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EARNINGS VARIABILITY AND SHARE PRICE VOLATILITY OF QUOTED NON-FINANCIAL FIRMS AT THE NAIROBI SECURITIES EXCHANGE

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ABSTRACT

Share price volatility affects smooth operations of the financial system creating uncertainties hence affecting stock market performance. This study sought to establish the effect of earnings variability on share price volatility of quoted non-financial firms at Nairobi Securities Exchange. The position of stock market efficiency, and information asymmetry crusades by signalling theory become unclear especially from the Nairobi Stock Exchange (NSE) context, which further necessitated the need to carry out the study. Efficient market hypothesis was analysed to test the significance of the objective of the study. The study adopted quantitative research design to evaluate earnings variability and share prices of quoted non-financial firms at Nairobi securities exchange. The population of the study of 44 -financial companies quoted at the NSE over the period January 2003 through December 2022. The mean EV ratio value presents an increased likelihood of earnings smoothing. Therefore, the likelihood of an enterprise's earnings manipulation in the financial statements is higher. This signifies that there was high variation in volatility which is not desirable for the measures of dispersion

Key Words: *Share Market, Security Exchange, Share Volatility*

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INTRODUCTION

Organizations use financial statements as a medium of communication with different stakeholders and therefore leaders and regulators in accounting have concerted their efforts in the improvement of the quality of financial statements for improved transparency (Vijitha & Nimalathasan, 2014). The essential drive for accounting standards is to safeguard the interest of the investors and other stakeholders of the organizations (Zimmerman, 2015). According to International Accounting Standards Board, IASB (2010), the principal objective of general financial reporting is to provide financial information about the reporting entity that is helpful (value relevant) to existing and possible investors, lenders and other creditors in arriving at conclusions about providing resources to the entity. Since the establishment of International Accounting Standards (IAS) in 1973, it has given fundamental guidance and reference point for many issuers of local accounting standards, preparers and analysts of financial reports. This is pointed toward offering support for capital market efficiency as an approach of mitigating the impact of information asymmetry on value relevance (Odoemelam, Okafor, & Ofoegbu, 2019). Therefore, standard financial reporting key standards and strategies serves as a guide for producing relevant and reliable accounting data is an indispensable regulatory framework. This is because of the fact that securities exchange participants' desire high-quality accounting information to strengthen their confidence in the local and global stock markets.

Consequently, it is vital to infer financial statements as external feasible sources regarding the company's financial position. The use of financial statements has grown more though the accounting practices have not matched the rapid changes in technology that influence the relevance and credibility of accounting information. The International accounting standard board (IASB Framework) says in section 26 that information is significant "when it impacts the financial choices of clients by assisting them with assessing past, present or future occasions or confirming, or rectifying, their previous assessments". Financial accounting standard board concept statement No. 2, Qualitative attributes of accounting data says in section 47 that, to be relevant, "accounting information must be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations," and goes on to define event and outcome (IASB Framework).

Literally, value relevance is the ability of financial statements accounting information to capture information that is capable of influencing share value in the stock market (Karğin, 2013). Zeng, Lee, & Zhang, (2016) posits that, value relevance concept is all about how much of an entity's market value can be described by accounting information disclosed. According to Nijam, & Jahfer, (2018), test of value relevance is one approach to operationalise stated criteria of relevance and reliability (qualitative characteristics of accounting information) by the standards setters. Also, value relevance is one of the desirable attributes (or measures) of accounting quality (Perotti, & Wagenhofer, 2014). Generally, etymology of value relevance study has been traced to Ball and Brown's (1968) seminar through which they argued that newly released useful accounting information will affect efficient capital market (BoliBok, 2014; Desoky & Mousa, 2014; Okafor, Anderson & Warsame, 2016).

The ability of the current earnings to forecast future earnings is referred to earnings quality (Lyimo, 2014). Earnings are considered to be of good quality if reversals on earnings are not projected. Investors focus on valuation and are concerned in future earnings by focusing on the current ones. Further earnings are said to be of poor quality if the current reported earnings are not good indicators of future ones.

Okonkwo and Jude (2019) explored the causal connection between stock gains volatility and selected macroeconomic variables in the Nigerian Stock Exchange from 1981 to 2018. The study used industrial production and exchange rates as variables, whose effect on stock gains volatility was analysed using Johansen co integration and Granger Causality impact assessment tests. The results revealed a causal relationship between stock return volatility and selected macroeconomic variables in the long run. By

augmenting the selection of variables beyond the microstructure of the stock market and considering a longer time horizon of 37 years, Okonkwo and Jude (2019) seem to have cured the inadequacies of a shorter term period in the research by Pirzada (2017) who had recommended consideration of variables beyond the scope of his study.

Earnings variability is a situation where there is a fluctuating pattern of a company's net income or earnings per share (EPS) during a given period of time. Insiders can hide a firm's economic performance change, using operating decisions and financial reporting aspects. Moreover, they are capable of using accounting discretion to cover economic shocks to the cash flow of a firm. For instance, they may delay the reporting of current costs to hide poor current performance or accelerate the reporting of future revenues. The objective seeks to evaluate the effect of earnings variability on share price volatility of non-financial firms listed at Nairobi Securities Exchange.

the stock market accelerates economic growth by boosting domestic savings and improving the overall investment quantity and quality (Abbas, Pei, & Rui, 2016). Bisaro and Hinkel (2018), opined that the stock market mobilizes savings through the provision of extra financial instruments that may be better in terms of risk and liquidity demands for individuals. In addition, stock markets are an avenue for companies to raise low-cost capital rather than depending on credit finance, thus reducing the credit risk of these firms. The belief by the management is that, if the firm value is not maximized, other economic agents may gain firm control and replace the existing management for more efficiency. Additionally, the effected management changes ensure that firms' resources are efficiently utilized (Moorman & Day, 2016).

Earnings Quality and Share Prices Volatility in the Nairobi Securities Exchange

The NSE, through which public companies issue their debt and equity securities, has stringent disclosure rules with respect to financial information. The reflection of information inherent in the securities traded at the NSE is revealed in several indices which include the NSE all-share index (NASI), the NSE-20 share index, the FTSE NSE Kenyan 15 index and the FTSE NSE Kenyan 25 index. The listed companies at the NSE are divided to ten segments that are identified as Agricultural, Automobiles and Accessories, Banking, Commercial and Services, Construction and Allied, Energy and Petroleum, Insurance, Investment, Manufacturing and Allied as well as Telecommunications and Technology segments.

The NSE was first constituted in 1954, it is a member of the East African Securities Exchanges Association (NSE, 2015). For continued listing of a company's securities, the NSE regulations require that public companies must on an ongoing basis provide interim and final financial statements similar to those required by the Companies Act Cap.486. Also to be furnished should be selected notes to the financial statements. The notes provide for the inclusion of accounting policies, which in the context of this study include the mode of dealing with earnings, cashflow from operations, total assets and accruals.

The NSE (2015) regulations require that for continued listing, the accounting measurement rules and procedures followed by a business must ensure that the resulting financial information is reliable. They further indicate that a business should select and apply accounting policies such that financial statements are consistent with all the relevant and applicable International Accounting Standard (IAS) or International Financial Reporting Standard (IFRS) and the standing interpretation committee of IAS. This requirement implies that the provision of IAS 18, revenue, with regard to revenue accrual and deferral, is consistent with the expectations of NSE for accrual accounting and the International Accounting Standards Board's (IASB) framework of accounting.

The Nairobi Securities Exchange is a stock market that has been characterized by a few market participants and it has grown considerably over time. The NSE successfully instituted the central securities depositories (CSD) in November 2004 and installed an automated trading system (ATS) in November 2007. The exchange is also undergoing restructuring of its governance system through demutualization. Characterized by its

liquidity, market capitalization and turnover, the NSE may be classified as both an emerging market as well as a frontier market. The NSE is therefore a model market in view of its high returns, vibrancy and well-developed market structure.

There are 44 non-financial firms listed at the NSE under the accompanying areas: Agriculture, Commercial and services, technology and telecommunication, automobiles and accessories, investment, Manufacturing and allied services, Construction and allied, Energy and petroleum sectors. Given the significant role that a capital market plays in the economy, understanding the principal drivers of stock returns in a specific market is pivotal. It is of prime importance to recognize the crucial factors on the impact of earnings quality and share price volatility in emerging markets, like the Nairobi Securities Exchange.

Statement of the Problem

Earnings that demonstrate a steady growth tendency are named as desirable (Stallings, 2017) thus in this way, in financial statements analysis, unusual, non-operating or non-recurring items reported on the income statement require more consideration than others in terms of quality of earnings. This is because these items have negative effect on the sustainability of earnings. The term "persistence" is widely used interchangeably with sustainable earnings in the literature. Thus, high quality of earnings is sustainable earnings as often referred in financial analysis.

The ability of investors to identify differences in earnings persistence is critical in valuation. If earnings are permanent, investors do not need to make cash-flow predictions to value equity; they can simply divide permanent earnings by the risk-free rate (Penman, & Reggiani, 2013). As a result, Young, (2014) points out investors have sought to identify the determinants of earnings persistence in order to better understand the relation between current earnings and permanent earnings. It is therefore essential to determine the extent to which earnings persistence influence share price volatility of quoted non-financial firms at the NSE.

Investors depend on accounting information in their pricing of shares and companies which provide good quality information have thus an advantage in a lower cost of capital. Thus, an investigation of earnings quality and share price volatility focusing on the quoted non-financial firms is an important matter for developing countries like Kenya. Therefore, this study aims at assessing the earnings quality and share price volatility of quoted non-financial firms at Nairobi Securities Exchange and evaluating the moderating effect of firm size on the effect of earnings quality and share price volatility of non-financial firms listed at NSE.

Objective of the Study

The objective of this study is to assess the influence of earnings variability and share price volatility of quoted non-financial firms at Nairobi Securities Exchange. The study sought to answer the following research hypothesis;

- H_{01} There is no significant effect of earnings variability on share price volatility of quoted non-financial firms at NSE.

LITERATURE REVIEW

Theoretical Review

Theoretical support for the study was drawn from the theories dealing with information theories. There are several theories that explain the relationship between earnings quality and share price volatility. They include free cash flow theory 1976 by Jensen, efficient market hypothesis 1970 by Fama, Modigliani and Miller hypothesis 1958 and random walk theory 1973 by Malkie.

Efficient Market Hypothesis (EMH)

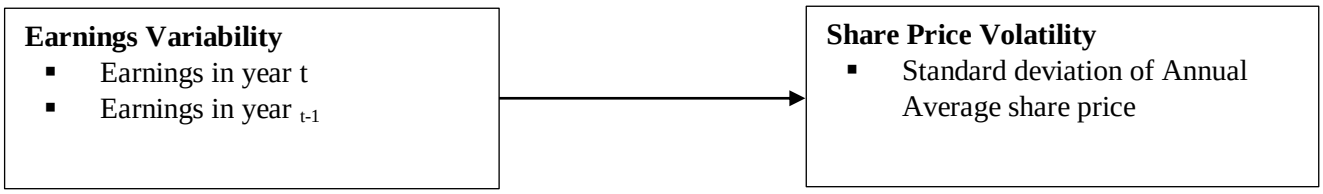
Stock prices are a reflection of all available information in the capital market according to Fama, (1970) and are traded at their fair value at all times making it impossible to choose stocks that will beat the returns of the

overall market. In the event of fresh information becoming available, it spreads swiftly and is immediately reflected in the price of shares. Investors can achieve higher returns by selecting "undervalued" stocks, according to the theory, which states that the study of past stock prices is an attempt to predict future prices known as technical analysis. Neither this theory nor fundamental analysis, which is the analysis of financial information such as company earnings and asset values, etc., helps investors select "undervalued" stocks.

EMH completeness was studied by Malkiel, (1973), who focused on the theory of random walk hypothesis, a stock market theory that says past price movement or direction cannot be utilized to forecast future market movement. Bachelier (1900) cited in (Dimson & Massoud, 2000) incorporated the concept of Brownian motion in finance theory, which stated that "past, present and even discounted future events are reflected in market price, but often show no apparent relation to price changes".

There are "too many" consecutive moves in the same direction for Lo & MacKinlay (1999) to reject the hypothesis that stock prices behave as random walks, and they find that short-run serial correlations aren't zero. Short-term stock prices appear to be gaining traction. In addition, Lo, Mamaysky and Wang (2000) also find that some of the stock-price signals used by "technical analysts" such as "head and shoulders" formations and "double bottoms" may actually have some modest predictive power, using sophisticated nonparametric statistical techniques that can recognize patterns. Short-term and long-term stock price predictions are based on the efficient capital market theory. This theory is therefore relevant and therein linked to earnings variability because of the nature of earnings and share prices fluctuating either in the short term or in the long term and the extent to which they vary from one period to another.

Conceptual Framework



Independent Variable **Dependent Variable**

Figure 1: Conceptual Framework

METHODOLOGY

The research design for this study was a quantitative survey. The target population for this study was the entire population of 39 non-financial firms listed on the Nairobi Stock Exchange (NSE) (NSE, 2017). The sampling frame for this study includes all 33 non-financial companies listed in Nairobi Securities Exchange as at 31st December 2022. Secondary data was captured from the Nairobi Securities Exchange and the individual companies' websites. Because the dependent variable was measured with two different contrasts, two-panel regression models were used. To examine earnings quality and share price volatility of quoted non-financial firms at Nairobi Securities exchange, the study adopted panel data set since the data is time and cross sectional.

Earnings Variability

Earnings variability is usually calculated as the standard deviation of year-over-year earnings per share growth over (n-) number of previous fiscal years. The higher the EV, the less stable the earnings growth.

In this study, we focus on the variability associated with the change in earnings over time. The change in reported earnings of a firm can be disaggregated into change in earnings before discretionary accruals (*EBDACC*) and change in discretionary accrual (*DACC*). This relationship is summarized as follows:

$$CFO + NDACC = EBDACC + DACC = NE$$

Where;

Change in cash flows from operations (*CFO*)
+ Change in "naturally occurring" accruals (i.e. non-discretionary) (*NDACC*)
Change in earnings before discretionary accruals (*EBDACC*)
+ Change in discretionary smoothing accruals (*DACC*)
Change in reported net earnings (*NE*)

The change in earnings before discretionary accruals is the sum of the change in cash flows from operations and the change in non-discretionary accruals. Non-discretionary accruals are created in the normal course of accounting for a firm's operations. They are distinguished from discretionary accruals, which result from a manager's selective use of choices within GAAP in order to smooth earnings. In this study, we are interested in whether analysts recognize the extent of managerial intervention in the financial reporting process when forecasting earnings. Thus, we distinguish these "naturally-occurring" accruals from discretionary accruals, and use earnings before discretionary accruals as our proxy for the firm's underlying operating performance. A similar decomposition is used in Ghosh and Olsen (2009).

FINDINGS

Descriptive Statistic for earnings variability and share price volatility

The mean value for earnings variability (EV) was -8.0152. When factoring earnings variability, for measures of central tendency, lower values are preferred. In this context, the mean value satisfies the condition for the decision rule. The measures of dispersion for earnings variability less variability is preferable. The standard deviation was 1.07732, skewness was -0.106, kurtosis was 0.137, the sum was -4961.41, maximum value was -5.23 and the minimum value was -11.36 for the same period.

The distribution is skewed on the right side since it is negative, kurtosis is positive hence leptokurtic, standard deviation measures variability from the mean and from the statistics it can be said that the variable is great. That is, it varies from the mean value of -8.0152 to 1.07732. The greater the standard deviation the greater the magnitude of the distribution, meaning that there was relatively high EV variance in the standard deviation value over the years, hence it is not preferred.

In comparison with the measures of dispersion for share price volatility where less variation in volatility is desirable. The minimum value was 0.71, maximum value was 762.27, the sum was 28742.31, standard deviation was 86.89926, skewness was 4.029, while kurtosis was 20.819. the kurtosis of the dependent variable is positive or leptokurtic, the skewness longer on the left side therefore positive, the standard deviation measures the dispersion of a data set relative to its mean, the greater it is the greater the magnitude of the distribution.

On the contrast the decision rule for measures of central tendency for share price volatility, lower values are preferred. The mean value of 45.841 high hence not preferred. This signifies that there was high variation in volatility which is not desirable for the measures of dispersion. Further, the mean EV ratio value is,however, less, which presents an increased likelihood of earnings smoothing as according to Manukaji, (2018), the smaller this ratio, the less changeable the earnings variability will be, compared to the fluctuation of the cash flow. Therefore, the likelihood of an enterprise's earnings manipulation in the financial statements is higher.

The table 1 below contains the basic features of the data trends which comprised the means, standard deviation, standard errors, maximum and minimum values computed for earnings persistence variable. The section also presents the correlation matrix. There was also the likelihood of heteroscedasticity and the need to have dimensional homogeneity between the variables, the ratios in the independent variables were

transformed in their natural logarithms. Table 1 gives the summary statistics for the earnings variability used in the study.

Table 1: Summary Statistics for Earnings Variability

		EOI Ratio	Change in reported N/E Ratio	Earning ratio to outstanding stock	CACC Ratio	Log of total F.A	SD OF annual share Price
N	Statistic	633	633	633	633	633	633
Minimum	Statistic	-0.5478	0	0	-0.5478	48229	0
Maximum	Statistic	1.656429	0.005376	1.78E+09	1.656429	2.54E+09	1085
Sum	Statistic	78.25372	0.357008	1.99E+10	78.31344	2.76E+10	42630.2
Mean	Statistic	0.123624	0.000564	31494111	0.123718	43655511	67.34628
Std. Deviation	Statistic	0.172528	0.000721	1.43E+08	0.172477	2.13E+08	123.5617
Skewness	Statistic	2.937	2.983	9.163	2.939	9.497	4.004
	Std. Error	0.097	0.097	0.097	0.097	0.097	0.097
Kurtosis	Statistic	19.233	10.937	90.066	19.253	96.709	20.621
	Std. Error	0.194	0.194	0.194	0.194	0.194	0.194
		Ln_EOI	Ln_CRNER	Ln_EROS	Ln_CACC	Ln_TFA	Ln_SDASP
N	Statistic	559	619	632	560	633	627
Minimum	Statistic	-8.48	-11.36	9.91	-8.18	10.78	0.71
Maximum	Statistic	0.5	-5.23	21.3	0.45	21.66	762.27
Sum	Statistic	-1339.18	-4961.41	9579.81	-1342	9834.07	28742.31
Mean	Statistic	-2.3957	-8.0152	15.1579	-2.3964	15.5356	45.841
Std. Deviation	Statistic	1.13381	1.07732	2.04824	1.13293	1.86523	86.89926
Skewness	Statistic	-1.206	-0.106	0.006	-1.204	0.219	4.029
	Std. Error	0.103	0.098	0.097	0.103	0.097	0.098
Kurtosis	Statistic	3.574	0.137	0.007	3.579	0.485	20.819
	Std. Error	0.206	0.196	0.194	0.206	0.194	0.195

Correlation Analysis

The data was subjected to correlation analysis to test for highly correlated variables. Table 2 below shows correlation coefficients results.

Table 2: Correlation coefficients results

		Ln_EV	Ln_FS	Dev_SP
Ln_EV	Pearson Correlation	1.00000		
	Sig. (2-tailed)			
Ln_FS	Pearson Correlation	-.681**	1.00000	
	Sig. (2-tailed)	0.00000		
Dev_SP	Pearson Correlation	.187**	-.202**	1.00000
	Sig. (2-tailed)	0.00000	0.00000	

The results in Table 2 indicate that all the variables are correlated, meaning that they are linearly related. Earnings variability had a correlation coefficient of 0.187 which was significant and indicates that there was a positive correlation between earnings variability on share prices of quoted non-financial firms at NSE. This meant that an increase in earnings variability would lead to increased share price volatility. While a positive correlation suggests a relationship where higher earnings variability coincides with increased share price volatility, and vice versa, this is an associative relationship and not a definitive causal relationship between the

variables. That is, we cannot conclusively state that changes in earnings persistence cause changes in share price volatility.

Diagnostic Tests

Test of Normality

When estimating a multiple regression model, normal distribution of data is an important requirement. Therefore, the current study used skewness and kurtosis to the test of normality of the data. Skewness is lack of symmetry in data distribution (Baker, 2019), and is categorized into both into both negative and positive distributions. A distribution is positively skewed when its tail is more pronounced on the right side than it is on the left. Since the distribution is positive, the assumption is that its value is positive. As such, most of the values end up being left of the mean. This means that the most extreme values are on the right side.

A negatively skewed (also known as left-skewed) distribution, on the other hand, is a type of distribution in which more values are concentrated on the right side (tail) of the distribution graph while the left tail of the distribution graph is longer. Kurtosis is a measure of the tailedness of a distribution. Tailedness is how often outliers occur. Excess kurtosis is the tailedness of a distribution relative to a normal distribution. Values which are close to zero indicate that the data shape was close to normal while negative value indicates distributions flatter than the normal. Positive kurtosis values show shapes peaked than normal. According to Flammer (2016), kurtosis and skewness values lying between 2 or -2 are sufficient for statistical analysis. The summary statistics for the normality tests carried out in this study are shown in Table 3.

Table 3: Normality Test

		Ln_EV	**Ln_FSize**	**Ln_SP**
N	Statistic	619	633	627
Minimum	Statistic	-11.36	10.78	0.71
Maximum	Statistic	-5.23	21.66	762.27
Sum	Statistic	-4961.41	9834.07	28742.31
Mean	Statistic	-8.0152	15.5356	45.841
Std. Deviation	Statistic	1.07732	1.86523	86.89926
Skewness	Statistic	-0.106	0.219	4.029
	Std. Error	0.098	0.097	0.098
Kurtosis	Statistic	0.137	0.485	20.819
	Std. Error	0.196	0.194	0.195
Jarque-Bera		1.4335	11.26394	4.9685
Prob.		0.022156	0.041101	0.03921
Sum.Sq.Dev.		7.13809	14.82611	9.11026

Table 3 shows that the p-values for the variables; earnings variability, firm size, and share price volatility, lied between 0.0176 and 0.0411. The corresponding Jarque-Bera values were 5.03892, 1.4335, 0.0043, 5.735147, 11.26394 and 4.9685, respectively all which were less than the critical chi-squared value is 5.991 for a significance level of 0.05 and 2 degrees of freedom. Therefore, we fail to reject the null hypothesis that that the data comes from a normal distribution. Further the kurtosis and skewness values, all lying between 2 and –2, which is indicative that all variables were normally distributed as recommended by Flammer (2016).

Hypotheses Testing of Earnings Variability on Share Price Volatility

The hypothesis of this study H_{01} stated that there is no significant effect of earnings variability on share price volatility of quoted non-financial firms at NSE. The results showed that earnings variability had a coefficient of 15.15 and a p-value of $0.000 \leq 0.05$. This means that earnings variability had a significant and positive negative association with share prices of quoted non-financial firms at NSE during the 20-year period under

investigation implying it led to significant share price volatility of quoted non-financial firms at NSE. The results further, implies that a unit change in earnings variability has a corresponding positive effect of 15.15 standard deviation units share prices of quoted non-financial firms at NSE seteris peribas. We therefore reject the null hypothesis that there is no significant effect of earnings variability on share price volatility of quoted non-financial firms at NSE. This meant that during the period of the study, the alternative hypothesis obtained indicating that earnings variability significantly coincided with share price volatility of quoted non-financial firms at NSE.

CONCLUSIONS AND RECOMMENDATIONS

The study found significant associations between earnings variability and share price volatility of quoted non-financial firms at NSE. This was consistent with the hypothesized relations where higher earnings variability would portend higher share price volatility of quoted non-financial firms at the NSE context and equally the expectations of the Efficient Market Hypothesis. Literally, the current findings indicates that a trend where increased earnings variability coincides with increased share price volatility, but not as a definitive cause of it.

The NSE should develop earning variability reporting mechanisms which when listed in their websites and other publications, can aid the investors to tract the earnings variability of firms prior to making decisions about engagements with the firms' assets. An assessment of the reasons for variability should also be made available to the investors and the firms alike for improving decision-making.

Area for Further Research

The study focused only on the firms listed at the Nairobi securities Exchange. This provided a limited population of about five dozen companies. Although these are representative of the various economic segments in the Kenyan environment, the firms are largely large in size. The fact that most firms in Kenya are not listed implies that a suggestion for study on the effect of earnings quality on share price volatility of small and medium size enterprises is apt. The findings from such a study could be compared to those from this study to check if there are any significant differences between share price volatility and earnings quality characteristics of the listed and non-listed firms as well as large and small scale enterprises in Kenya.

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