The Effect of Corporate Governance and Ownership Structure on Earnings Management of Manufacturing Companies in Nigeria

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Abstract

This research paper investigated the effect of corporate governance mechanisms and ownership structure on the earnings management of manufacturing companies in Nigeria. Data for the study was collected through content analyses of the annual financial statements of 15 manufacturing companies quoted on the Nigeria Stock Exchange (NSE) for the period 2009 to 2019. The ordinary least square (OLS) panel data regression technique was adopted for data analyses. The findings of the research showed that there is a negative relationship between board composition (BCOM) and discretionary accruals (DSAC) among manufacturing companies in Nigeria. This implies that increase in the proportion of independent members represented on the board of directors is predicted to lead to a decrease in discretionary accruals. Audit committee (AUDC) had a negative relationship with discretionary accruals (DSAC). However, discretionary accruals (DSAC) had a positive relationship with ownership concentration (OWNC). It is thus concluded that having a board of directors with a high percentage of independent members will help to reduce the incidences of earnings management. It is further concluded that having a strong audit committee is an important factor in reducing incidences of earnings management. However, there is need to enhance their role in checking such activities. Finally, dispersed ownership as opposed to concentrating firm ownership in the hands of very few people will improve earnings management activities. Thus, regulations capable of engendering better corporate governance mechanisms should be implemented. Business organizations should also be incentivized to create an enabling environment that will encourage the right corporate governance structure.

Keywords: *Corporate governance, earnings management, discretionary accruals, ownership structure, board composition, audit committee size.*

Introduction

According to Lev (1989) earnings are the single most important item in a typical corporate financial statement of a quoted company. They provide information on the extent to which a company has engaged in value added activities. Earnings are a signal that helps direct resources allocation by investors in the capital market. In theory, the value of a company's stock is the present value of its future earnings. Consequently, increased earnings is an indication of increased value of the corporation while decrease in earnings indicates a decrease in the value

of the corporation. With such information, investors are wont to take appropriate actions in line with the information provided in a company's earnings. An increase in earnings will attract more investors thus improving the market value of the company while a decrease in earnings will have the opposite effect.

Considering the importance of reporting a good earnings value, it is no wonder that executives in many companies routinely take actions to manage earnings to give the impression that the earnings of their company is much better. Akers, Giacomino and Bellovary (2007) stated that earnings management involves actions by management to influence reported earnings using specific accounting methods or adopting new methods, recognizing one-time non-recurring items, deferring/accelerating revenue or expense transactions or using other methods designed to influence short-term earnings. However, earnings management should not be confused with illegal activities aimed at manipulating accounting records and financial statements. Some earnings management activities may be frowned at on grounds of reasons why it was embarked but earnings management activities do not fall within the purview of a crime or illegal activity.

Reasons for companies to indulge in earnings management activities can be broadly categorized into personal benefits of the perpetrators and in the interest of the company. For personal interest would include where earnings management is done to make the income of the organization look better in order to earn better emoluments that are tied to the earnings of the company. Take for example, where executives can earn bonuses if the earnings of the company reach a certain threshold. On the other hand, earnings management can also be practiced purely for the benefit of the company - at least on the short run. Thus, managers can use earnings management practices to make the earnings of a company look more stable and predictable and thus more attractive to investors.

Healy and Wahlen, (1999) describe earnings management as 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. Corporate governance mechanisms are established in organizations to forestall the occurrence of certain activities which may not be in the best interest of the organization. For example, the audit committee have oversight functions over accounting and financial reporting activities in order to ensure that all activities within these functions are to the best interest of the organization. Thus, it is nigh impossible for a company's management to manage earnings without the knowledge and approval of the audit committee.

In the same vein, the ownership structure of the company is also a determining factor in whether or not earnings management is practiced. Furthermore, where the earnings management activity is to the benefit of the organization, these critical stakeholders within the corporate governance framework are likely to approval such actions. However, if such activities are for personal benefits of individuals within the company, chances of success may depend on how dispersed or concentrated the ownership structure is and the level of control they exert over other corporate governance mechanisms in the organization. Consequently, this research paper is aimed at investigating the effect of corporate governance characteristics and ownership structure on earnings management practices of manufacturing companies in Nigeria.

Statement of Problem

Several corporate crises in the past have been blamed on company managers taking undue advantage of their position to influence or manipulate earnings to their personal interests. Even where such actions are taken in the interest of the organization, the benefits are most likely to

be short lived. Thus, in the long run, investors in the company are the once who suffer the consequences of managers influencing earnings to suit their interest. However, earnings management can only occur where there are loopholes in accounting laws and regulations that manager can take advantage. A typical example is a situation where management is allowed to change accounting rules or given a 'choice' whether to and when to adopt a certain standard. In which it can be abused for personal interest. However, ability to manage earnings to a large extent is dependent on the agreement/connivance of the elements within the corporate governance structure. A strong corporate governance mechanism will be able to check the excesses of management but where the corporate governance mechanism is weak, its ability to check management excesses will be quite low.

Thus, the knowledge base and personal integrity of members of the audit committee, the risk advisory committee, the structure of the board of directors and ownership structure of the organization will determine the ability of the corporate governance mechanisms to perform optimally. Previous research on corporate governance is quite numerous. However, most of them have concentrated on its relationship with organizational performance (Ene & Bello, 2016; Adekunle & Aghedo, 2014) with little interest to investigate how corporate governance affect the decision of organizations to manage their earnings. Those that have given research interest to its nexus to earnings management (Vihi, Abu & Iortima, 2019; Abata & Migiro, 2016; Uwuigbe, Peter & Oyeniyi, 2014) also appear not to appreciate the potent role of ownership structure when added to the 'mix'. This paper is aimed at filling this gap in research by investigating the effect of corporate governance characteristics and ownership structure on earnings management practices of manufacturing companies in Nigeria.

Research Hypotheses

Ho_1: Board composition does not significantly affect earnings management activities of manufacturing companies in Nigeria.

Ho_2: Audit committee size does not significantly affect earnings management activities of manufacturing companies in Nigeria.

Ho_3: Ownership concentration does not significantly affect earnings management activities of manufacturing companies in Nigeria.

REVIEW OF RELATED LITERATURE

Corporate Governance

Corporate governance through its structures and mechanisms provide a means for exerting control over the self-serving actions of managers as agents of an organization. Corporate governance mechanisms are broadly categorized into external and internal governance mechanisms. While regulators appear to focus solely on internal mechanisms, in practice external mechanisms are also important (Agrawal & Knoeber, 1996). External corporate governance mechanisms are determined by outside factors and aim to control the activities of firms in favour of the interests of stakeholders, and include items such as legal protection and takeover rules, regulatory based mechanisms. Internal mechanisms are decided by internal factors, including insider shareholding as well as board structures and characteristics, including the proportion of independent directors, director backgrounds, audit committees, remuneration committees, and ownership structures (Man & Seng, 2013).

Shareholders provide capital to firms in exchange for control rights and this creates a contractual relationship that includes charters and bylaws between shareholders and firms (Hart, 1995). Where the agents of the firm fail to keep to the terms of their contractual agreement, shareholders can seek remediation through the legal system. Under corporate laws,

shareholders as owners of the firm have and can exercise different rights including voting/appointing and removal of directives and executives, remuneration of same and approval of the firm's future goals and objectives, and alteration of firm charters and bylaws (Easterbrook & Fischel, 1983).

Another important control of the firm's management is provided by the board of directors. Shareholders elect members of the board to act on their behalf, and the board in turn delegates power to top management while still monitoring management performance and ratifying any decision that demonstrates a lack of good faith for shareholders. The composition of a board of directors is also important corporate governance mechanism that can effectively check the excesses of managers and reduce earnings management. Board composition includes determining the mix of non-executive and executive directors; designating audit, compensation, nominating and other committees; determining the mix of qualifications and areas of expertise; and determining the proportion of female directors on the board (Man & Seng, 2013). Bertrand and Mullainathan (2000) also consider internal governance measurements, including the percentage of independent directors on the board and the number of board meetings. Independent directors supervise the managers in the firm and reduce the misappropriation of assets by the managers at the expense of shareholders

The Audit committees mainly provide independent oversight of internal control effectiveness and the quality of the accounting information and financial reporting and work done by external auditors. Other roles of the audit committee include providing assurance that firms are in compliance with pertinent laws and regulations, conducting internal and external affairs ethically, maintaining the control mechanisms in an effective way against fraud, and dealing with conflicts of interest. The audit committee also provides a communication bridge between the board, external auditors, internal auditors, and the relevant authorities (Hart, 1995).

Ownership Structure

Four types of ownership structure are relevant in determining the earnings management attitude of a company. These are managerial ownership, institutional ownership, ownership concentrated in the hands of few individuals/entities and dispersed ownership. As Jensen and Meckling (1976) noted, managers are better motivated to protect the interest of a firm when they have an ownership stake in it. However, they can also become overly powerful where such ownership stake is substantial. Thus, with reasonable stake, managerial ownership can prevent earnings management activities that have potential to harm the company.

Institutional owners on the average are better informed and better motivated to monitor the activities of a company. Koh (2003) asserted institutional ownership is associated with a better monitoring of management activities, reducing the ability of managers to opportunistically manipulate earnings. This is because as stated by Almazan, Hartzell and Starks (2005), institutional investors can provide active monitoring that is difficult for smaller, more passive or less-informed investors.

According to Shleifer and Vishny (1986) large concentrated shareholders have a strong incentive to actively monitor and influence firm management to protect their significant investments. Therefore, ownership concentration may reduce agency costs by increasing monitoring and alleviating the free-ride problem. However, this may not always be the case as a result of conflict of interest. Thus, large shareholder is also an executive, such a shareholder may collude in earnings management if substantial benefit may accrue from such an action. Furthermore, where the earnings management activity brings private benefit to majority

shareholders to the detriment of the minority shareholders, such a state of affairs may incentivise majority shareholders to support such an action against the best inters of the firm.

Earnings Management Practices

According to García-Meca and Sánchez-Ballesta (2009), the very nature of accounting accruals gives firm managers a great deal of discretion in determining the earnings a firm reports in any given period as a result of the information asymmetry between managers and owners. Managers have all the information about the finances of the organization however, owners depend on managers for their information. In which case managers can alter accounting information before making it available to owners. Managers can manipulate earnings in order to maximize their own interests or to signal their private information, thus influencing the informativeness of earnings (Healy, 1985). Earnings management involves the alteration of a firms' reported economic performance by insiders either to mislead some stakeholders or to influence contractual outcomes (Healey & Wahlen, 1999).

The practice of earnings management involves altering the earnings figures reported through the use of judgmental discretions as allowed by the Generally Accepted Accounting Principles (GAAP). This serves to mislead the users into believing what is actually not true in respect of the earning's figures to secure a favourable response (like increased demand for the firm's shares), or to influence contractual outcomes which is dependent on the reported earnings (Ogbonnaya, Ekwe & Ihendinihu, 2016). From the above, we infer that earnings management can either be done to the private benefits of the individuals involved or to the benefit of the organization or both .

A typical example is a situation where raising new funds from established stakeholders is dependent on the company achieving a given threshold of earnings. Where the company's earning falls below the expected limits, managers may decide to prop up the firms earnings in order to get the required earnings. However, the misleading will likely also give a false impression about the performance of the managers or even afford them the right to performance base remuneration and job security which may have not been if the actual earnings were to be made public. Earnings management can be motivated by a preference for more stable earnings, in which case management will carry out an income smoothing earnings management activity. Opportunistic income smoothing can in turn signal lower risk and increase a firm's market value. Other possible motivations for earnings management will include the need to meet and possibly beat analysts' targets, maintain the levels of certain accounting ratios for debt covenants purposes, the pressure to maintain increasing earnings etc (Subramanyam, 1996; Richardson, Tuna & Min, 2002).

Empirical Review

Vihi, Abu and Iortima (2019) investigated aspects of corporate governance mechanisms and earnings management in Nigeria with reference to the oil and gas and ICT sectors of the economy. The study adopted a correlational study design and collected secondary data from published annual statements of 5 companies from each of the two sectors for the period 2013 to 2017. Board composition had a negative and insignificant association with cash-based earnings management while board size had positive and insignificant association with earnings management. Ownership concentration had positive and significant relationship with cash-based earnings management. The interaction of board concentration and board composition demonstrated positive and significant relationship with cash-based earnings management.

Ogbonnaya, Ekwe and Ihendinihu (2016) investigated the effect of corporate governance and ownership structure on earnings management of Brewery industries in Nigeria between 2004

and 2013. The research adopted the use of secondary data which were collected from the annual report and accounts of the companies under review. While the Ordinary Least Square (OLS) multiple regression technique was used as method of data analyses. The result showed that CEO and Managerial ownership had positive and significant effect on Earnings management, the findings also reveal that price earnings ratio, net assets per share of firm affect earnings management.

Abata and Migiro (2016) investigated the effects of corporate governance variables on earnings management among selected listed firms from the manufacturing and banking sectors. Data was collected from a sample of 24 listed companies from 2008 to 2013. Employing the panel regression analyses, it was shown that board independence, audit committee independence and audit committee size are insignificantly positively correlated with earnings management. Board size is insignificantly negatively correlated with earnings management while ownership structure is insignificantly negatively correlated with earnings management. Audit quality is positively correlated with earnings management, though not statistically significant. Based on these findings, the study concludes that corporate governance structures, as it were, had not helped to address earnings management.

Attia and Hegazy (2015) evaluated the relationship between ownership structure as corporate governance mechanism and earnings management and their effect on the financial performance in Egypt. This study focused on a sample of 49 listed companies whose shares are among Egypt's 100 most actively traded shares (EGX100 price index) for the period 2006 to 2013. An advanced panel threshold regression estimation model was adopted as method of data analyses. The results showed that institutional ownership is only significant to the firm value up to a threshold level from (62%- 64 %). While, family ownership is only significant to the firm value up to a threshold level from (36%-41%). Thus, additional increase in level of ownership structure beyond the threshold level does not add to a firm's value. The research concluded that excessive levels of ownership structure could lead to severe agency problems and overhang situation at the microeconomic firm level; this could eventually cause vulnerability in financial systems and thus lead to the financial catastrophes.

Uwuigbe, Peter and Oyeniyi (2014) examined the effects of corporate governance mechanism on earnings management in Nigeria. Using a sample of 40 listed firms in the Nigerian stock market which were selected on the basis of judgmental sampling technique. Data was collected from annual reports for the period 2007-2011 and analyzed using OLS regression analysis techniques. Findings from the study revealed that while board size and board independence have a significant negative impact on earnings management, CEO duality had a significant positive impact on earnings management for the sampled firms. Hence the paper concluded that firms with larger boards and diverse knowledge are more likely to be more effective in constraining earnings management than smaller boards since they are likely to have more independent directors with more corporate or financial expertise.

Shah and Shah (2014) analysed the impact of corporate governance and ownership structure on earnings management for a sample of 372 listed firms in Pakistan over the period 2003 to 2010. Data for the study was collected using the Jones (1991) model and Kothari, Leone, and Wasley (2005). The results indicated that discretionary accruals increase monotonically with the ownership percentage of a firm’s directors, their spouses, children, and other family members. This supports the view that managers who are more entrenched in a firm can more easily influence corporate decisions and accounting figures in a way that may serve their interests. Their findings further revealed that institutional investors play a significant role in constraining earnings management practices. However, CEO duality, the size of the auditing

firm, the number of members on the board of directors, and ownership concentration do not influence discretionary accruals.

Lanfeng and Anlin (2004) examined the relationship between board characteristics and earnings management. Management of a firm may engage in earnings management for his own benefit. However, under proper corporate governance mechanism, the board of directors might be able to monitor the firm and prevent the management from engaging in earnings management. The findings showed that when the board size is large, the higher the extent of earnings management. However, when there are more outside directors in the board, the extent of earnings management is lower. The effects of board characteristics on earnings management are significant only for group affiliation firms or non-electronic firms.

Methodology

The ex-post facto research design was adopted for the study. This is considering the fact that the phenomena under study (earnings management) has already occurred. Thus, we use the method of content analysis to extract the necessary information from the annual financial reports of the companies in our sample. Our population consist of all manufacturing companies quoted on the Nigeria Stock Exchange. However, fifteen manufacturing companies were chosen to be included in our final sample due to availability of the necessary information which can only be extracted from the annual financial statements of the companies. Period of coverage is the ten years (2009-2019) for which information are available.

Data for the study consist of those on earnings management **(EMGT)** which is measured using discretionary accrual **(DSAC)**; Board composition **(BCOM)** which is measured as independent board members divided by total board members; Audit committee size **(AUDC)** which is as total number of members of the audit committee; and Ownership concentration **(OWNC)** which is measured as the total holding of the top five shareholders of the company regardless of whether they are institutional or individual or corporate investors. Data for the study was calculated using the ordinary least square (OLS) regression technique.
The relaionship between the variables is stated functionally as:

$$DSAC = f(BCOM, AUDC\ OWNC) \ldots\ldots 1$$

Fitted into the OLS regression model, we have that:

$$DSAC = a + \beta 1BCOM + \beta 2AUDC + \beta 3OWNC + \mu t \ldots\ldots 2$$

Discretionary accruals will be determined using the Modified Jones model as depicted in Dechow, Sloan, Sweeney (1995) which is given as:

$$T' = \Delta CA_t - \Delta Cash_t - \Delta CL_t + \Delta DCL_t - DEP_t \ldots\ldots 3$$

Where:

ΔCAt = Change in current assets
$\Delta Cash_t$ = Change in cash and cash equivalents
ΔCL_t = Change in current liabilities
ΔDCL_t = Change in debt included in current liabilities
DEP_t = Depreciation and amortization expense

From the Total Accrual (TA) as shown above, the non-discretionary accrual is calculated thus:

$$NDA_t = \alpha_1(1/A_{t-1}) + \alpha_2\,[(\Delta REV_t - \Delta REC_t)/A_{t-1}] + \alpha_3(PPE_t/A_{t-1}) \ldots.\ 4$$

Where:

ΔREC_t = Net receivables in year t less net receivables
ΔREV_t = Revenues in year t less revenues

Discretionary accruals are then derived as follows.

$$DSAC_t = TA_t - A_t \ldots.. 5$$

Data Analyses and Interpretation

Table 1:

Dependent Variable: LDSAC
Method: Panel Least Squares
Date: 09/28/19 Time: 07:07
Sample: 2009 2019
Periods included: 10
Cross-sections included: 15
Total panel (balanced) observations: 150

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	16.86254	3.186231	5.292315	0.0000
BCOM	-5.500927	1.012320	-5.433982	0.0000
AUDC	-0.432492	0.527698	-0.819583	0.4138
OWNC	0.003190	0.000219	0.014556	0.9884

R-squared	0.171880	Mean dependent var	16.44581
Adjusted R-squared	0.154864	S.D. dependent var	1.482549
S.E. of regression	1.362926	Akaike info criterion	3.483450
Sum squared resid	271.2049	Schwarz criterion	3.563733
Log likelihood	-257.2587	Hannan-Quinn criter.	3.516066
F-statistic	10.10098	Durbin-Watson stat	0.968716
Prob(F-statistic)	0.000004		

Results in table 1 shows that there is a negative relationship between board composition (BCOM) and discretionary accruals (DSAC) among manufacturing companies in Nigeria. The coefficient of regression for the variables gave a value of -5.501 with the implication that increase in the proportion of independent members represented in the board of directors is predicted to lead to a decrease in discretionary accruals. In essence, the increase in representation of independents members reduces the incidences of earnings management activities by manufacturing companies. Similarly, Audit committee (AUDC) had a negative relationship with discretionary accruals DSAC with a coefficient value of -0.432 implying that the role of the audit committee reduces incidences of earnings management. Finally, the coefficient of discretionary accrual (DSAC) and ownership structure (OWNC) gave a value of 0.00319 which implies that ownership concentration in the hands of few investors increases the incidences of earnings management among manufacturing companies in Nigeria. Furthermore, of the independent variables, only board composition had a statistically significant (negative) relationship with discretionary accruals. Thus, increased number of independent members in the board can be relied on to reduce earnings management practice by manufacturing companies. Finally, the value of the coefficient of determination (R-Square) gave a value of 0.1719 which implies that only about 17.89% of the variations in discretionary accruals can be attributed to the combination of board composition, audit committee size and ownership concentration.

Discussion of Findings

This research paper investigated the effect of corporate governance mechanisms and ownership structure on the earnings management practices of manufacturing companies in Nigeria. Data for the study was collected through content analyses of the annual financial statement of 15 manufacturing companies quoted on the Nigeria stock exchange (NSE) for the period 2009 to

2019. Data collected consisted of those on earnings management measured by discretionary accruals (DSAC) and board composition (BCOM), audit committee (AUDC) and ownership concentration (OWNC). The ordinary least square (OLS) panel data regression technique was adopted for data analyses.

The findings of the research showed that that there is a negative relationship between board composition (BCOM) and discretionary accruals (DSAC) among manufacturing companies in Nigeria. This implies that increase in the proportion of independent members represented on the board of directors is predicted to lead to a decrease in discretionary accruals. This finding corroborates that of Uwuigbe, Peter and Oyeniyi (2014) who examined the effects of corporate governance mechanism on earnings management in Nigeria and found that board size and board independence have a significant negative impact on earnings management. In essence, having a well diversified board of directors representing different interest groups has a good chance of checking the excesses of executives of the organization.

Similarly, Audit committee (AUDC) had a negative relationship with discretionary accruals (DSAC) implying that the role of the audit committee reduces incidences of earnings management. The core functions of the audit committee include mitigating internal accounting and financial reporting malfeasance emanating from within the organisation. Thus, where earnings management practice has the potential to harm the organization, the audit committee should be able to check such activity. This of course is only possible if the audit committee is not compromised from within. However, this contradicts with the findings of Abata and Migiro (2016) who's revealed a positive albeit insignificant relationship between the audit committee role and earnings management role in Nigeria.

Discretionary accrual (DSAC) had a positive relationship with ownership structure (OWNC) which implies that ownership concentration in the hands of few investors increases the incidences of earnings management among manufacturing companies in Nigeria. Vihi, Abu and Iortima (2019) in a similar study agreed that ownership concentration had positive and significant relationship with cash-based earnings management. However, this is contradicted by the findings of Abata and Migiro (2016) whose study revealed a negative relationship between ownership structure and earnings management. This finding points to the fact that where ownership is concentrated in the hands of few individuals or entities, their personal interests will take precedence over the interests of the organization. Furthermore, of the independent variables, only board composition had a statistically significant (negative) relationship with discretionary accruals. Thus, increased number of independent members in the board can be relied on to reduce earnings management practice by manufacturing companies.

Conclusion and Recommendations

From the findings of the study, it is concluded that having a board of directors with a high percentage of independent members will help to reduce the incidences of earnings management practices especially where such activities will not benefit the company. It is further concluded that having a strong audit committee is an important factor in reducing incidences of earnings management. However, there is need to enhance their role checking such activities. Finally, dispersed ownership as opposed to concentrating firm ownership in the hands very few people will improve earnings management activities. From the above, it is apparent that efforts aimed at reducing earnings management will be more effective by having a strong corporate governance mechanism in the organization. Thus, regulations capable engendering better corporate governance mechanisms should be implemented. Business organizations should also

be incentivized to create an enabling environment that will encourage the right corporate governance structure.

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