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Earnings Management and Corporate Governance in Nigeria

Olayinka Marte Uadiale
Department of Accounting, University of Lagos, Lagos State, Nigeria
E-mail: ayomideose@yahoo.com

Abstract

Earnings management has received considerable attention in recent times. This is due to its linkage with the reliability of published accounting reports. Indication from the academic literature has shown that the practice of earnings management is quite extensive among publicly traded firms. In response to the demand for greater proportion of independent directors on corporate boards and the need for financial sophistication of audit committee members, this study examines the role of the board of directors and audit committee in preventing earnings management in Nigeria. Using a questionnaire survey, the study finds that board dominated by outside directors brings a greater breadth of experience to the firm and are in a better position to monitor and control managers, thereby reducing earnings management. It was also observed that audit committee whose members possess certain level of financial competencies would reduce the likelihood of earnings management. The study recommends that board composition should include greater proportion of independent outside directors with corporate experience. Audit committee members should be encouraged to possess a certain level of financial competencies in order to decrease the likelihood of earnings management.

Keyword: Earnings management, audit committee, board composition, corporate governance, Nigeria

1. Introduction

The issue of earnings management and corporate governance mechanisms has received considerable attention in recent years from academics, market participants, and regulators. It continues to receive attention due to recent corporate failures that has bought about doubts in the minds of stakeholders on the credibility and reliability of financial report. Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy & Whalen 1998).

There has been a considerable debate in recent times concerning the need for strong corporate governance (Adeyemi & Fagbemi 2010; Adeyemi & Uadiale 2010; Dabor & Adeyemi 2009; McConomy & Bujaki 2000) with countries around the world drawing up guidelines and codes of practice to strengthen governance (Cadbury 1992; Corporate Governance Code of Nigeria 2005).

Little wonder therefore that several studies and initiatives have been undertaken by countries and International Institutions on the subject “corporate governance”. As a result of the foregoing, several codes of corporate practices and conduct have been fashioned out and are in use in various jurisdictions including Nigeria. The rationale for this emphasis can be linked to increased concerns over the integrity of securities markets (International Federation of Accountants-IFAC 2003; Millstein 1999).

Good corporate governance by boards of directors and audit committee is recognized to influence the quality of financial reporting which in turn impacts investors’ confidence. Studies have shown that good governance reduces the adverse effects of earnings management as well as the likelihood of creative financial reporting arising from fraud or errors (Beasley 1996; Dechow *et al*. 1996; McMullen 1996). As a result, there has been a concerted effort to devise ways of enhancing independence and effectiveness of the board of directors and audit committee (Blue Ribbon Committee 1999; Corporate Governance Code of Nigeria 2005).

Earnings management can only be curbed when the board of directors and audit committee amongst others perform their duties well. This study examines the relationship between earnings management and two corporate governance mechanisms (composition of board of directors and audit committee).

1.1 Aim and Objectives of the Study

The aim of this study is to provide information that may help improve financial reporting in Nigeria by investigating the relationship between earnings management and two corporate governance mechanisms. In order to achieve this aim, the study specifically seeks to:

i. Examine the extent to which the proportion of independent directors affects earnings management in Nigeria; and

ii. Verify the extent to which possession of certain level of financial competencies by audit committee members affect earnings management in Nigeria.

1.2 Research Questions

The following research questions were raised in order to achieve the objectives stated.

i. To what extent does the proportion of independent directors affects earnings management in Nigeria?

ii. Does the possession of certain level of financial competencies by audit committee members affect earnings management in Nigeria?

1.3 Research Hypotheses

The hypotheses stated below were tested in order to provide answers to the research questions.

Hypothesis One

H_0: Boards with greater proportion of independent directors do not reduce the likelihood of earnings management in Nigeria.

H_1: Boards with greater proportion of independent directors reduce the likelihood of earnings management in Nigeria.

Hypothesis Two

H_0: Possession of certain level of financial competencies by audit committee members do not reduce the likelihood of earnings management in Nigeria.

H_1: Possession of certain level of financial competencies by audit committee members reduce the likelihood of earnings management in Nigeria.

1.4 Scope of the Study

This study basically seeks to investigate the relationship between earnings management and corporate governance mechanisms among listed firms in Nigeria. To achieve this objective, judgmental sampling technique was adopted to choose respondents whose jobs are finance and accounting-related from companies listed on the Nigerian Stock Exchange shoes headquarters are in Lagos State, Nigeria. The study was restricted to Lagos State as it harbours 60% of the Federation's total industrial investments and foreign trade and attracts 65% of Nigeria's commercial activities (The Academy of Business Strategy 2011).

2. Literature Review

One issue that has come to the forefront of recent debate on corporate failures regarding unethical behavior is that of earnings management. Research on earnings management shows that it is a pervasive phenomenon (Burgstahler & Dichev 1997) which has generated a great deal of talk and argument. However, earnings management is not always alleged as wrong. Arguments supporting it have also been made (Rudra & Bhattacharjee 2012). Scott (2003) believed that there is a good side of earnings management and that it can be a device to convey inside information to the market, enabling share price to better reflect the firm's future prospects. The accounting profession has also accepted that not all earnings management techniques are deceptive. However, the current accepted idea among accountants, regulators and standard setters is that, more often than not, earnings management is detrimental. It deceives investors and reduces the dependability of financial reporting. Mulford & Comiskey (2002) defined earnings management as the active manipulation of earnings toward a predetermined target. In the same vein, the Assurance Handbook (2003) defined earnings management to include the recording of accounting entries, without any event to justify the accounting or the failure to record or correctly record transactions for the purpose of altering results. From the definitions above, it can be said that the common subject is one of altering results.

It has been argued that the practice of earnings management is quite extensive among publicly traded firms (Barth *et al*. 2008; Burgstahler & Dichev 1997; Jian & Wrong 2004). Earnings management is primarily achieved by management actions that make it easier to achieve desired earnings levels through accounting choices from among Generally Accepted Accounting Principles (GAAP) and operating decisions. Thus, standard setters and the accounting profession are critically concerned about the practice of earnings management and the unfavorable consequence it has on financial reporting.

2.1 Corporate Governance in Nigeria

In recent times, a series of well-publicized cases of accounting improprieties in Nigeria (for example, such as is reported in relation to Wema Bank, NAMPAK, Finbank, and Springbank in Nigeria) has captured the attention of investors and regulators alike. As a result, there has been a concerted effort to devise ways of enhancing independence (Corporate Governance Code of Nigeria 2005; Blue Ribbon Committee 1999).

In view of the importance attached to the institution of effective corporate governance, the Federal Government of Nigeria, through her various agencies came up with various institutional arrangements to protect the investors of their hard earned investment from unscrupulous management/directors of listed firms in Nigeria. These institutional arrangements, provided in the "code of corporate governance" issued in November 2003 The code proposes that the business of a firm should be managed under the direction of a board of directors who delegates to the CEO and other management staff, the day to day management of the affairs of the firm. The best practices of the code also recommend that the board sees to the appointment of a qualified person as the CEO and other management staff. The directors, with their wealth of experience, are expected to provide leadership and direct the affairs of the business with high sense of integrity, commitment to the firm, its business plans and long-term shareholder value. In addition, the board provides other oversight functions. Other mechanisms of corporate governance include audit committee, shareholders rights and privileges.

The emergence of mega banks in the post consolidation era prompted the Central Bank of Nigeria to issue a new code of corporate governance which became operative in 2006. In the same vein, the Nigerian Securities and Exchange Commission (SEC), published the revised Code of Corporate Governance in September, 2009 after consultations with other regulatory bodies. The new code was issued to address the weaknesses of the 2003 code and to improve the mechanism for its enforceability. It requires the separation of the position of the managing director from that of the chief executive officer. Also, the code recommends that the number of non-executive directors should be more than that of executive directors subject to a maximum board size of twenty (20) directors. In order to ensure both continuity and injection of fresh ideas, non-executive directors should not remain on the board for more than three terms of four (4) years each, that is, twelve (12) years. In 2009, the insurance industry also embraced a corporate governance code.

The importance of effective corporate governance to corporate and economic performance cannot be over-emphasized in today's global market place. Companies perceived as adopting international best corporate governance practices are more likely to attract international investors than those whose practices are perceived to be below international standards.

Corporate Governance has succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. However, the concept of corporate governance is poorly defined because it potentially covers a large number of distinct economic phenomena. Babatunde (2003) defines Corporate Governance as the stewardship of an organization in terms of the way it is run, (directed and controlled). It is concerned with the respective roles, powers, responsibilities and accountability of stakeholders and the board.

The Organisation for Economic Cooperation and Development (OECD) in 1999 gave a definition which is consistent with the submissions of Cadbury 1992; Wolfensohn 1999; Uche 2004 and Akinsulire 2006. It defines corporate governance as the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spell out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

2.2 Composition of the board and earnings management

Among the set of corporate governance mechanisms, the board of directors is often considered the primary internal control mechanism to monitor top management and protect the shareholders' interest. For example, Fama (1980) argues that board of directors is a "market-induced institution, the ultimate internal monitor of the set of contracts called a firm, whose most important role is to scrutinize the highest decision makers within the firm".

It has been argued that it is the responsibility of the directors to ensure that financial statements are prepared according to approved accounting standards (Saleh *et al*. 2005). Since the applicability of accounting standards is very flexible, management may choose an acceptable accounting method or estimate that is appropriate for the need of the organization. In this respect, the compliance with the accounting standards may not necessarily mean that financial statements are free from manipulation. Thus, the compliance with accounting standards as required in the Companies and Allied Matters Act (CAMA), 1990 may reduce the propensity to manage earnings but may not eliminate the entire practice of earnings management. Therefore, it is important that the board of directors carry out its monitoring role effectively in order to ensure that financial reporting provides quality information to users by reflecting proper underlying economic substance of the company transactions.

The components within the board are essential ingredients for effective monitoring. The appointment of managers as directors (i.e. insiders) is important because they have more information about the organization compared to outside directors. However, domination by insiders may lead to transfer of wealth to managers at the expense of the stockholders (Beasley 1996; Fama 1980). Therefore, outside directors are appointed on the board mainly to obtain independent monitoring mechanism over the board process thereby reducing agency conflicts and improve performance (Craven & Wallace 2001). Consistent with this theory, results in prior studies suggest that outside directors are positively related to abnormal stock return (Rosentein & Wyatt 1990) and performance (Dalton *et al.* 1999) and negatively related to fraudulent reporting (Beasley 1996). Similarly, there is a negative relation between outside directors and earnings management (Klein 2002).

However, there are critics on the role of non-executive directors on the board. Some believe that they perform little role in monitoring the board because lack of real independence, time, as well as enough information (Gilson & Kraakman 1991; Patton & Baker 1987). To be effective, independent non-executive directors should have both, strong incentives to monitor the board, and the capabilities to identify earnings management (Peasnell *et al*. 2000).

Boards dominated by outsiders are arguably in a better position to monitor and control managers (Dunn 1987). Outside directors are independent of the firm's managers, and in addition bring a greater breadth of experience to the firm (Firstenberg & Malkiel 1980; Vance 1983). A number of studies have linked the proportion of outside directors to financial performance and shareholders' wealth (Brickley *et al.* 1994; Byrd & Hickman 1992; Subrahmanyan *et al*. 1997; Rosenstein & Wyatt 1990). Sakar *et al*. (2006) posit that firms with high quality governance mechanisms, such as independent board of directors are associated with low levels of earnings management. To the extent that independent outside directors monitor management more effectively than inside directors, this study hypothesizes that companies with a greater proportion of independent directors will be less likely to engage in earnings management than those whose boards are staffed primarily with inside directors.

2.3 Audit committee and earnings management

An audit committee is an operating committee of the Board of Directors charged with oversight of financial reporting and disclosure. Committee members are drawn from members of the company's board of directors, with a Chairperson selected from among the committee members. The Companies and Allied Matters Act (CAMA), 1990 states that a public limited liability company should have an audit committee (maximum of six members of equal representation of three members each representing the management/ directors and shareholders) in place. The members are expected to be conversant with basic financial statements.

The audit committee's function has evolved over the years. The primary objective of an Audit Committee is to increase the credibility of annual financial statements, assist directors in meeting their responsibilities and enhance audit independence (Bradbury 1990). Audit Committees have been involved in monitoring and protecting the interests of shareholders (Harrison 1987; English 1994; Menon & Williams 1994; DeZoort *et al.* 2002; Gendron & Bedard 2006). Researchers have also argued that financial reporting is more reliable and questionable corporate practices are reduced where an audit committee exists (Kolins *et al*. 1991; Eichenseher & Shields 1985; DeZoort 1998; Carcello & Neal 2003).

Due to their responsibility for oversight of internal control and financial reporting, good governance dictates that audit committee members should possess a certain level of financial competencies. Thus, the Blue Ribbon Committee (1999) recommends that each member of the audit committee should be or become financially literate and that at least one member should have accounting or related financial management expertise, where 'experience' is defined as 'past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities'. This recommendation is supported by DeZoort & Salterio (2001). They observe that the accounting experience of audit committee members as well as their knowledge of auditing is positively associated with the likelihood that they will support the auditor in an auditor-corporate management dispute. These recommended best practices and research findings suggest that the financial competencies of audit committee members decrease the likelihood of earnings management.

The audit committee has a very important role to play regarding fraud and overseeing fraud risk management. In this regard, audit committees play an important role in preventing, detecting and investigating fraud and earnings management. As far as fraud and earnings management is concerned, the audit committee should have zero tolerance, and all instances of such should be taken with all seriousness.

3. Research Methodology

Survey research method was adopted in this study. The use of survey research method is justified because it follows a co relational research strategy and helps in predicting behavior (Bordens & Abbott 2002).

The population of this study is defined as all business organizations quoted on the NSE. Judgmental sampling technique was adopted to choose respondents whose jobs are finance and accounting-related. The justification for using judgmental sampling technique is that when one wishes to select a biased group for screening purposes, this sampling method is a good choice (Cooper & Schindler 2001). The study surveyed a sample of one hundred respondents in Lagos. The study was restricted to Lagos State as it harbours 60% of the Federation's total industrial investments and foreign trade and attracts 65% of Nigeria's commercial activities (The Academy of Business Strategy 2011).

Primary data was obtained from the targeted respondents through a carefully constructed questionnaire. The questionnaire was designed to capture the demographic data of the respondents and their opinions with respect to the research questions. The questionnaire was divided into two (2) sections.

Section A was designed to obtain information on the demographic details of respondents, while section B consisted of questions designed to establish the relationship between board compositions, audit committee and earnings management in Nigeria. The questionnaire was constructed using a five-point Likert type scale. The respondents were required to indicate the extent of their agreement or disagreement with each of the statements on a scale of one (1) to five (5). A score of one (1) represented strong disagreement with the statement, while a score of five (5) represented strong agreement. A total of eighty (80) usable responses, giving 80% response rate were used for data analysis. The hypotheses formulated were tested with the pearson chi-square statistics.

4. Data Analysis

This section of the study is devoted to presenting the results of the analysis performed on the data collected to test the propositions made in the study. Analyses were carried out with the aid of the Statistical Package for Social Sciences, (SPSS Version 15.0). Table 1 shows the test statistics on the likelihood of reduction in earnings management by boards with greater proportion of independent directors.

The chi-squared test statistic is 21.750 with an associated p-value less than 0.001 ($p < 0.001$). The null hypothesis is rejected, since $p < 0.001$ and the alternative hypothesis retained. It is therefore concluded that boards with greater proportion of independent directors is associated with earnings management in Nigeria.

Table 2 presents the test statistics on the likelihood of reduction in earnings management by possession of certain level of financial competencies by audit committee members. The test statistics return a chi-squared value of 29.625 with an associated p-value less than 0.001 ($p < 0.001$). The null hypothesis is rejected, since $p < 0.001$ and the alternative hypothesis retained. It is therefore concluded that possession of certain level of financial competencies by audit committee members is associated with earnings management in Nigeria.

5. Conclusion and Recommendations

The study aimed at analyzing the relationship between corporate governance mechanisms (board composition and audit committee) and earnings management. The study found that board dominated by outside directors brings a greater breadth of experience to the firm and are in a better position to monitor and control managers.

As regards the audit committee, it was established that audit committee is capable of increasing the public's confidence in the credibility and objectivity of published financial statements. It was found that audit committee whose members possess certain level of financial competencies would reduce the likelihood of earnings management.

In the light of the foregoing conclusions, the study recommends that board composition should include greater proportion of independent outside directors with corporate experience. Audit committee members should be encouraged to possess a certain level of financial competencies in order to decrease the likelihood of earnings management. Corporate organizations should provide formal orientation programs for their new and existing directors and support the development of external courses on issues of corporate governance and earnings management.

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Appendices

TABLE 1: TEST STATISTICS

	BOARDS WITH GREATER PROPORTION OF INDEPENDENT DIRECTORS REDUCE THE LIKELIHOOD OF EARNINGS MANAGEMENT
Chi-Square	21.750[a]
Df	4
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 16.0.
Source: Analysis of surveyed data (2011)

TABLE 2: TEST STATISTICS

	POSSESSION OF CERTAIN LEVEL OF FINANCIAL COMPETENCIES BY AUDIT COMMITTEE MEMBERS REDUCE THE LIKELIHOOD OF EARNINGS MANAGEMENT
Chi-Square	29.625[a]
Df	4
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 16.0.
Source: Analysis of surveyed data (2011)