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Retained Earnings, Corporate Governance and Market-To-Book Value of Listed Firms in Nigeria

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ABSTRACT: *The study analysed the importance of corporate governance practices in strengthening the relationship between retention policy and firm value from 2008 – 2018. The study adopted descriptive survey design and used secondary data. The population of the study comprised of 78 listed manufacturing firms on the Nigeria Stock Exchange as at the end of 2018. Purposive sampling technique was used to select firms with up-to-date published financial data and whose stocks were traded on the stock market totaling 56. The data were analysed using table, percentages and random effect estimation techniques. Findings from the analysis indicated that corporate governance index (t = 2.155, p<0.001), earnings per share (t=5.393, p<0.001) and retained earnings per share (t=9.761, p<0.001) were positively and significantly related to the market-to-book value of firms in Nigeria. The study therefore recommends that a higher level of retained profit of these firms together with efficient management practices through good governance will affect-their values positively.*

KEYWORDS*:* corporate governance, earnings, retained earnings, market-to-book.

JEL CODES: D46, G32, G34, G38, 016, M14.

INTRODUCTION

The declining trend in the value of corporate firms across Nigeria appears to be a global phenomenon, eroding investors' confidence and a source of concern to policy makers and other stakeholders. Gradual reduction in the value of stocks is generating a lot debates among financial analyst, researchers and shareholders globally. This is due to the fact that prices of stocks do not really reflect the intrinsic value of firms in the capital market. The height of this concern is also expressed on the delisting of firms and the inactiveness of some stocks in the capital market. Consequently, this has brought to the fore and rekindled the interest of scholars in delving into the possible causes. The continuing reduction in the firms' value reflected by the falling share values have been ascribed to the level of inconsistency in earnings reported annually by firms, coupled with the non-regular payment of dividend or the low dividend payout ratio. The aim of investors is to generate higher returns through dividend but the non-payment of dividend may therefore warrant investors deciding to divert their resources from a particular sector of the economy to other areas considered to be more lucrative. Thus, the gradual decline in stock prices and reduction of stocks could lead to loss of investor's confidence in entities not paying dividend.

The inability of firms to maintain their share price or market value in the capital market is not limited to developing economy as the collapse of many organisations were also witnessed in the developed economy. Studies have shown that the decline in value can be linked to poor financial performance resulting from high cost of capital, excessive financial risk, high maintenance cost which characterized the financial environment of business firms and the exposure of which invariably erode profitability (Abdullah, Aziz, Najid & Mohammed, 2019). Part of the efforts advocated to ameliorate and perhaps reduce financial risk is that businesses should look inward to harness internal accruals such as retaining part of the earnings to finance viable projects and support the operation of the business. Businesses should reduce financial leverage to lesson the burden of financial risk and for organizations with high volatile operating profit, engaging in financial leverage also posts high risk by putting pressure on the profit and consequently affect value of firms in the long run. Apart from adopting retention policy, effective corporate governance structure are also canvassed among corporate managers and business executives. (i) However, the significance of corporate governance in strengthening the relationship between retained earnings and market to book value of firms in Nigeria remain the focus of this study.

LITERATURE REVIEW

Conceptual Literature

This section provides a clear interpretation of the main concepts which are highlighted in the following subsections.

Retained Earnings (RE)

Retentions represent part of the trading surplus of an organization not paid out to investors or shareholders as return on their investment but set aside by management for business expansion and future growth of the entity. Retained earnings constitute the inflows of the company's surplus after all attributable costs and dividend payable must have been deducted. Chasan (2012) opined that major dispute always exists between corporate managers (agents) and the shareholders (principal) with regards to the retention policy for the organization. It is natural for the shareholders to expect immediate returns on their investment through constant dividends, however corporate managers may prefer an increased earnings retention to be able to finance expansion and business growth.

(i) According to Adeniji (2022), there were marginal charges in retained earnings among listed manufacturing firms in Nigeria and a non-linear trend as retained earnings curve decreased by 1.8% between 2008 and 2011, leveled off between year 2013 and 2014, increased by 2.3% between 2015 and 2017 and then moved downwards by 0.6% from 2017 to 2018

Corporate Governance (CG)

For decades, different researchers, theorist and organizations have made enormous effort in explaining the rationale behind corporate governance. These efforts resulted in corporate governance being garnished with different opinion and explanations. According to the Organization for Economic Cooperation and Development (OECD, 2004), Corporate governance represents the rules and practices that governed the relationship among the managers and shareholders of corporations, which contribute to the growth and financial stability by underpinning market confidence, financial market integrity and economic efficiency. It is logical to posit that the application of corporate governance principle is central to the attainment of organizational goals. However, Mayer (1997) observed that merging the business motives of shareholders and the corporate managers towards achieving the organizational objectives and maximizing investors returns constitute the focus of corporate governance. In this study, the key components of corporate governance used include (i) Board structure (ii) Executive Compensation (iii) Ownership and Control Structure (iv) Disclosure and Financial Transparency and (v) Shareholder's Right.

Market-to-Book (MB) Ratio

According to Caccagnoli (2009), market to book ratio constitute the amount that the market attached to the net asset of an organization or the ability of corporate managers to effectively utilize the available assets in enhancing business growth. MB ratio combines both forward looking market indicators of firm performance and historical accounting. It therefore reflects the perception of the market with regards to the management efficiency in administering the business outfit through premium or discount with low premium. Several scholars have adopted this approach in measuring firm value (Akinkoye & Akinadewo 2018; Gusta Kennedy & Weaver 2009).

Empirical Review

The extant literature on the effect of retained earnings and firm value produced contradictory findings in both developed and developing economies globally. Many scholars have associated firm retained earnings with firm value, but the results are not convergent (Ugah, Uche & Ogba, 2019; Ball, Gerakos, Linnainimae & Kharah 2017, Thirumalaisamy & Al-Baloushi, 2017). Most researchers opined that effective and consistent retention policy is an important panacea for increase in market value of shares, as well as the economic growth of the nation (Akinkoye & Akinadewo, 2018; Ball, Grakos, Linnainman & Nikolaer, 2019; Munir, Khara & Abidi, 2017; Thirumalaiosamy & Al-Baloushi, 2017).

According to Zarmountz (1992), the level of corporate investment can be used to gauge the performance level of any economy from both micro and macro perspectives. From the macro perspective in a business circle, investment decision account for the majority of the volatility in the Gross Domestic Product (GDP) dynamics and their magnitude serves as a significant leading indicator of economic performance. From the micro perspective, they are crucial for the growth of individual companies, increasing their efficiency by reducing unit costs (Zarnorvitz, 1992). Therefore, the positions of different scholars on the effect of retained earnings and market value can be grouped into three categories, positive, neutral and negative. Among several empirical researches reviewed for this study, a selected sample of (24) twenty-four journals revealed that (17) seventeen studies show a positive relationship, five (5) revealed negative relationship while (2) two scholars observed no relationship.

Notable scholars therefore supported the position that a positive relationship exist between retained earnings and firm value (Akinkoye & Akinadewo, 2018; Urooj Sundhu, Hashmi & Hussain, 2017; Munir & Kharal, 2017). Other researchers opined that retained earnings merely decreases the value of firm (Ugah, Uche & Ogbu, 2019; Josh, 2015; Thuraniva, 2014; Jalai, Shabir, Hamad, Iqbal & Muhammed, 2014). Some other researchers however established no relationship between firm value and retained earnings. The implication of this position is that retained earnings has no effect on share value of an enterprise (Gul, Sajid, Razzaq & Khan, 2012; Toby, 2014). In Nigeria to be precise, scholars are also divided with regards to the effect of retained earnings on firm value. Some researchers observed that a positive relationship exist and as such retained earnings increases firm value (Akinkoye & Akinadewo, 2018, Ekwe & Inyiama, 2014). Other researcher, however argued that increase in retained earnings decreases firm value (Ugah, Uche & Ogbu, 2019) while Toby (2014) posited that retained earnings has no effect on firm value, thereby supporting the notion of dividend irrelevance theory postalated by Modighani and Miller in 1958.

Despite the avalanche of prior studies relating firm value with retained earnings, non of these researchers was able to investigate the combined effect of both retained earnings and corporate governance on market value of listed firms in Nigeria. It is also evident in all surveys that the relationship between retained earnings and market value are not clear cut, while the influence of corporate governance practices in this relationship is completely omitted. Also, from the position of corporate governance compliance, scholars were mainly preoccupied with the effect of corporate governance compliance on market value (Egiyi, 2022; Esan, Nwobu, Adeyanju & Adeyemi, 2022; Ergene & Karadeniz, 2021; Nag & Challerjee, 2020; Ika, Rachmanti, Nugroho & Putri, 2020; Oladeji & Agbesanya, 2019; Ahulu & MacCarthy, 2019; Sagin & Suleiman 2019) without evaluating its impact on retained earnings policy. Several theories propounded on retained earnings relied on the assumption that managers always acted in the manner that are regarded in line with the motives of shareholders. Conversely, the underline theories associated with corporate governance such as agency, situate that as a result of separation of ownership from control, conflict of interest may arise between the principal (shareholders) and the agent (managers). These two

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positions are contradictory and must be resolved. This study therefore explained how retained earnings and corporate governance practices influences the firm value among listed manufacturing firms in Nigeria.

METHODOLOGY

Theoretical Framework

This study was anchored on both the Agency Theory and Pecking Order Theory. The decision to adopt both theories was based on different positions. Firstly, if there was no dichotomy between ownership and control in any establishments, the problem associated with information asymmetary would not arise. In the absence of information asymmetary would not arise. In the absence of information asymmetoy, investors may not be bothered much about whether or not retention policy is in the best interest of the organization, since the investors are mainly the beneficiaries of future returns. Secondly, corporate governance compliance became imperative as a result of the various sharp practices among the agents of the establishments. Thirdly, in the absence of information asymmetary, agency cost would be minimal or non-existence. According to Easterbrook (1984), problems associated with retention policy are directly related to agency cost which include managerial attitude towards dividend payment. This assertion is traceable to the fact that management emoluments constitute a direct cost to the organization. Lastly, Pecking order theory postulated that for the sake of corporate financing, management will prefer to source the required funds internally before considering external borrowings despite the fact that on the longrun, debt financing may be cheaper to the firm.

Population, Sample and Data Collection

The study adopted descriptive survey research design and used secondary data. Population framework for the study comprised of 78 listed manufacturing firms traded consistently between 2008 and 2018 on the Nigerian stock market. A sample of 56 manufacturing was selected through purposive sampling technique representing about 72% of the entire population. Information on economic value of firms covering a period of 2008-2018 were obtained. Data on economic variables such as retained earnings, earnings per share and all other related financial information were sourced from the published accounts and other public and relevant data disclosed by the sampled forms. The data consisted of retained earnings, corporate governance and other control variables whose influence on value cannot be ignored. The study used descriptive and inferential statistics to examine the effect of retention policy and corporate governance on firm's value.

RESULT AND DISCUSSION OF FINDINGS

The general properties of the selected variables were evaluated using descriptive statistics analysis. A multi-collinearity test was concluded to rule out the possibility of interdependence and relatedness of the independent variables. Significant correlations among the variables was examined using correlation matrix. The strength of the association between the studied variables was tested using regression analysis.

Descriptive Analysis

The sample size consists of 56 manufacturing firms traded on the Nigerian Stock Exchange from 2008 to 2018 whose firms' stocks were actively traded in the floor of the market. The sample size was appropriate to represents the entire population and all the data required. There was no evidence of clustering in any of the years. Table 4.1 shows frequency distribution of the firms during the sample period. Data collected and used in this work is a balanced panel data comprising both annual and cross-sectional data. The categories of firms by industry and distribution by years are shown in the Table 4.2 below.

Table 4.1 Distribution of Firms

Period	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Firms	56	56	56	56	56	56	56	56	56	56	56

Source: NSE Factbook Publication 2021.

Table 4.2 Distribution by Sectors

Sectors	**Number of Firms**	**% of Sample**
Agriculture	5	8.93
Consumer Goods	20	35.71
Healthcare	11	19.64
Industrial Goods	15	26.79
Natural Resources	5	8.93
Total	56	100

Source: Nigerian Stock Exchange Publication 2021

The study also performed properties check on all the variables. The descriptive analysis indicated average, maximum and minimum values of the variables. It also show the extent of dispersion of the variables from the mean. The primary independent variables in the study retained earnings proxy with (retained earnings per share and earning, per share) and corporate governance components. Also included are control variables (leverage, liquidity, size, tangibility and firm age) whose influence on firm's value cannot be ignored and have been used prominently in finance literature. The descriptive analysis as reported in Table 4.3 was conducted on 5% level of confidence. In Table 4.3 the value of retained earnings per share range from 0.462 minimum to 0.883 maximum. This implies that some establishments reinvested as much as 88% of earnings accrued to shareholders. The value of earnings per share ranges from 0.091 to 7.667 indicating that some firms performed relatively well as the amount of earnings accrued to equity is high. The mean value of 2.347 and standard deviation of 2.181 clearly indicate that listed firms on the Nigerian Stock Exchange on average, make a good return on equity, and the value sparely dispersed from the mean. The mean value of corporate governance index (LCG1) is 1.336 which implies that the level of compliance with governance code among manufacturing firms in Nigeria is moderate. The maximum value is 1.398 while the lowest value is 1.279. The standard deviation of 0.045 shows that the differences in levels of compliance among firms are insignificant.

Table 4.3 Descriptive Statistics of the Variables

	EPS	LCGI	LEV	LIQ	MRK	RPS	SIZE	TAN	LAGE
Mean	2.347	1.336	0.155	0.826	0.224	0.734	8.796	0.067	1.475
Median	2.432	1.342	0.134	0.753	0.122	0.746	8.873	0.063	1.477
Maximum	1.67	1.398	0.287	1.265	0.582	0.883	9.029	0.097	1.544
Minimum	0.091	1.279	0.064	0.479	0.032	0.462	8.525	0.022	1.398
Stand Deciation	2.181	0.045	0.067	0.241	0.187	0.106	0.161	0.024	0.046
Skewness	1.091	0.076	0.606	0.363	0.891	-1.124	-0.489	-0.343	-0.125
Kurtis	3.577	1.655	2.289	1.989	2.257	4.542	1.944	1.930	1.801
Jarque	130.79	47.02	50.62	39.77	95.60	170.67	53.15	41.47	38.52
Prob	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Observation	616	616	616	616	616	616	616	616	616

Source: Eviews Output

DISCUSSION OF FINDINGS

Analysis on the effect of retained earnings and corporate governance on market-to-book value of firm was done using the random effect model after Hausman test suggested its appropriateness. The study regressed market-to-book value on corporate governance and retained earnings measure together with the control variables. The overall findings opine that retained earnings and corporate governance are significantly and positively associated with the market-to-book value. The result from the panel regression of value on corporate governance index along with other control variables shows a significant and positive relationship at 1% level of significance. The coefficient of the relationship is strong which suggests the presence of good governance practice brings improvement in the management of firm's resources and subsequently enhances performances. The retained earnings measure that is, retained earnings per share and earnings per share were also found to be positively and significantly related to value. This result is consistent with earlier studies in the literature (Klapper & Love, 2002; Black & Jang. 2003; Chason, 2012; Omele 2015 and Thuranira, 2014). The positive relationship can be ascribed to the benefit accruable to or associated with the use of owners' fund to finance investment opportunity free of transaction cost and finance cost that characterized debt financing. The use of internal accruals to reduce debt liabilities also lessen the burden of firms' financial obligations. The result showed that the higher the retained earnings ploughed back by firms to finance business operations and investment opportunity with high potentials of generating future income, the higher the firms' value. These results strongly

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suggest that better-governed firms in Nigeria are highly regarded by investors who are willing to pay a premium for high governance standard.

Further analysis to single out the importance of corporate governance and retained earnings on firm value was carried out by controlling for other firm characteristics. In the regression, the key characteristics that the theory predicts should have effects on market-to-book were controlled. The result showed that all the control variables are statistically significant at 1% level in all the regression. The study showed that a two-standard deviation change in total retained earnings, corporate governance measures and other control variables predicts 0.79 of the market to book value. The adjusted r^2 indicates the effects of the independent variable on the dependent variable and explains over 21% of the variance in the market to book value of the firms. Interestingly, the result also showed that many of the control variables are significant in predicting market to book value of firms. The co-efficient of their relationship are strong and this suggests the extent to which a unit increase in the independent variables will influence the dependent variables.

Table 4.4 Retained Earnings, Corporate Governance Index Regression on Market Valuation

Independent Variable **Retained Earnings & Corporate Governance**	**Dependent Variable** **Market-to-book**
Constant	-11.644
LCGI	(-7.654) -0.812
RPS	2.155 0.844
EPS	9,761 0.016
LEV	5.393 2.285
LAGE	(17.259) 9.245
LIQ	(11.551) 1.287
TANG	(14.262) 14.033
SIZE	(10.614) 0.026
Obs no	(0.363) 616
R^2	0.80
Adj R^2	0.79

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CONCLUSION AND RECOMMENDATIONS

This study was motivated by the ongoing concern expressed by equity investors and other stakeholders on what seemed to be a declining trend in the value of listed firms. Additionally, the increasing amount of unclaimed dividends and undistributed earnings among firms in Nigeria. The main objective of the study was to investigate the effects of retained earnings and corporate governance and firm value on one hand, and retained earnings and firm value on another hand. The results showed that governance has positive effect on market value, likewise retained earnings exhibited positive relationship. The results confirmed the hypothesis that retained earnings and the presence of good corporate governance practices contribute to the value of firms. The primary assumption is that good corporate governance will ensure proper and efficient utilization of financial resources and improve firm performance. The result of this study is directly relevant and similar to the conclusion drawn from wealthy countries where studies had focused exclusively on the relationship between retained earnings, corporate governance and market value.

The study of this nature is valuable and crucial for policy implication. The extent to which retained earnings and corporate governance practice can predict the value of the firm has been established. The study therefore recommends the need to create a conducive business environment by ensuring good corporate governance structure is put in place by firm to allow more foreign investment and the development of the capital market. In addition, effort should be made to ensure efficient use of any retained earnings to generate future cashflow. It is also recommended that firms should review their retention policy regularly to ensure that the expectation of shareholders are always met.

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