and Earnings Persistence, earnings smoothing and Earnings management have been carried out over the last decades, as a result of the recent corporate scandals involving a number of corporations in both developed and developing economies. These studies have produced divergent opinions on the impact of earnings quality on share prices.

Ducharme, Malatesta and Sefcik (2012) in their study aim at examining the relations among earnings management, stock offerings, abnormal accruals, post offer and shareholders lawsuits. Their sample consists of firms that made public offering from 1988 to 1997. They posit that firms in the period around stock offer report positive abnormal accrual components in their earnings. However, in the period after the stock offerings, the abnormal accruals are negatively related to the returns or even they tend to reverse in the post offer period. The research also reveals that the stock returns are much lower and the reversal are more pronounced in the post stock offer period if the firms are sued in connection with their stock offer than those who are not sued. The study is quite credible but the findings will be different if they might have considered other ways in which stocks are issued.

Li (2008) examine a popular belief that managers of high valuation companies have a stronger incentive to manipulate future earnings than low valuation companies. Using U.S. data from 1988 to 2004 with a sample of 74,051 firm-year observations, they find the belief to be only half true. A positive relationship between valuation and future discretionary accruals only exists for companies receiving limited attention. Investigating single economy may not be enough to have a general conclusion as there exist barriers in terms of laws, culture, among others.

Zaluki (2008) investigates the operating performance and the existence of earnings management for a sample of 254 Malaysian IPO companies over the period 1990-2000. Using accrual-based measure of operating performance, the study finds strong evidence of declining performance in the IPO year and up to three years following IPOs relative to the pre-IPO period. This finding is consistent with the results of prior studies documenting the long run underperformance of IPO companies. The results also confirm that the decline in post-IPO operating performance is due to the existence of earnings manipulation by the IPO manager at the time of going public. The study was unable to match all companies using all three measures.

Ekoja (2013) presents a cross sectional analysis of discretionary accruals in detecting earnings management by quoted banks in Nigeria. He employs a regression following Jeter and Shivakumar (2011) cash flow model. The data were collected from Nigerian Stock exchange library and from 2010 Stock Exchange Fact book. Due to the fact that the study is a cross sectional one, only the financial statements of the selected banks for the year ended

2009 were analyzed and a final sample that consists of 20 banks was reached. The study found out that the total accruals were not from a normal distribution and the F-test of the regression showed that there is evidence that earnings management exist in the banks on a cross sectional basis. The result may be different if it is a time series analysis.

Bouwman (2015) examines the effect of managerial optimism on earnings smoothing listed U.S. firms that have appeared on a Forbes 500 list at least four times between 1984 and 1994 and the data set is complemented with Compustat, CRSP and institutional Brokers' Estimate System (IBES) data. The study arrives at a final sample that contains 210 firms and 374 CEOs. They proposed two hypothesis; first, optimistic managers smooth earnings more on average than rational managers do. Second, optimistic managers are less likely than rational managers to report earnings that fall short of analysts' forecasts by much or exceed them by a substantial amount, and are more likely than rational managers to show small (negative or positive) earnings surprises. These hypotheses are tested using existing optimism measures and supporting evidence is found for both predictions. The data is analyzed with the use of univariate and multivariate regression. This finding is consistent with the premise of the underlying theoretical motivation that optimists report higher earnings than rational managers in bad times, which then compels them to report lower earnings in good times. A number of studies have examined the effect of income smoothing on cost of equity, earnings informativeness, liquidity, and bond rating. For instance (Hunt, Moyer and Shevlin 2010; Francis, LaFond, Olsson and Schipper 2005; Graham, Harvey and Rajgopal 2005; Li and Richie 2009; Chen 2014).

Francis, LaFond, Olsson and Schipper (2004) examine the effect of income smoothing on the cost of equity. They find that income smoothing has a negative effect on the cost of equity, although the effect is weaker than for other attributes of earnings, such as accrual quality. Taken collectively, these studies support the notion that income smoothing represents an efficient vehicle for managers to reveal private information. Using survey data, Graham, Harvey and Rajgopal (2005) find that the overwhelming majority of managers prefer a smooth earnings growth rate. Based upon the literature, companies with smoothed earnings are more attractive to investors than companies with widely fluctuation earnings.

Theoretical Framework

Studies of various types and in different disciplines employ different but relevant theories that explain them. There are highlighted some related theories such as Agency Theory, Stewardship Theory, Prospects Theory and Signaling Theory but this study would select from among them the theory that backs the study.

The relevant theory reviewed for the purpose of this study is the signaling theory. Qualities can be almost anything: strength, honesty, genetic robustness, poisonous, suitability for bookkeeping employment, etc. We rely on signals when direct evaluation of the quality is too difficult or dangerous. An employer wants to determine before making a hiring decision whether a candidate will be successful or not, and relies on signals such as a resume, references, and the candidate's actions and appearance to predict suitability for the job. Signaling theory looks at how the signal is related to the quality it represents and what are the elements of the signal or the surrounding community that keep it reliable. Spence (1973) introduced the notion of signaling in economic thinking. According to him, **when information is imperfect**, individuals who possess strong qualities will send signals to distinguish themselves from the others. Spence began his model with a hypothetical example, suppose that there are two types of employees good and bad and that employers are willing to pay a higher wage to the good type than the bad type. Relating this example to stock market, one can clearly see that investors may respond to earnings that are quality by attaching higher price to them and vice versa. Among the theories reviewed, however, for the purpose of this study, the signaling theory is considered as the theory that underpins the study.

The justification for the adoption of the theory is the objective of the study which is to investigate the impact of earnings quality on share prices in the food/ beverage and tobacco sector of the Nigerian Stock Exchange market. Response of investors to the actions of management after the release of financial statement is an important factor in the study and is the main focus of the theory.

METHODOLOGY

The study employs the descriptive research approach in order to address the problem, looking it from correlational design perspective. The population of the study constitutes all the 8 quoted Conglomerate firms in the Nigerian Stock Exchange as at 31st December, 2016. The sample of the study is the same as the population of the study since the total population size is not much and all the data needed for the study was obtainable. The data is obtained from secondary source only. It is collected from the published financial statements of the sampled firms covering the period of six (6) years (2011-2016). Nigerian stock exchange fact books covering the period of the study and the daily official list of the exchange is also used.

Model Specification

The data collected from the financial statements and market value (share prices) of the sampled firms is used to compute earnings quality under the three(3) approaches and substitute the values in the below model of the study;

$Sp = \beta_o + \beta_1 DACC_1 + \beta_2 EPST_2 + \beta_3 EVAR_3 + \varepsilon_{it}$

Where Sp= share price

β_o= intercept

$DACC_1$= Discretionary accruals

$EPST_2$= Earnings persistence

$EVAR_3$ = Earnings Variability

$\beta_1, \beta_2, \beta_3$ = coefficient of the equation

ε_{it} = error term

Results and discussion of findings

This section presents the model summary of the study. Table 1 contains the R square, adjusted R square (coefficient of determination) as well as Durbin Watson values.

Table 1: Model summary of the study

Model	R	R Square	Adj. R-Square	Std. Error of the Est.	Durbin-Watson
1	0.663	0.439	0.401	1.14793	0.997

Source: SPSS 17 Regression results

The summary of the overall results of earnings quality is shown in table 1. It shows that earnings quality (EQ) has made a significant impact on the share prices of quoted food and beverage firms in Nigeria in the period under study. The R is 66% showing commutatively the earnings quality is positively and strongly related with share prices of quoted food and beverage firms in Nigeria. The coefficient of determination reveals a value of 0.439. The implication of which earnings quality has explained up to 44% the variation share prices of quoted food and beverage firms in Nigeria and the remaining 66% is covered by other factors. This signifies the fitness of the model. Thus, the model is fit and the explanatory variables are well selected and utilized. This can be confirmed by the value of adjusted R squared which even after the adjustment is still positive and strong to proof the fitness of the model.

Finally, the overall result indicates that earnings quality impacted positively and strongly on share prices of quoted food and beverage firms in Nigeria. This is arrived at by the results of Fishers' statistics of 11.50, which is significant at 1% level of significance. This lead to the rejection of the whole stated null hypothesis of the study. Table 4.6 shows the ANOVA of the study.

Table 2: ANOVA

Model	Sum of sq	DF	Mean square	F	Sig
Regression	45.459	3	15.153	11.499	0.000
Residual	57.981	44	1.318		
Total	103.440	47			

Source: SPSS 17 regression results

Conclusion and Recommendation

The study has provided statistical and empirical evidence on the using three independent variables in predicting as well as explaining the influence of earnings quality on the share prices of quoted food and beverage firms in Nigeria. It is however, concluded that earnings quality are among the determinants of share prices of quoted Conglomerate firms in Nigeria. The study concludes that DACC helps in making share prices to go up in the Stock Exchange Market. The study also concluded that persistency in the reported earnings of quoted food and beverage firms in Nigeria are among the items that sustained high prices of shares in the industry. Finally, variability of earnings relative to cash flow among accounting periods has a negative influence on share prices, this means that investors price the shares of quoted food and beverage firms in Nigeria when they discover that there is variability earnings relative to cash flow that is to say management has employed some techniques to smooth reported earnings.

The following are recommendations made from the findings and conclusions of the study. Discretionary accruals are accruals that are valued by management at their discretion. This means they can manipulate the reported earnings of the company by choosing to value certain accruals for more or less than the true value. These discretionary accruals are hard to detect and can alter reported earnings. For this, management should not be allowed to use their discretion but be given a particular a guide and procedure on treat by the accounting bodies regulating the accounting profession about the items that are more exposed to the management discretion. As one of the measures of quality of earnings and a figure that captures more regarding to the performance of firms, it would be of importance that the management of firms should expressly make a statement of declaration upon the quality of the reported earnings quarterly, semi-annually as well as annually in the annual report and accounts of firms by having a document which contains its quarterly report as regards the progress of the firm. Amendment of all standards and laws that management hide under to temper with the accounting figures whether the numbers (earnings) are good or bad should be considered by SEC, NSE and Accounting bodies. This is evident in the last finding where the variability of the earnings relative to that of the cash flow caused the share prices to move in an opposite direction to earnings variability. The regulatory authorities should closely monitor this sector by reviewing its regulatory framework with regards to the earnings management challenges and strengthening its capacity in ensuring the firms are being adhered with the rules and regulations.

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