Board Structure as Determinant of Earnings Management Practices of Listed Consumer Goods Firms in Nigeria.

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Abstract

Accounting scandals and collapse of corporate organisations across the world in the past decades hasve increased global attention regarding the quality of companies' governance process and financial reporting practices. This study seeks to examine board structure as determinant of earnings management practices of listed consumer goods companies in Nigeria. The study is anchored on the Agency theory and collected data from secondary sources for the period 2019 and 2020. Findings of the study showed a positive but not significant association between audit committee independence and earnings management practices. The study further indicated that board size and board independence have a negative but not significant relationship with earnings management practices and recommends that companies should strengthen their board for better governance and financial reporting quality.

Key Words: *Earnings management, Corporate governance, Audit Committee, Board size, Board independence.*

1. Background of Study

In recent times, financial scandal and collapse of many companies have brought to the fore the need for improved governance of corporations worldwide. Further, the seperation of ownerhip from management has amplified the call for a transparent financial reporting of the affairs of the company. It has long been recognized that financial statements play an important role in assessing managers' performance by the board of directors, outside investors and external regulators. It is therefore, not unlikely that managers will manipulate financial reports in order to produce a good image of themselves and the firms that they manage. According to Muhammed (2014), earning management is the manipulation of a company's reporting income or revenue by firms using accounting preparation bases and policies that are largely at the discretion of the managers to achieve personal or firm's goals.

In Nigeria, there have been several financial scandals in both financial and non-financial institutions some of which include Bank PHB, Spring Bank Plc, Oceanic Bank Plc, Intercontinental Bank Plc., African Petroleum Plc., and Levers brother. An investigation into the causes revealed significant, deep-rooted problems in the account preparation and also the intentional misconduct of managers which led to the sack of eight (8) bank chiefs by the governor of Central Bank of Nigeria and the call for an investigation of the efficacy of the monitoring and controlling of managerial and financial behavior of managers (Otuya, Donwa & Egware, 2017).

For firms in Nigeria, poor corporate governance practice has been cited as one of the causes of the corporate collapses noticed among firms in the financial sector (Adeyemi & Fagbemi, 2010). Also, there have been arguments about the weaknesses of corporate governance not being effective enough to protect investors from expropriation in the past.

Specifically, this study concentrates on board size, audit committee independence and board independence as determinants of companies' earnings management practices. The study is motivated by the fact that corporate governance has been accepted by so many countries including Nigeria as the easiest way of dealing with agency issues, financial irregularities, and creating an attractive investment environment. This research work seeks to find the nature of relationship that exists between corporate governance mechanisms and earnings management in the consumers goods sub sector of the manufacturing sector in Nigeria.

Objectives of the Study

The broad objective of the study is to examine the determinants of earnings management of some selected listed consumer goods firms in Nigeria. The study outlines the following specific objectives:

1. To ascertain to what extent board size influences earnings management

2. To find out the relationship between audit committee independence and earnings management.

3. To investigate to what extent board independence determines earnings management practices.

Research Hypotheses

In line with the research objectives, the following null hypotheses were formulated.

Ho$_1$: board size is not a significant determinant of earnings management practices.

Ho$_2$: audit committee independence is not a significant determinant of earnings management practices.

Ho$_3$: board independence is not a significant determinant of earnings management practices.

2. Literature Review

Corporate Governance in Nigeria

In Nigeria the code of CG was issued by SEC and CBN in 2003, and has addressed the issue of BOD, shareholder and the audit committee. For the BOD the code recommends a board size of not more than 15 and not less than 5 including executive and non-executive directors.

In the case of the audit committee, the code emphasizes that the number of executive directors (EDs) on the audit committee must be limited to one with other members as nonexecutive directors (NEDs) and a strong NED to serve as the chairman, so also the tenor of the members of the committee will be fixed and there will be option for election.

Earnings Management Incentives

Firms have incentives to manage earnings to help achieve a smooth and growing earnings stream. This is as a result of the investors need for more stable earnings; and pattern thus, managers tend to smooth earnings towards a long-term sustainable trend. (Ortega & Grant, 2003; Muhammed, 2014). Earnings are either managed upwards or downwards to earn a minimum or maximum bonus. Thus, if earnings are below the minimum level required for bonus to be earned, managers employ earnings management techniques to bring earnings up, if earning are above the maximum level at which no additional bonus is paid, then earnings will be managed. Magrath and Weld (2002) indicated that improper revenue recognition is the cause of one-third of all voluntary or forced restatement of income filed with the SEC from 1977 to 2000. However, management usually commits itself to analysts and investors by providing estimates which at the end leaves the management with the problem of ensuring that these estimates are met at all cost. In order to avoid this, some companies try to shift their focus from meeting short-term earnings estimates to achieving their long-term strategies.

Theoretical Framework

Agency Theory

This study uses the agency theory as a theoretical background to form an empirical framework for assessing corporate governance characteristics and earnings management of selected listed companies in Nigeria. An agent is someone who acts for, or in the place of another by authority from him. In practice the two persons; the one that is represented and the one that represents are known as the principal or owner and agent or manager respectively. An agency relationship is one in which the principal party makes use of the second party for the purpose of utilizing the specialized skills or knowledge of the second party (Otuya, 2019).

Empirical Review

Studies on earnings management and corporate governance are varied with divergent results. For instance, Fan and Zhang (2020) in a study examined the causal effects of corporate governance on earnings management using shareholder-sponsored proposals that pass or fail by a small margin of votes in annual shareholder meetings. This setting provides a causal estimate that overcomes concerns of endogeneity. Findings of the study suggest that improvements in corporate governance curtail earnings management, and support the underlying premise of regulators that improvements in corporate governance would improve financial reporting.

Neeraj et al (2020) carried out a study to examine the effect of corporate governance on earning management practices in India. The study utilized random-effect point estimates on 1613 non-finance organizations working in the Indian subcontinent. The data pans from 2004 till 2018. The empirical findings are in accordance with the concept of corporate governance. CEO-chair duality is significantly connected with practices of earnings management.

Rajashee and Devdas (2020) in a study attempts to search for a robust model for the estimation of discretionary accruals (proxy for earnings management) of select manufacturing firms in India. The study reveals strong negative association of earnings management with the percentage of independent directors on the board and with diligence of the board members. However, it fails to accept the conjecture that percentage of promoters on the board has a positive impact on earnings management.

Otuya, Donwa, and Egware (2017) in a study seeks to examine the relationship between earnings management and quality of corporate governance in Nigeria. The study adopted the content analysis research design and data were obtained from financial statements of sampled companies. The population of the study consists of all companies listed in the Nigeria Stock Exchange. The study using data from annual reports of manufacturing companies for the period 2012 to 2016 analyzed some simple descriptive and correlation statistics and used regressions to examine the relationship between the variables highlighted in the study. The study showed that quality of corporate governance, audit committee strength and executive compensation have a significant negative relationship with earnings management.

Ejeagbasi, Nweze**,** Ezeh, and Nze (2015) examined the relationship between corporate governance and the quality of auditor's report with evidence from the Nigerian Banking Industry. The research design adopted for this study is the ex-post facto as the research relied on historic data. Eleven (11) deposit money banks quoted on the Nigerian Stocks Exchange were sampled. In testing the hypothesis, the correlation analysis was applied to a dataset covering seven (7) years from 2007 to 2014 that is the post corporate governance period. Analysis suggests that while board composition has a negative and insignificant relationship with audit quality, separation of the roles of the CEO from that of the chairman of the board, board size, and composition of the audit committee has positive and significant relationship with audit quality.

Abbadi, Hijazi, Qutaiba and Al-Rahahleh (2018) in a paper investigate the effect of corporate governance quality on earnings management in Jordan. Using a panel data set of all industrial and service firms listed on Amman Stock Exchange (ASE) during the period 2009-2013. The paper provides evidence that earnings management is affected negatively by corporate governance quality Egbunike, Ezelibe and Aroh (2015) in a study explored the influence of corporate governance and earnings management practices in Nigerian quoted companies. Primary and secondary data were used on a sampled of quoted Nigerian companies' selected through purposive sampling technique between a period of 2011-2014. Collected data were analyzed using tables, simple regression techniques done with the aid of SPSS. The research findings show that corporate governance practices such as the board size, firm size, board independence, and strength of the audit committee have significant influence on earnings management practices among Nigerian quoted companies.

Onalo, Lizam, and Kaseri (2018) carried out a study to investigate the likelihood of virtually all key elements of corporate governance in reducing the scope of banks earnings management in both developed and emerging economies. The Modified Jones Model is explored to investigate earnings management. The sample of this study consists of all the listed Nigerian banks and Malaysian commercial banks for year 2007- 2011. For Nigerian banks the earnings management has a negative mean, which means that the total accrual was negative in the majority of the sample. On the other hand, total accruals have a positive mean for Malaysian sample banks. Consequently, the residual value in the equation (et) was higher for Nigerian banks compared to Malaysian banks, indicating respectively, lower/higher accruals and earnings quality. Omoye and Eriki (2014) aim to classify Nigerian quoted companies into high and low earnings management levels and also to investigate how corporate governance mechanisms relate to these categories of earnings management levels. A sample of 130 companies were drawn from quoted companies on the Nigerian stock exchange over the period of 2005 to 2010 and to identify the unique firm's corporate governance characteristics and control variables that influence firms' decision to engage in earnings management. The study revealed that, quoted companies in Nigeria prefer to use high earnings management practices. Board independence had a positive and significant influence on the probability of Nigerian companies adopting absolute high earnings management, Audit committee independence had a negative and significant influence on the probability of Nigerian companies adopting absolute high earnings management, Board gender representation had a negative and significant influence on the probability of Nigerian firms adopting absolute high earnings management and Also Board size and CEO shareholding were found to be statistically not significant in influencing the likelihood of Nigerian quoted companies adopting high earnings management levels. The control variables; firm size, auditors' type and industry class were found to be positive and statistically significant in determining absolute high earnings management levels of Nigeria quoted companies.

3. Methodology

Design and Methods

The study adopted an *ex-post facto* research design since the data were already available. The study also used the correlational approach to find the relationship between and among the studied variables. The research population is made up of all the consumer goods firms listed in the Nigeria Stock Exchange (NSE).

Of the 304 listed firms, 16 companies are operating in the consumer goods sector. Based on this population, a normal confidence level of 95% and error tolerance of 0.05% was used. The final sample size for this study was based on the Yamane's formula (1967). The statistical formula is stated, thus: n= $N/1+N(e^2)$.

Where n = Sample size

N = Population size

e = level of significance desired.

Given that: N = 16 and e = 0.05, the sample therefore = $16/1+16(0.05^2)$ which gives a sample size of 15 companies.

Secondary data were used for the study. The secondary data were retrieved from financial statements and notes in the annual reports of the sampled consumer goods companies. The secondary data were obtained from the financial statements of the sampled listed consumer goods firms for 2019 and 2020 giving a total of 30-year end observations.

Operational Measures of Variables

Table 1: Measurement of the variables:

Variables	**Measurement**	**Appriori sign**	**Notation**
Earnings Management	Cash flow from operating activities minus profit after tax divided by Total assets	-	DACC
Board Size	Total number of members of the board	+	BSZE
Audit Committee Independence	Proportion of independent directors as a total of audit committee size.	+	ACND
Board Independence	Number of independent directors divided by total number of directors on the board	+	BIND

Model Specification

To test the hypothesis developed, a linear and multivariate regression model which expresses earnings management as a function of corporate governance mechanism is stated in functional form as follows:

$$DACC_{it} = \beta_0 + \beta_1 BSZE_{it} + \beta_2 ACND_{it} + \beta_3 BIND_{it} + e_{it}$$

Where:

DACC = Discretionary Accruals

BSZE = Board Size

ACND = Audit Committee Independence

BIND = Board Independence

e = Stochastic or disturbance term

i = Companies

t = Time dimension of the Variables

β_0 = Constant or intercept

β_{1-3} = Coefficients to be estimated or the Coefficient of slope parameters.

4. Results Presentation

Results of data analysed for the study are presented below:

Table 2: Correlation Statistics

	DACC	BSZE	ACND	BIND
DACC	1.000000			
BSZE	-0.014276	1.000000		
ACND	0.173614	-0.018084	1.000000	
BIND	-0.051531	-0.045568	0.301453	1.000000

KEY: DACC: Discretionary Accruals; BSZE: Board Size ; ACND: Audit Committee Independence; BIND: Board Independence

A correlation matrix is adopted to check the level of relationship between the dependent and independent variables on one part, and among the independent variables on the other. The correlation statistics shows that DACC has a positive relationship with ACMD (r=0.1739) but a negative correlation with BSZE(r=-0.0142) and BIND (r=-0.0515). The implication of the results is that consumer goods company with large boards and more independent directors in board composition practice less earnings manipulations. On the other hand, consumer goods firms with higher audit committee independence tend to indulge more in earnings manager as shown in the correlation statistics.
Further, it is observed that BSZE has a negative relationship with ACND (r=-0.0180) and BIND (r=-0.0455). Further, BIND is observed to have a positive relationship with ACND (r=0.3014).

Regression Analysis

Regression Analysis Table

Dependent Variable: DACC
Method: Least Squares
Date: 06/14/21 Time: 11:31
Sample: 1 30
Included observations: 29

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.024429	0.034983	0.698298	0.4914
BSZE	-0.000162	0.002012	-0.080400	0.9366
ACND	0.030408	0.030013	1.013151	0.3207
BIND	-0.021885	0.039119	-0.559450	0.5808
R-squared	0.442256	Mean dependent var		0.030172
Adjusted R-squared	0.372673	S.D. dependent var		0.020597

S.E. of regression	0.021332	Akaike info criterion	-4.729788
Sum squared resid	0.011376	Schwarz criterion	-4.541195
Log likelihood	72.58192	Hannan-Quinn criter.	-4.670723
F-statistic	0.367673	Durbin-Watson stat	1.634459
Prob(F-statistic)	0.776945		

Table shows the result for the model which examines the relationship between board structure and earnings management. As observed, The OLS regression estimation shows an R^2 value of 0.442 which suggests a 44.2% explanatory ability of the model for the systematic variations in the dependent variable with an adjusted value of 0.372. The F-stat (0.367) and p-value (0.7769) indicates that the hypothesis of non-significant linear relationship between the dependent and independent variables cannot be rejected at 5% level. For an evaluation of the effects of the explanatory variables on earning management practices, we examine their slope coefficients. As observed, the coefficients of corporate governance structures in form of board size and board independence appeared negative (-0.00162) and (-0.0218) respectively while audit committee independence appeared positive (0.0304) However, board size, audit committee independence and board independence all show non-significant relationship as probability values are greater than 0.05 (p.>0.05). The D. W statistic of 1.6344 which approximates 2 indicates the absence of serial autocorrelation of the residuals in the model.

Discussion of Findings

The aim of this study is to examine board structure as a determinant of earning management practices of listed consumer goods firms in Nigeria. Annual reports of consumer goods companies for the years 2019 and 2020 were used as the source of data. Findings of the study are discussed below:

Board Size and Earning Management.

The study reveals that there is a negative but not significant relationship between size of corporate board and earning management practices of consumer goods firms. What this implies is that large size of board does not encourage manipulation of income This resultdid meet our priori expectation. We expected that larger board size will motivate management to manipulate earnings so as to please board members. This result however is consistent with prior studies such as Mohammed (2004) and Abdulrahman and Ali (2006).

Audit Committee Independence and Earnings Management

Results from our regression statistics show that audit committee independence has a positive but not significant relationship with earnings management practice of listed consumer goods firm. What the result implies is that independent audit committees have the tendency to encourage manipulation of earnings. This finding did not meet our prior expectation. We expected an independent audit committee to perform its oversight function and promote better financial reporting quality. This result did not also conform to findings from Chytourou, Bedard, and Courteau, (2001).

Board Independence and Earnings Management.

Regression estimates reveal a negative but not significant effect of board independence on earnings management practices of listed consumer goods companies in Nigeria. This means that an independent board of directors which is composed of a mixture of non-executive directors will not indulge much in income smoothing practices. This result meets our a priori expectation. The result is in agreement with previous studies such as Murhadi, (2009) and Abdulrahman and Ali (2006).

Conclusion

This study was carried out to examine board structure as determinant of earnings management practices of listed consumer goods companies in Nigeria. The study, using the results of the financial statement statistics and exploratory variables in a regression model showed that board size and board independence have a negative but not significant relationship with earnings management practices of listed consumer goods firms in Nigeria. The study also finds a positive but not significant between audit committee independence and earnings management practices of listed consumer goods companies in Nigeria. The study therefore concludes that good corporate governance mechanism minimizes earnings management practices of listed consumer goods companies in Nigeria.

Recommendations

In line with the findings of this study, the following recommendations are proffered:

1. Companies should adopt a manageable board size in order to minimize earnings management practices and by extension promote financial reporting quality.
2. Board independence enhances corporate enhances better accountability and transparency. This is observed in this research hence corporate boards should be composed of more independent directors so as to promote relevance of accounting information.
3. Although the study showed that audit committee independence encourages earnings manipulations, it is recommended that companies should have strong and experienced audit committees to perform their oversight functions.

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