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## Do Reputable Companies Have Superior Earnings Quality?

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### **Abstract:**

*Our main objective in this paper is to compare the earnings quality of reputable companies with non-reputable companies in Nigeria. We capture corporate reputation using a public measure - “The Top Listed West African Companies” by Forbes. Ten (10) Nigerian companies that made the Forbes list of top 25 West African companies in 2012 were used as the final sample size with each sampled firm having a matching firm with closet size (measured by total assets) within the same industry. Earnings quality was estimated using modified Jones (1991) model. The test for the significance of the difference in earnings quality between the two pair of firms was done using the paired sample t-test. Result of our analysis does not provide any evidence to support the claim that Nigerian companies with a higher reputation ranked by the Forbes West African top 25 companies shared a significant superior earnings quality relative to their match pairs of similar size in the same industry. The implication of our study is that much in-depth analysis of earnings quality using other proxies to complement corporate reputation should precede investment decision since the so called reputable companies do not have a significant superior earnings quality than their non reputable pairs to avert future occurrence of another Enron.*

**Key words:** Earnings Quality, Corporate Reputation, Forbes top 25 West African Companies, Nigeria

### **1. Introduction**

The main objective of our paper is to compare the earnings quality of reputable companies with the earnings quality of non-reputable companies in Nigeria. To achieve this objective, we capture corporate reputation using a public measure - “The Top Listed West African Companies” by Forbes in 2012, while earnings quality was measured using modified Jones (1991) model. We choose to examine earnings quality because earnings are the most attractive figure in the eyes of an investor. Similarly, the incidence of many recent accounting scandals such as ZZZZ Best, Xerox, Enron, Adelphia, Kmart, Tyco, AIG, among others across the globe indicate that earnings quality is lacking. This is likely to persist given the following classic Wall Street joke: a company is going through the interview process to hire a Chief Financial Officer (CFO). In the last interview session, each of the three finalists is given the company’s financial data and asked, “What earnings are?” two applicants diligently compute the net earnings. Neither of them gets the job. The candidate who landed the position answers the question by replying, “what do you want them to be?”

The anecdote in the above paragraph portrays that integrity and quality of earnings is, and will continue to be lacking. Companies’ no longer hire a qualified Chief Finance Officer instead they go for an experienced Chief Freaked out Officer who can always help them to meet targets by cooking the books. This suggest that the quality of earnings is lacking, so assessing the quality of financial information is an important issue to investors and should be an ex ante tool for investment decisions. Ordinarily, earnings quality and corporate reputation should be closely related. The usual question that arose is, could investors use corporate reputation to also mean earnings quality? A number of literatures suggest that corporate reputation have value for a firm that possesses it (Derrickx & Cool, 1989; Rumelt, 1987). It is a highly perishable critical asset of an organisation, thus a company can do anything possible to ensure that their reputation proxies by a ranking as a top rank (admired) firm, does not evaporate overnight. Again the amortisation of reputation is fast, while building of reputation is something difficult and takes longer time. Only three companies from Fortune America’s Top 100 Most Admired companies in 2000 were among the top 10 Most Admired companies in 2006 (Iwu-Egwuonwu, 2011). Again IBM which was once ranked number one in Fortune Top America’s Most Admired companies survey fell to rank number 354 in 1993 (Gaines-Ross, 2009). It took IBM 10 years to come back into the Fortune Top 10 America’s Most Admired All-Star list. These show that corporate reputation which is a critical asset of an organisation is highly perishable thus; those who own it will do even desperate things to retain it. This is a timely and crucial study because investors and other financial statement users place a very high emphasis on earnings for various economic decisions.

The rest of the paper is structured as follows: section 2 reviews the previous studies on corporate reputation and earnings quality. Section 3 cover the methodology adopted in the paper where sample selection, earnings quality model, and statistical technique for data analysis were discussed; section 4 present and discussed the results of our findings; and finally conclusion was in section 5

## 2. Review of Related Studies

### 2.1. The Concept of Corporate Reputation

There is no consensus definition of corporate reputation in academic literature just as there is no general agreement exists in the literature on how corporate reputation should be measured; however, there is a general agreement that it is important (Schwaiger, 2004). The fuzzy definitions and a lack of scientific literature on corporate reputation should not raise the impression that corporate reputation has not been noticed for a long time. The work of Ballen (1992) indicates that legendary Fortune index “Most Admired Companies” has been published since 1983 and ever since been imitated by many ranking agencies in many countries.

Reputation according to Fombrun (1996) is “a perceptual representation of a company’s past actions and future prospects that describe the firm’s overall appeal to all its key constituents when compared to other leading rivals” (p. 72). Several other recent studies try to define corporate reputation somehow different. Robert and Dowling (2002) defined corporate reputation as a general organisational attributes that reflects the extent to which external stakeholders view the company as “good” or “bad”. Barnett, Jermier and Lafferty (2006) looked at corporate reputation as an observer’s collective judgement of a corporation based on assessment of the financial, social and environmental impacts attributed to the corporation over time. Argenti and Drunkenmiller (2009) hold similar views with Barnett et al. (2006) that corporate reputation is the objective representation of multiple constituencies’ images of a company, built up over time and based on the company’s identity, its performance and how constituencies have perceived its behaviour. In this study, corporate reputation is considered as the overall estimation of a firm by its stakeholders who are expressed by the net effective reactions of customers, investors, employees, and the general public.

### 2.2. Components of Corporate Reputation

Corporate reputation is driven by so many factors inside the firm. That is, the components of corporate reputation are the characteristics of a company’s own performance that drive reputation- positive or negative. Several studies have identified some notable components (measures) of corporate reputation (e.g Rossiter, 2002; Schwaiger, 2004; Lloyd & Mortimer, 2006; Martin de Castro, Lopez, & Saez, 2006; Harrison, 2009). According to Schwaiger (2004) and Harrison (2009), corporate reputation has ten (10) different components namely:

- Quality of employees
- Quality of management
- Financial performance
- Quality of products and services
- Market leadership
- Customer orientation
- Attractiveness
- Social responsibility
- Ethical Behaviour
- Reliability

Many corporate reputation ranking agencies around the world have their measures of corporate reputation, although such measures are related to the ones itemise above. Some of these agencies include:

- Fortune’s Magazine: World Most Admired Companies
- Financial Times: World’s (Europe’s) Most Respected Companies
- Management Today: Britain’s Most Admired Companies
- Burson-Marsteller: Maximizing Corporate Reputation
- Corporate Branding LLC: Corporate Branding Index
- Asian Business: Asia’s Most Admired Companies
- Delahaye Medialink: Delahaye Medialink Corporate Reputation Index
- Forbe’s Africa Magazine: Africa top Ranking Companies

The ranking of these agencies is predominantly based on the following attributes of reputation:

- Quality of management
- Quality of products /services offered
- Innovativeness
- Value as long-term investment
- Soundness of financial position
- Ability to attract /develop /keep talented people
- Responsibility to the community /environment
- Wise use of corporate asset

Worthy of note is that all the above factors are influenced by the quality of corporate governance hence internal to the firm with the exception of financial performance. Financial performance represents the naira (₦) vote casted by the customer to the firm and is not under the control of the Board of Directors nor Management. Black, Carnes and Richardson (1999, p.5) noted that “individual raters appear to be heavily influenced by previous performance”, where this is not met management may not want to lose sight of their organisation’s reputation, they will then cook the books to look profitable in the eyes of the public because of the information asymmetry they enjoy with the hope that the future will even up.

### 2.3. Benefits of Corporate Reputation

Many academic disciplines have shown interest in reputation research. Accounting studies for instance have observed the importance of intangible assets under the name of goodwill for a long time, while other recent studies examined the association between corporate reputation and different accounting variables. Strategic management theory suggests that positive reputation can create a sustainable competitive advantage and affect corporate performance. Roberts and Dowling (2002) complemented this theory that a firm with a good reputation may possess a cost advantage, since people prefer to work for firms with high reputations, and they work harder even for a slightly lower remuneration. Also, suppliers prefer to do business with high-reputation firms in order to reduce contractual hazards. Therefore, Roberts and Dowling (2002) found that firms with superior reputation are better able to maintain superior profitability over time.

Francis, Huang, Rajgopal and Zhang (2008) examine the association between CEO reputation and earnings quality. Using the extent of press coverage as proxy for CEO reputation, they found that more highly reputed CEOs are associated with poorer earnings quality. They conclude that firms with poor earnings quality required more highly reputed CEOs. Luchs, Stuebs and Sun (2009) examined the association between corporate reputation and the quality of the firm’s earnings. Using a public measure – “America’s Most Admired Companies” as a proxy for reputation and the modified Jones (1991) model to estimate earnings quality, they posit that firms with superior reputation also should have superior earnings quality.

After a review of corporate reputation studies, Iwu-Egwuonwu (2011) sum up the benefits of corporate reputation to include the ease to put higher price tag on its products and services, support from stakeholders in period of controversy, preference from customers, high stock valuation in the financial market, and high attraction to employees even at a slight lower remuneration. Due to these benefits it is always painful for companies to lose their reputation. Accordingly we hypothesise as follows:

H<sub>0</sub>: Earnings quality of reputable firms is not significantly higher than earnings quality of non reputable companies in Nigeria.

While most prior studies are based in Europe and America and they used America’s Most Admired Companies by Fortunes Magazine as a proxy for corporate reputation (e.g. McLaughlin, Ruback, & Tehranian, 1996; Black, et al., 1999; Robert & Dowling, 2002; Riahi-Belkaoui, 2004; Tan, 2007; Luchs et al., 2009). No such study is found in Nigeria or Africa as a whole hence necessitation for this study.

### 3. Methodology

Two variables- corporate reputation and earnings quality are of interest in this study. We use the list of Nigerian companies that are among top 25 West African companies according to Forbes African ranking in 2012 as a proxy for good corporate reputation. Since the list of top 25 West African Companies was published in July 2012, we use 2011 financial data. We adopted the modified Jones (1991) Model and a cross-sectional estimation method to compute discretionary accruals. The absolute value of discretionary accruals is viewed as a measure of earnings quality. That is, a higher absolute value of discretionary accruals suggests lower earnings quality and vice versa.

The total accruals using cash flow approach is

$$TA_{i,t} = NI_{i,t} - CFO_{i,t} \quad (1)$$

Where

TA<sub>i,t</sub> = Total Accruals of firm i in year t

NI<sub>i,t</sub> = Net income of firm i in year t

CFO<sub>i,t</sub> = Cash flow from operation of firm i in year t.

To estimate the discretionary accruals of firm i in the year t, we first estimate the cross-sectional total accruals by modified Jones (1991) model using all the firms in the industry. The model is:

$$NDA_{j,t} = \alpha(1/ATA) + \beta_1[(\Delta Sales_{j,t} - \Delta REC_{j,t})/ATA] + \beta_2(PPE_{j,t}/ATA) + \varepsilon_{j,t} \quad (2)$$

Where

NDA<sub>j,t</sub> = industry j total accruals in year t

ΔSales<sub>j,t</sub> = industry j change in sales in year t

ΔREC<sub>j,t</sub> = industry j change in Receivables in year t

PPE<sub>j,t</sub> = industry j gross Property, Plant and Equipment at the end of year t

ATA = average Total Assets

β<sub>1</sub> and β<sub>2</sub> = coefficients

α = intercept

ε<sub>j,t</sub> = error term

The industry specific estimate of parameters in equation (2) depicts a relationship between non-discretionary accruals and accounting variables. The discretionary accruals for firm i in year t can be computed as follows:

$$TDA_{i,t} = TA_{i,t} - NDA_{i,t} \tag{3}$$

Where TDA is total discretionary accruals which must be 0

We obtain the list of top Nigerian companies from Forbes Africa ranking. The full list consists of 20 Nigerian firms. Nine (9) financial institution firms were excluded in this study because it is difficult to define accruals and unexpected accruals of these institutions. Our final sample therefore consists of 11 firms using purposive non random sampling technique. Panel A of Table 1 reconciles the sample selection process. Panel B in Table 1 presents the sample distribution across industry categories.

Panel A: Sample Selection	
2012 Top Nigerian Companies under Forbes Africa list of Top West African Companies	20
Financial Institution firms	-9
Final Sample size	<u>11</u>
Panel B: Industry Distribution	
Industry	number of firms
Building materials	2
Breweries	2
Food/beverages	3
Conglomerate	3
Petroleum (marketing)	<u>1</u>
	<u>11</u>

Table 1: Sample Selection and Industry Distribution

For each sampled firm, a matching firm with closet size (measured by total assets) within the same industry is selected for our earnings quality comparison. The descriptive statistics was used to explain the attributes of the data while for the significance of the difference in earnings quality; we use the paired sample t-test. A paired sample t-test is used to compared the means of two populations when samples from the population are available, in which each individual in one sample is paired with an individual in the other sample (Landau & Everitt, 2004). The paired sample t-test is calculated as:

$$t = \frac{\bar{d}}{s_d \sqrt{n}}$$

Where

$\bar{d}$  = the mean of the differences between the paired groups

$s_d$  = the standard deviation of the differences

n = the number of pairs (differences).

Using 95% Confidence level, our decision rule is to reject the null hypothesis if the computed t-statistic value is more than 1.83 (the critical t-value) at 10 degrees of freedom; or if the calculated p-value is less than 0.05; otherwise accept the null hypothesis ( $H_0$ ).

#### 4. Data Analysis and Results

The Descriptive statistics in Table 2 displays the mean, sample size, standard deviation, and standard error for both sample firms (reputable companies) alongside their match pairs of non reputable companies.

	Mean	N	Std. Deviation	Std. Error Mean
REPUTABLE COMPANIES	.147087	10	.1981654	.0626654
NON REPUTABLE COMPANIES	.245034	10	.2262180	.0715364

Table 2: Paired Samples Descriptive Statistics

Source: Researchers' Computation Using SPSS Version 16.0 output

The working sample size for the study is 10 reputable companies and 10 match pair observation. 1 company (Cadbury, Nigeria) was excluded from the working sample because of exceptional higher value of discretionary accrual based on the modified Jones (1991) model. Across all the 10 subjects, an earnings quality level of reputable firms is higher than the earnings quality of non reputable companies about 10 points on average. The standard deviations of earnings quality for reputable and non reputable companies reveal that subjects were more variable with respect to non reputable companies than the reputable companies.

At 0.229 (see Table 3), the correlation between the earnings quality between reputable and non reputable companies is not statistically significant (i.e.,  $p = 0.525$  is more than 0.05).

		N	Correlation	Sig.
Pair 1	REPUTABLE COMPANIES NONREPUTABLE COMPANIES	10	.229	.525

Table 3: Paired Samples Correlations

Source: Researchers' Computation Using SPSS Version 16.0 output

The Mean column in the paired-samples t- test in Table 4 displays the average difference between earnings quality of reputable and non reputable companies (-0.978).

	Paired Differences					t	df	Sig. (1-tailed)
	Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
				Lower	Upper			
REPUTABLE COMPANIES NON REPUTABLE COMPANIES	-.097946	.2644912	.0836395	-.2871523	.0912589	-1.171	9	.136

Table 4: Paired Samples Test

Source: Researchers' Computation Using SPSS Version 16.0 output

The Standard Deviation column displays the standard deviation of the average difference score (0.2645) while the Standard Error Mean (0.0836) column provides an index of the variability one can expect in repeated random samples of 10 firms with match pairs similar to the ones in this study. The 95% Confidence Interval of the Difference provides an estimate of the boundaries between which the true mean difference lies in 95% of all possible random samples of 10 reputable firms with match pairs of non reputable firms similar to the ones participating in this study. The t statistic and Sig. (1-tailed) column displays the t value and the probability of obtaining a t statistic that is used for accepting or rejecting the hypothesis.

Since the calculated t statistics (-1.171) is lower than the 1.83 (critical t value using table) and significance value (0.138) for the difference in mean of earnings quality between reputable and non reputable companies in Nigeria is more than 0.05, we conclude that the average difference in earnings quality between the reputable and non reputable companies of -0.098 per company is due to chance variation.

## 5. Conclusion

Result from our analysis does not find evidence to support the claim that Nigerian companies with a higher reputation ranked by the Forbes West African top 25 companies shared a significant superior earnings quality relative to their match pairs of similar size in the same industry. The result of our analysis as presented in the descriptive statistics however, suggest that such reputable companies are associated with a slightly higher but not statistically significant earnings quality than their match pairs of non reputable forms. This finding is similar to that of Luchs et al. (2009) in America. The imperative of this study is to avert the second Enron occurrence where investors misconstrued corporate reputation as the viable investment ground with a huge loss as a consequence in the end. The study should therefore be of importance to financial analyst who conducts researches to unveil a company's earnings quality. The study also serves as a caution to investors that much in-depth analysis of earnings quality using other proxies to complement corporate reputation should precede investment decision since the so called reputable companies do not have a significant superior earnings quality than their non reputable pairs.

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