

*Original Research*

# Earnings Quality and Financial Performance of Kenyan Public Listed Non-Financial Firms

Edwin Sitienei<sup>1</sup> 

Department of Accounting and Finance, Pioneer International University,  
Nairobi, Kenya

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## Abstract

This study sought to address the effects of earnings quality on the financial performance of Non-financial firms listed at the Nairobi Securities Exchange (NSE). Three attributes of earnings quality; predictive value, feedback value, and earnings accruals quality, were adopted as measures of earnings quality. The study adopted returns on assets (ROA) to measure financial performance. A 5-year data (2018-2022) for the 44 non-financial firms listed in the Nairobi Securities Exchange were obtained from secondary data sources. The data were analyzed using Stata 17, and the findings showed that accrual quality and feedback value exhibited a significant positive relationship with financial performance. The predictive value of the earnings revealed an insignificant negative relationship with financial performance. The model was significant at a 10% significance level with a coefficient of 0.492. This implies that earnings quality constructs significantly and positively affect the performance of Kenyan public-listed non-financial firms. The findings of this study have important implications for users of financial information in ascertaining the importance of earnings quality on the performance of Kenyan public non-financial firms. This study is also beneficial to standard setters in Kenya that view the earnings quality as an indirect indicator of the quality of financial reporting standards that have been issued.

**Keywords:** Accruals quality, Earnings quality, Feedback value, Predictive value.

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<sup>1</sup> Corresponding author's Email: [sitieneied@gmail.com](mailto:sitieneied@gmail.com)

## Introduction

Existing literature identifies several attributes of reported income widely considered desirable characteristics of a firm's earnings (Barton et al., 2010; Francis et al., 2004). Earnings Quality of financial information has been a topical issue, especially after the major scandals of Enron and WorldCom Andreas (2007). The quality of earnings is usually defined in accounting studies from two perspectives: decision usefulness and economic-based perspectives. From a decision usefulness perspective, earnings quality is regarded as high if the earnings numbers are useful for decision-making. The earnings number acts as a summary measure of a firm's performance. Thus, the earnings number reported in a firm's financial statements must be reliable, relevant, and free from manipulation (Barragato and Markelevich 2008). Managers may manage earnings for many reasons, including capital market motivations, compensation, bonus, and debt or lending contracts, resulting in low-quality earnings.

Dechow and Schrand (2004) state that when earnings conform to the spirit and the rules of generally accepted accounting principles, they are of high quality in the eyes of regulators. Earnings should be free from fraud and show an accurate and fair view of a company's financial performance. However, standard accounting setters are also concerned with the effectiveness of the standards that they have promulgated. By focusing on the usefulness of earnings numbers to financial statement users, standard setters can evaluate the quality of earnings prepared under a particular set of accounting standards. Earnings quality can be referred to as the degree to which reported earnings capture a firm's economic reality. The quality of accounting information plays an essential role in reducing asymmetries between firms and investors (Elaoud & Jarboui, 2017)

### *Statement of the problem*

Earnings quality has deteriorated over time, as evidenced by the deteriorating relationship between stock prices and earnings. The issue of earnings quality becomes essential before any reliance on published accounting information can be placed. To safeguard the investors' confidence in the capital and equity markets, NSE and CMA are retracting their mandate to instill discipline in the market players and protect investors' funds. Some firms, such as Uchumi supermarket, Haco Tiger, and Baumann and Company, have been found to have falsified their revenue, receivables, and tangible assets. These scandals lead to serious concerns about the quality and usefulness of reported earnings that users of financial information will use to evaluate their decisions.

Studies on the association between earnings quality and firm performance have been done in many countries (Elaoud & Jarboui, 2017; Pirveli, 2020). These studies suggest that the decline in the association between earnings and firm performance measures indicates a decline in the quality of earnings. However, there are few studies on the effect of earning quality on the financial performance of firms in the Kenya scenario. Thus, this study aims to systematically and explicitly examine the association between earnings quality and the financial performance of non-financial firms listed in NSE Kenya.

### *Literature Review and Hypothesis Development Theory*

Dechow and Dechev (2002) introduced the quality of the accruals as a benchmark for income stability and accordingly believed that the more quality of accruals that a company has, the more its earning has stability, which is called earnings with quality. Elaoud and Jarboui (2017) discussed earnings with more accruals quality, and ERC is the earnings with the quality. Dang, Nguyen, and Tran (2020) believes that earnings with high-quality and less extraordinary accruals are quality earnings. Han, Rezaee, and Tuo (2020) believe that the earning that shows the effects of bad news and has a significant relationship with the stock price is the earning with quality. Therefore, whether accruals improve the predictive ability of earnings relative to cash flows is not clear. In practice, the incremental benefit of accruals is even less obvious. Accruals require estimation, and estimation error (intentional or unintentional) reduces the ability of earnings to reflect future cash flows. Thus, we hypothesize in H01 that there is no significant effect between the quality of accruals and the financial performance of non-financial firms in NSE Kenya.

Predictability is viewed as a desirable attribute of earnings because it increases the precision of earnings forecasts. The predictive value (PV) of earnings is measured in terms of the ability of earnings to predict future earnings. Svabova, Kramarova, Chutka, and Strakova (2020) introduced earning stability as the benchmark for earning quality. Accordingly, the income stability in the current period is a good signal of the quality of earnings in future periods. Pirveli (2020) have based their definition on the predictability of the earnings and mentioned that the earnings that have less vitality and are more predictable have more quality. It is suggested by Kimouche (2020) that disaggregation of earnings into its components may improve the predictive ability to estimate year-ahead earnings. Thus, we hypothesize in H02 that there is no significant effect between predictive value and financial performance of non-financial firms listed in NSE Kenya.

According to SFAC No. 2, feedback value refers to the ability of information to influence decisions by confirming or correcting earlier expectations of decision-makers (Mahmud, Ibrahim, & Pok, 2009). Feedback value (FV) is expected to affect firm performance positively. Since feedback value (FV) is a direct measure of earnings quality, a positive coefficient for FV indicates that as earnings quality increases, performance will increase. Thus, we hypothesize in H03 that there is no significant effect between feedback value and the financial performance of non-financial firms listed in NSE Kenya.

### *Data and Methods*

To achieve the study objectives, a cross-sectional survey of the firm's design was adopted to carry out the study. The study population comprised all listed Non-financial firms at the Nairobi securities exchange in Kenya for the period of 2018 to 2022. This period was considered long enough to provide sufficient data to assist in the time series correlation of earnings quality and performance measures. The data collected was analyzed using multiple regression and correlation analysis to establish the relationship between the independent variables of earnings quality and the dependent variable of performance measures.

## *Operalization of Variables*

### Independent variables

#### 1. Accrual Quality

To measure accrual quality, accrual estimation error was developed by Dechow and Dichev (2002) and modified in McNichols (2002) and Francis et al. (2005). This measure defines the quality of accruals as the extent to which they map into past, current, and future cash flows.

$$\Delta WC = \beta_0 + \beta_1 CFO_{t-1} + \beta_2 CFO_t + \beta_3 CFO_{t+1} + \beta_4 \Delta REV_t + \beta_5 PPE_t + \varepsilon_t$$

Where;

Where

$\Delta WC = \Delta CA - \Delta CL$  that is, the change in the current assets minus the change in current liabilities

$CFO = CFO$  is the cashflow from the operating activities of a firm measured at  $t-1, t, t+1$

$\Delta REV =$  change in revenue between year  $t-1$  and year  $t$

$PPE$  is the gross value of plant, property, and equipment

The error term shows the extent to which accruals map into realized cash flows, and the standard deviation hereof is a proxy for accruals quality. High variance in the estimation errors yields non-persistent earnings and is an inverse measure of earnings quality. The idea is that systematically small or large estimation errors do not create problems for users since they can still predict future earnings. Instead, a significant variation in the error term is less precise about mapping total current accruals into current, previous, and future cash flows. Because the variability of the residuals, not the magnitude, is the measure of accruals quality, it is expected that firms with low accruals quality will also have low earnings persistence. Dechow and Dichev (2002) do not distinguish intentional estimation errors from unintentional ones since all errors signify poor accruals quality, regardless of the underlying intent.

#### 2. Predictive Value

##### **Future current earnings predicted on current earnings**

Predictive value is measured in terms of the ability of earnings to predict future earnings and future cash flows. To measure the predictive ability of earnings, the study employs Barua, (2006) model of return on assets, where future earnings are regressed on current earnings.

$$EARN_{i,t+1} = \alpha_0 + \beta_1 CFO_{i,t} + \beta_2 TAC_{i,t} + \varepsilon_{i,t}$$

Where;

$EARN_{i,t+1}$  Profit after tax of firm  $i$  in year  $t+1$  deflated by average total assets

$CFO_{i,t}$  Cash flow from the operation of firm  $i$  in year  $t$  deflated by average total assets

$TAC_{i,t}$  Total accruals (the difference between cash flow from operation and earnings) of firm  $i$  in year  $t$  deflated by average total assets

$\varepsilon_{i,t}$  Prediction error

### 3. Feedback value.

In order to measure the feedback value of earnings, the following earnings prediction model employed by Kormendi and Lipe (1987) is used.

$$EARN_{i,t} = \alpha_0 + \beta_1 EARN_{i,t-1} + \varepsilon_{it}$$

Where,

$EARN_{i,t}$  - Profit after tax of firm  $i$  in year  $t$  deflated by average total assets Profit

$EARN_{i,t-1}$  -Profit after tax of firm  $i$  in year  $t-1$  deflated by average total assets

$\varepsilon_{it}$  - prediction error

Dependent Variable

Return on Assets was used in the research to determine the financial performance. The annual company financial statements obtained the total assets and net profits.

$$ROA = \frac{NetIncome}{AverageTotalAssets}$$

### *Measures of control variables*

The research adopted leverage as a control measure due to the hypothesis that highly leveraged firms are likely to engage in opportunistic activities and manipulation to avoid breach of the debt covenant violation. According to this study, there is a negative correlation between leverage and the accuracy of financial reporting. In earnings management research, accounting for firm size is a common practice. Since a large firm typically has diversified or decentralized management decision-making, it is expected to have relatively higher discretionary accruals than a small firm. As a result, this study

anticipates that there will be a converse in the relationship between firm size and financial reporting quality. The natural logarithm of the total assets at the end of the period is used to calculate the size ( $\ln it = \log (A_i,t)$ ).

### Empirical Regression Models

To test our hypothesis on whether earnings quality in year  $t$  affects financial performance in year  $t + 1$ , we estimate the OLS regression as shown in the Equation.

$$ROA_i = \alpha_{i,t} + \alpha_1 ACC_{i,t} + \alpha_2 PRED_{i,t} + \alpha_3 FED_{i,t} + Control\ variable_{t,1} + \varepsilon_{i,t} \dots \dots \dots Model 1$$

### Empirical results

Table 1. Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
ROA	.127	1.75	-10.234	32.681
ACC	0	4.758	-74.719	16.795
PRED	0	11.687	-175.398	116.685
FED	0	9.027	-170.278	4.432
Leverage	.629	.318	.001	1.8
Firm size	15.715	2.167	8.791	20.997

Table 1 presents descriptive statistics for the study variables: earnings quality, financial performance, and control variables. On average, Kenyan public listed non-financial firms according to the findings of this study exhibit a favorable performance in terms of return on assets (ROA). The mean ROA of 0.127 indicates that, on average, these companies are efficiently utilizing their assets to generate income. The research findings on the predictive value of earnings revealed a mean of 0.000. It implies that the absolute prediction error from the earnings regression model used is small, indicating that the predictive ability of current earnings to predict future earnings is high. Regarding the feedback value of earnings (FED), the mean is also 0.00. This finding suggests that the ability of the current year's earnings to change the prediction about next year's earnings is slightly low. The study reveals that the average firm size, represented by the natural log of 15.715, is relatively large. A higher value signifies that, on average, the Kenyan public listed non-financial firms are larger in size. The mean leverage ratio stands at 0.629, indicating a relatively high debt ratio among Kenyan public listed non-financial firms. On average, these firms rely significantly on debt for income generation and financial operations. The variability in leverage ratios maximum and minimum leverage ratios are 1.8 and -0.001, with some firms exhibiting very high debt levels (as indicated by the maximum value of 1.8) and the presence of a potential outlier with a negative ratio, which may require further investigation due to data anomalies.

#### Correlation Analysis

Table 2 shows the correlation matrix for all model variables, with Pearson coefficients of correlations as appropriate. The three proxies of earnings quality reveal a positive

correlation with financial performance. The correlation coefficients are below 1, indicating that these measures capture different earnings quality dimensions. This justifies using these three measures in our tests to increase the generalizability of our inferences. The data also indicate that the correlations between variables used in the model do not exceed the value of 0.77. This aligns with Gujarati (2009), who suggested that the correlation matrix should not exceed 80% to ensure any self-association problems.

Table 2. Correlation Matrix

Variables	(1)	(2)	(3)	(4)	(5)	(6)
(1) ROA	1.000					
(2) ACC	0.799***	1.000				
(3) PRED	0.007	0.047	1.000			
(4) FED	0.014*	0.048	-0.001	1.000		
(5) Firm size	-0.058	0.044	0.041	-0.112**	1.000	
(6) Leverage	-0.001	0.023	0.012	-0.014	-0.126**	1.000

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

Table 2 provides the correlation matrices for the key variables. Based on the table, ROA is positively and significantly correlated with Accrual quality and feedback value (FED), whereas predictive value (PRED) is positively correlated with ROA though the relationship is insignificant. Large firms seem less profitable as the correlation between size and ROA negatively correlates with size. These findings are inconsistent with those of (Kimouche, 2020). Regarding leverage (Lev), ROA had a negative and insignificant correlation.

### Multivariate Analysis

The Breusch-Pagan Lagrange Multiplier (LM) test, followed by the Hausman test, determines whether to use a random-effect regression or a simple OLS. The Hausman test is then used to distinguish between random and fixed effects. Finally, the association between the dependent variables (earnings quality) and the independent variables (financial performance) is estimated using panel regression with a random effect model.

Table 3. Earnings Quality and Financial Performance Model

	(1)	(2)	(3)	(4)	(5)
	ROA	ROA	ROA	ROA	ROA
ACC	0.109*** (23.444)	0.109*** (23.267)	0.109*** (23.234)	0.110*** (23.539)	0.110*** (23.523)
PRED		-0.001 (-0.565)	-0.001 (-0.554)	-0.001 (-0.434)	-0.001 (-0.423)
FED			0.004* (1.710)	0.003 (1.415)	0.003* (1.393)
firm size				-0.026**	-0.027**

	(1)	(2)	(3)	(4)	(5)
				(-2.517)	(-2.573)
Leverage					-0.043
					(-0.620)
_cons	0.041*	0.042*	0.042*	0.453***	0.492***
	(1.842)	(1.811)	(1.827)	(2.749)	(2.784)
Observations	314	310	310	310	310
r2_w	0.621	0.610	0.613	0.616	0.617
<i>P-values are in parentheses.</i>					
*** $p < .01$ , ** $p < .05$ , * $p < .1$					

Accrual quality benchmarks income stability (Dechow and Dechev 2002). The more quality of accruals that a company has, the more its earnings stability. Accruals require estimation, and estimation error (intentional or unintentional) reduces the ability of earnings to reflect future cash flows. The financial performance of listed companies in the study sample could be predicted to be significantly impacted by accrual quality at the 0.01 significance level. Based on the results,  $H_{01}$  test specifications prove that accrual quality has a positive (0.110) significant coefficient with ROA. Thus, we fail to reject the null hypothesis  $H_{01}$ .

Earnings stability is a good index for predicting future earnings (Penman and Zhang 2002). Accordingly, the income stability in the current period is a good signal of the quality of earnings in future periods. According to the research findings, the predictive value of earnings reveals an insignificant negative relationship with ROA at 10% significance. Based on the results,  $H_{02}$  test specifications provide evidence that predictive value has a negative (-0.001) insignificant coefficient with ROA at a 10% significance level. Thus, we reject the null hypothesis  $H_{02}$ .

Feedback value refers to the ability of information to influence decisions by confirming or correcting earlier expectations of decision-makers (Mahmud, Ibrahim, & Pok, 2009). Feedback value (FV) is expected to affect firm performance positively. According to this research, earnings' feedback value reveals a significant positive relationship with ROA at 10% significance. Based on the results,  $H_{03}$  test specifications provide evidence that feedback value has a negative (+0.003) significant coefficient with ROA at a 10% significance level. Thus, we fail to reject the null hypothesis  $H_{03}$ .

The model was found significant at a 10% significance level with a coefficient of 0.492. This implies that earnings quality constructs significantly positively affect the performance of Kenyan publicly listed non-financial firms. Leverage was found to have a negative association with ROA. This result contrasts with the role of leverage as a disciplinary mechanism. The negative effect of leverage on performance is in line with the argument that debt commitments force the firm to forgo positive present-value projects and are consistent with those obtained by (Alexandridis, Antypas, Gulnur, & Visvikis, 2020; Han et al., 2020) and (Han et al., 2020). This study reports that firm size was negatively and significantly associated with firm performance based on ROA, suggesting that firms with more significant sales growth experience lower performance. This finding was inconsistent with that of Chen et al. (2005) and King and Santor (2008). However, it is argued that greater sales growth may lead firms to become diversified.

Nagarajan, Mohanty, and Khatua (2023) suggest that diversification negatively affects firm performance since diversified firms are prone to cross-subsidize investments and poor growth opportunities.

## Summary and Conclusions

The study attempted to address whether the earnings quality of Kenyan publicly listed non-financial firms are associated with performance. Three attributes of earnings quality, namely predictive value, feedback value and accrual quality, and financial performance measure returns on assets (ROA), were examined. The accrual quality and financial performance findings revealed a significant positive association in the Kenyan-listed non-financial firms. The predictive value of earnings, according to the findings of this research, reveals an insignificant negative relationship with ROA at 10% significance. It means the earnings of Kenyan publicly listed non-financial firms are yet to show their predictive value.

Further, the feedback value of earnings, according to the findings of this research, reveals a significant positive relationship with ROA at a 10% significance. This implies that current earnings can influence decisions by confirming or correcting earlier expectations of decision-makers. Overall, the model is significant at a 10% significance with a coefficient of 0.492. This implies that high earnings quality earnings constructs result in high performance of Kenyan public listed non-financial firms. Moreover, after controlling the effects of firm-specific characteristics, this study revealed that the earnings quality of Kenyan publicly listed non-financial firms had a mixed association with their performance and did not affect the earnings quality significantly.

The findings of this study have important implications for users of financial information in such a way that they assist in ascertaining the importance of earnings quality association with firm performance in Kenya. This study is beneficial to standard setters in Kenya that view the earnings quality as an indirect indicator of the quality of financial reporting standards that have been issued. These findings have implications for several interested parties, including auditors, institutional investors, regulators, and policymakers, who assess how well corporate boards of directors supervise a company's financial reporting and disclosure procedures. Moreover, this paper recommends adopting better strategies for corporations and their corporate governance structures when communicating with audit committees and assessing their effectiveness in improving financial reporting quality and disclosure.

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