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Original Research Article

## **Board Characteristics and Earnings Management: Evidence from Quoted Firms in Nigeria**

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### **Abstract**

*The study investigated the association between board characteristics and earnings management practices. A longitudinal survey was used covering a time frame of six years (2007-2012). Historical data were extracted from the financial statements of eighty-eight sampled non-financial firms quoted on the Nigerian Stock Exchange. The statistical instrument used was the fixed effect Panel least Square regression. The study found that board independence and audit committee independence have negative relationship, while managerial shareholdings and board political connections have positive relationship with earnings management practices among Nigerian firms. Recommendations were made.*

**Keywords:** Board, Earnings, Management

***JEL Classification Codes: G300, G390***

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## 1. INTRODUCTION

Earnings management is the process of taking deliberate steps within the bands of Generally Accepted Accounting Practices (GAAP) to bring about a desired level of reporting performance. Board of directors is charged with the responsibility of accounting for the activities of firms and rendering proper stewardship on how the financial resources of the shareholders were managed accordingly. It is the directors' duty to ensure that the financial statement reported is a reflection of the firms' performance. In a bid to reduce tax, increase share values as a way to attract investors and by extension keep their jobs, some directors capitalize on the loopholes in the standards and tax laws to alter accounts. This represents purposeful intervention in the external financial reporting process, with the intent of obtaining some private gains (Schipper, 1989). Earnings management can have serious effects on the future prospects of companies as prior studies show evidence of positive and negative effect on both short and long-run performance of companies (Peasnell, Pope & Young, 2000, Dechow & Skinner 2000, Hartzell and Starks, 2003, Kao, Wu, & Yang, 2009, Gul, Kim, & Qiu, 2010).

Many firms' failures today were, attributed to the unawareness of the boards concerning the management's manipulations, as well as their inability to ensure the rights of the shareholders (Clarke, 2007). Corporate scandals, in developing economies like Nigeria, the banking sector among other sectors has witnessed several cases of collapses, some of which include; the Alpha Merchant Bank Ltd, Savannah Bank Plc, Societe Generale Bank Ltd, Afribank Plc, Union Bank plc, Bank PHB, Spring Bank Plc, Oceanic Bank Plc, Intercontinental Bank Plc, African Petroleum, Fin Bank Plc, Lever Brothers and Cadbury. This indicates classified beautification of accounts

(Onwuchekwa, Era & Izedonmi, 2012). The collapse of such large corporations has exposed the intentional misconduct of managers and weakness of board structure which could not protect investors from expropriation and earnings management (Supawadee, Subba & Omar, 2013). Kato and Long (2006) states that CEOs often use their control of Boards not only to prevent and challenge their position, but also aggregate to themselves an increasing share of wealth generated by the company, both in terms of rapidly inflating salaries and massively growing stock options. This study therefore seeks to investigate the relationship between board characteristics and earnings managements among Nigerian firms.

The broad objective of the study is to investigate the relationship between board characteristics and earnings management in Nigeria. However, the specific objectives are to: examine the effect of board of director size on earnings management; assess the relationship between board independence and earnings management; evaluate the relationship between the managerial shareholdings and earnings management; examine the influence of audit committee independence on earnings management; and determine the effect of board political connection on earnings management.

## 2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

### Concepts of Earnings Management

Earnings management has been seen in different perspectives by authorities. Earnings management was a common practice among companies as it allowed managers to exercise their discretion through accounting practices or policies that were questionable in order to achieve desired earnings in spite of the presence of

other board members (Healy & Wahlen, 1999; Jiang and Wing, 2005). Rezaee (2002) notes that earnings management can occur through different implementation practices, such as falsification, alteration or manipulation of financial documents and records, intentional omission or misrepresentations of events or transactions or any other information relevant for the financial statement, deliberate misapplication of accounting principles, policies or procedures, inadequate disclosures concerning accounting principles of accounting records or amounts. Consequently, the manipulation can occur by an accounting record, without any effect on cash flows or on the real dimension of the firm, or by real, involving a change in the firm's level of investment or operating activities, both with an intention to impact the reported results (Lev, 2003). However, Supawadee, Subba and Omar (2013) consider earnings management to include improper revenue recognition: creation of fictitious revenue transactions such as; (a) improper cut-off sales; (b) premature revenue recognition; (c) unauthorized shipments sham sales; (d) overstatement of assets; (e) capitalization of expenses as assets, usage of higher market value to increase the value of the asset; (f) Misappropriation of assets; and (g) Inappropriate disclosure. Meanwhile, irrespective of the form earnings management would take, it is deceptive.

### **Relationship between the Board characteristics and Earnings Management**

#### **Board Size and Earnings Management**

The optimal size of board members is ensured by an adequate number of board members to perform the monitoring functions effectively. According to Rahman and Ali (2006), board size is positively related with earnings management. In contrast, Xie, Davidson, and DaDalt (2003) argued that smaller boards are better able to make timely decisions than large boards.

However, they stated that larger boards with diverse knowledge are more effective for constraining earnings management than smaller boards. Xie *et al.* (2003) further stated that large boards with various experts are more likely to have a higher degree of independence than small boards. Similarly, Peasnell, Pope, and Young (2004) found that having a large board is better in reducing earnings management compared to smaller boards and that the higher the number of members on the board, the greater the monitoring activity of management. If large boards enhance monitoring, they would be associated with less use of earnings management. In this same vein, Chtourou, Bédard and Courteau (2001), Ebrahim (2007), and Xie, *et al.*, (2003) found that larger boards are associated with lower levels of discretionary accruals. Lin and Germain (2003) found that earnings management is negatively correlated with board size. However, Cai (2003) stated that there is a significant positive correlation between board size and earnings management. Following the outcome of the above findings, we therefore hypothesized that, *H1: There is no significant relationship between board size and earnings management.*

#### **Board Independence and Earnings Management**

Issue of board independence has been investigated with great attention, considering the independent status of the directors as a good indicator of the Board's effectiveness (Hermalin & Weisbach, 2002). The components within the board are essential ingredients for effective monitoring. According to Peasnell *et al.*, (2004), outside directors play a more effective role in monitoring top managers' aggressive behaviors than insiders. Their results show that earnings management is negatively associated with a larger proportion of outside directors. Using data for varying sample size (ranging from 89 firms for regression to 205 firms for descriptive analysis) obtained from the

Nigerian Stock Exchange for the period 1996 to 2004, it was established (Ahmadu, Tukur and Aminu, 2008) that certain aspects of board independence could possibly have effect on firm performance.

However, Xie *et al.*, (2003) found that earnings management is less likely to occur in companies whose boards include both more independent outside directors and directors with corporate experience. But the level of earnings management may influence the subsequent selection of board. Davidson *et al* (2005) found that, based on a broad cross-sectional sample of 434 listed Australian firms, a majority of non-executive directors on the board are significantly associated with a lower likelihood of earnings management. Peasnellet *al.* (2005) examined whether the incidence of earnings management by UK firms depends on board monitoring. Results indicate that the likelihood of managers making income-increasing abnormal accruals is negatively related to the proportion of outsiders on the board. Hence, we hypothetically state that, *H2: There is negative relationship between board independence and earnings management.*

### **Managerial Shareholding and Earnings Management**

Several prior studies have examined the relationship between the board of directors and earnings management. The results of prior studies indicate that CEOs manage earnings to maximise their personal wealth (Cheng & Warfield, 2005). Ali, Salleh and Hassan (2008), Banderlipe (2009) and Persons, (2006) found that managerial shareholdings are associated with lower levels of earnings management. In fact, managers with high stock shareholdings could gain from earnings management with the purpose of keeping stock prices high and increasing the value of their shares (Yang *et al.* 2008). Meanwhile, Al-Fayoumi, Abuzayed and Alexander (2010), Cheng and Warfield (2005) and Mitani (2010) found

that firms with higher managerial ownership are associated with more earnings management. Therefore, higher managerial shareholdings encourage managers to use discretionary accruals to improve earnings and, consequently, the value of their stock holdings. Based on the outcome of the above findings, we therefore hypothesize that, *H3: There is negative relationship between managerial shareholding and earnings management.*

### **Audit committee independence and Earnings management**

The audit committee has been formed to act both as a conduit of information supplied by the management to the auditors, and at the same time to insulate the auditor from the pulls and pressures of the management. According to Klein (2002), auditing the operations of modern corporations is a complex process requiring understanding of the rules and judgments made by the management in preparing the financial statements. Moreover, Carcello *et al.* (2002) used a sample of 100 Fortune-500 companies to examine if a more independent audit committee tries to protect its reputation by insisting on differentially higher audit quality and negative relationship with earnings management. Dabo and Adeyemi (2009) found that audit committee is positively related with discretionary accruals in Nigerian manufacturing firms. Based on the outcome of prior studies, we hypothesized that, *H4: Audit committee independence has no significant influence on earnings management.*

### **Board Political connection and Earnings management**

The relationship between board political connection and earnings management have manifested in several ways. Political connections of the board of directors do influence the awarding of government contracts and blessings. Companies that have board connections to a political party will receive more government contracts

during periods in which that political party has greater control relative to periods in which that party has less control. In contrast, companies that are connected to the opposing party will receive fewer contracts. Politically connected enterprise can be seen as one that currently receiving favour (Peng & Luo, 2000; Johnson 2003; Khwaja&Mian, 2005; Osamwonyi&Tafamel 2013). Faccio and Parsley (2006) introduce a different approach in tracing for the political connections. They argue that political connection is based on the geographic origin and education and therefore suggest that politician systematically favour local firms and so location forms a basis of political connections.

Consequently, Baum *et al.* (2008) are of the view that the support of parliamentarians is extremely important for firms' minimization of transaction cost associated with government bureaucracy. Niessen and Ruenzi (2009) worked in a sample of 605 German public companies observed and found that politically connected firms are providing better accounting as well as stock market performance results. Faccio (2006) studies corporate political connections around the globe; she suggests that connections are particularly common in countries that are perceived as being highly corrupt: the connections are less common in the presence of the more stringent regulation of politica conflict of interest. Having examined the extant studies, we hypothesized that, *H5: There is negative relationship between board political connection and earnings management.*

### 3. METHODOLOGY

#### Research Design

The study is a combination of cross sectional and time series (longitudinal) survey of non-financial institutions quoted in the Nigeria Stock Exchange covering a time period of six (6) years (2007-2012). Content analysis of the financial statements

for the relevant years formed the source of the Earnings management proxy by Discretionary accrual (DA). Our target population comprises of one hundred and fifty-six (156) firms' in non-financial sector in operation and quoted in the Nigerian Stock Exchange (NSE) as at December 31<sup>st</sup> 2012. A total of eighty eight (88) firms constituted the sample size of this paper. The basis for arriving at the 88 sampled firms is by employing number estimation formula adopted from Yamane (1967). The statistical formula is stated, thus:

$$n = \frac{N}{1 + N(e^2)}$$

Where:

n= sample size

N= Population size

e= Level of significance desired, given that:

e = 0.07 and N = 156

$$n = \frac{156}{1 + 156(0.07)^2} = 88$$

The eighty-eight firms were selected through stratified purposive sampling techniques.

#### Model Specification

The extent of earnings management is most commonly assessed by the discretionary accruals in reported earnings (Persons, 2006). Meanwhile, Dechow *et al* (1995) observed that the original Jones model is unable to capture the impact of sales-based manipulation because accounts receivables should not be considered as nondiscretionary accruals. Hence, they proposed a modification to the original Jones model known as the Modified Jones model (1995). Based on the Modified Jones model, the nondiscretionary accruals (NDA) of the event period for the firm *i* in time phase *t* is calculated using:

$$NDA_{i,t} = A_{i,t-1} + (\Delta REV_{it} - \Delta AR_{it}) + PPE_{it}$$

Where:  $NDA_{it}$  = nondiscretionary accruals for company *i* in year *t*

$A_{i,t-1}$  = lagged (one year) total assets

$\Delta REVi,t$  = change in revenues for company  $i$  in year  $t$

$\Delta ARi,t$  = change in net receivables for company  $i$  in year  $t$

$PPEi,t$  = property, plant and equipment for company  $i$  in year  $t$

The discretionary accruals ( $DA_{it}$ ) is then calculated as:

$$DA_{it} = TA_{it} - NDA_{it}$$

In our study, total accruals ( $TA_{it}$ ) will be computed by the difference between income before tax and extraordinary ordinary items

( $EBXI_{it}$ ) and net cash flow from operating ( $CFO_{it}$ ) as follow:

$$TA_{it} = EBTXI_{it} - CFO_{it}$$

Finally, for the purpose of this study, our model is specified as:

$$DA_{it} = a_0 + a_1 BS_{it} + a_2 BI_{it} + a_3 MS_{it} + a_4 ACI_{it} + a_5 BPC_{it} + e$$

Where;

$a_0$  = Constant

The parameters:  $a_1, a_2, a_3, a_4, a_5, a_6$  and  $a_7$  represent the coefficients.

$it$  = firm ( $i$ ) at time ( $t$ ).

**Table 1: Operationalization of variables**

Variables	Proxy	Operation	Source	Apriori Sign
Earnings management	Discretionary Accrual (DA)	$DA_{it} = TA_{it} - NDA_{it}$	(Dechow et. al., 1995)	
Board Size	BS	Total number of members in the board of firm ( $i$ ) at time ( $t$ ).	(Wang & Lieu, 2003).	BS < or > 0 (Negative) or (Positive)
Board Independence	BI	Number of non executive directors divided by total board size (NED/TBS).	(Xie et.al., 2003)	BI < 0 - (Negative)
Managerial shareholding	MS	Shares held by (CEO) and other executive directors divided by total shares of firm ( $i$ ) at time ( $t$ ).	(Al-Fayoumi et.al.,2010)	MS > 0 (Positive)
Audit Committee Independence	ACI	Non executive divided by total Audit Committee size of firm ( $i$ ) at time ( $t$ )	(Klein, et.al., 2002)	ACI < 0 - (Negative)
Political Board Connection	PBC	Dichotomous variable of "1" for firm having board member with political title(s), otherwise "0" of firm at time ( $t$ )	(Khwaja & Mian,2005; Osamwonyi & Tafamel,2013)	BPC > 0 (Positive)

Source: Researchers' survey (2015).

#### 4. ESTIMATION RESULTS AND DISCUSSION

**Table 2: Descriptive Statistics**

	DA	BS	BI	MS	ACI	BPC
Mean	-2.970000	8.712121	0.682027	6.968100	0.553902	0.579545
Median	-6.440000	8.000000	0.670000	6.937321	0.500000	1.000000
Maximum	6.210000	16.000000	1.000000	10.65132	0.830000	1.000000
Minimum	-9.430000	4.000000	0.400000	3.060698	0.500000	0.000000
Std. Dev.	8.430000	2.538599	0.103919	1.616042	0.069716	0.494100
Skewness	-4.905353	0.667057	-0.182710	0.171970	1.365235	-0.322286
Kurtosis	57.34475	2.870142	3.041194	2.313410	5.148108	1.103869
Jarque-Bera	67091.23	39.52793	2.975019	12.97340	265.5363	88.23735
Probability	0.000000	0.000000	0.225935	0.001524	0.000000	0.000000
Sum	-1.570000	4600.000	360.1100	3679.157	292.4600	306.0000
Sum Sq. Dev	3.750000	3396.242	5.691132	1376.309	2.561363	128.6591
Observations	528	528	528	528	528	528

Table 2 highlights outcome of the descriptive statistics. Since most of the Jacque Bera test p-value calculated were

less than p-critical value which stood at 0,05 (5%), indicate that the results are normally distributed

**Table 3 Pearson Correlations**

	DA	BS	BI	MS	ACI	BPC
DA	1					
BS	-.283	1				
BI	.149	-.322	1			
MS	-.109	.205	-.177	1		
ACI	-.022	.029	-.086	-.078	1	
BPC	-.084	.271	-.026	0.92	.229	1

Table 3 highlights associations of variables examined. The outcomes are correlated at 0.05 (5%) significant level (2-tailed).

The result of the correlation reveals that Board Size, Managerial Shareholding, Audit Committee independence, Board Political connection are negatively associated with

discretionary accruals. This suggests that the higher the Board size, Board Size, Managerial Shareholding, Audit Committee independence, Board Political connection, the lower the level of earnings management. Board independence was seen to be positively associated with the discretionary accruals

**Table 4 Regression Result**

Variable	Coefficient	Std. Error	t-statistic	Prob.
C	2.360000	6.440000	3.667026	0.0003
BS	-2.26000	2.090000	-1.080365	0.2805
BI	5.156409	2.120000	0.024376	0.9806
MS	9.890000	3.410000	2.896737	0.0039
ACI	2.330000	6.700000	0.347407	0.7284
BPC	7.070000	3.050000	2.318033	0.0236
R-Squared	.54			
Adjusted	.53			
Durbin Watson	1.94			
F-Statistic	12.27185			
Prob. (F.Statistic)	0.000000			

The coefficient of determination  $R^2$  which stood at a value of 0.541, indicates that over 54% of the systematic variations in the dependent variable were accounted for by the independent variables. Similarly, after adjusting the degree of freedom, the adjusted coefficient of determination, ( $\bar{R}^2$ ) the adjusted R-square stood at 0.530 implying that over 53% of the systematic variations are explained while 47% are unexplained, hence captured by the stochastic disturbances. The low values of the coefficients of determination and adjusted R-square, indicated the presence of earnings management in the sampled firms. The overall coefficient statistic stood at 12.27 while the standard error of regression stood at a minimal value of 6.59 and Durbin Watson (DW) statistics indicated the absence of serial correlation with a value of 1.94. The results are impressive and capable for forecasting and taken fundamental decisions in relation to earnings management practices in firms.

### Discussions of Findings

The findings are discussed as follows:

Firstly, it is revealed that Board of directors' size has no significant effect on earnings management. The size of the board is mere composition of insider and outsider directors. The number of directors (executive and non-executive) cannot necessarily have an effect on earnings management practices of firms. Although, Peasnell *et al* (2004) and Ebrahim (2007) documented that large board size can reduce earnings management or lower level of discretionary accruals. While Baum *et al* (2008) stated that significant positive correlation exists between board size and earnings management.

Secondly, there is no significant relationship between board independence and earnings management. Board independence is fundamental in the monitoring and controlling of management who choose to run affairs of the firm for their personal gain. But a situation whereby the board independence has a conflict of interest, they may not exercise independence in monitoring the executive directors. Meanwhile, Davidson *et al* (2005), and

klein (2006) there is negative relationship between board independence and earnings management proxied by absolute discretionary accrual.

Thirdly, there is positive relationship between managerial share holdings and earnings management, executive directors owning shares in the firm can employ all form of deceptive strategies to take advantage of the firm for self interest. However, Ali *et al* (2008), Ebrahim (2007) had revealed that, management ownership in the firm is associated with lower level of earnings management. While Yang *et al* (2008) and Al-fayoumi *et al* (2010) found that managerial ownership are positively associated with more earnings management.

Fourthly, Audit committee independence has no significant influence on earnings management. The Audit committee as a subcommittee of the board of director, plays over sight function, monitoring and internal control effectiveness. This situation can affect the level of earnings management practices in the firm. But Carcello *et al* (2002) argued that independent Audit committee to be positively related to earning management proxied by discretionary accrual.

Fifthly, Board political connection has positive relationship with earnings management. A board member using it political connection to attract presence of government so as to reduce tax payment and increase share value of the firm. Faccio and Parly (2006), Niessan and Ruenzi (2009); Osamwonyi and Tafamel (2013) evidence proved that Board politically connected is positively related to earnings management.

## 5. Conclusion and Recommendations

Considerable attention has been focused on the critical issues board characteristics as relate to earnings management. Earnings management has become common practices among firms. Earnings management is deceptive, it is practiced either to reduce tax,

or to attract investors. The constituted board of firms charged with the responsibilities of monitoring and controlling activities of management who run the affair of the firm for their personal interest. Consequently, the presence of the board in the firm is geared towards ensuring credibility, transparency and integrity report either with minimal earnings management practices or not as the case may be. Consequently, although the law allows firms to take advantage of the loopholes in the various laws and standards, in reporting their earnings, it does not mean that the board to totally support or encourage earnings management, for it is deceptive.

We therefore recommend that:

1. The board of directors should be composed of men and women of credible, integrity and transparent characters. Several firms (financial and non financial) have become insolvent in recent times because the board was not vigilant enough to understand or notice early the handwriting/signal which was traceable to earnings management practices. When the board is composed of expert and intelligent members, they can easily track and hurt any sharp practices like earnings management that would have been detrimental to the firm in the long run.

2. Political connection members in the board should use their good offices to attract policies and issues that would be of immense benefits to the firm in which they represent and not to completely indulge or positive involved in earnings management practices. The political connected members should be seen as agent of success in the firm in which they represent the interest of the dispersed shareholders.

3. Managers of firms like the chief executive officer (CEO) and other executive members of the firms should be duly appointed. Identified persons to be appointed or appointed executive directors or C.E.O should be of persons accountable

and trustworthy of profession etiquette that would not involved or initiate deceptive activities in the firm. Managers of firms should endeavour to opportunistic gain on the detriment of the firm.

4. Earnings Management practices in firms have linked to activities of professional accountants who render non audit services such as in the case of Arthur Andersen (a reputable audit firm) who was the auditor of high profile demise firm Enron. The two Accounting professional bodies in Nigeria (Institute of Chartered Accountants of Nigeria (ICAN) and Association of National Accountants of Nigeria (ANAN)) should closely monitor activities of their practicing members or external auditors to firm such that their professional auditors do not engage in facilitating earnings management practices in firms.

5. The audit committee as subcommittee of the board of directors should be given adequate recognition as contained in the Companies and Allied Matters Acts (CAMA 1990). The independence member of the committee should ensure that financial statements and reports presented to them are closely examined and investigated so as to detect any form of earnings management practices if any and report accordingly. The audit committee independence should not encourage fraudulent practices in the firm.

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