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Some Aspects of Corporate Governance Mechanisms and Earnings Management: Evidence from Two Critical Sectors of Nigerian Stock Exchange.

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Abstract:*This study investigated some aspects of corporate governance mechanisms and earnings management in Nigeria with reference to two critical sectors of the economy. The study adopted a Correlational study designsuitable for explaining relationship between variables used in the study. Secondary data were obtained from published annual statements of 5companies each from the two sectors (oil & gas and ICT) investigated for the period 2013 to 2017. Descriptive Statistics and MultipleRegression were used for analysis. The overall result revealed negative association between earnings management and the study variables. The individual variables however revealed varying results ranging from negative to positive and from significant to insignificant. Board composition for instance revealed a negative and insignificant association with cash-based earnings management of the companies investigated while board size has positive and insignificant association with earnings management. Ownership concentration has 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. The result further suggested that 22% of the variations in the dependent variable were caused by independent variables while 78% were accounted for by other factors not captured in the model. We therefore recommended among others that the interaction of ownership concentration and board compositionare associated with increasing cash-based earnings management.*

Keywords:*Corporate Governance Mechanisms, Earnings Management, Ownership Concentration, Board Composition and Board Size.*

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I. Introduction

The reliability on published accounting reports has paved way for considerable attention given to earnings management in recent times (Uadiale, 2012). Moreover, the willingness with which shareholders entrust their resources withmanagersshowcase the level of confidence vested on them to exercise their discretionary rights aimed at increasing their wealth. However, these have been used as instrument of earnings manipulationeroding the confidence investors have on their responsibilities(Dabor&Adeyemi, 2009). The reliability of financial reporting has been a major concern to investors, regulators and practitioners, especially after high profile accounting scandals involving once well respected companies such as Enron and WorldCom. Earnings management comes to play when managers purposefully 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 (Healey &Wahlen, 1999).

The debate in recent times concerning the need for strong corporate governance is attributed to the works of various authors (Adeyemi&Fagbemi, 2010; Adeyemi&Uadiale, 2010; Dabor&Adeyemi, 2009; McConomy&Bujaki, 2000) invariouscountries drawing up guidelines and codes of practice to strengthen governance (Cadbury, 1992; Corporate Governance Code of Nigeria, 2005).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, Sloan & Sweeney, 1996). It is believed that independence of Auditors and effectiveness of board of directors can impact positively and significantly the performance of companies in Nigeria and the world over (Blue Ribbon Committee, 1999; Corporate Governance Code of Nigeria, 2005).

In response to calls for strengthening corporate governance mechanisms to enhance the oversight function of the board of directors and to restore public confidence in financial reporting, the Nigeria Stock Exchange (NSE)and Securities and Exchange Commission (SEC) promulgated the Code of Corporate Governance aimed at safeguarding the interest of shareholders and other investors alike (Xie,2001). To fast track the process, companies have taken a step by adopting international best corporate governance practices to boost performance and attract international investors than local standards.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.

Emphasis in the current study is on the effect of corporate governance mechanisms on cash-based earnings management. Specifically, the work will examine statistically whether a significant relationship exist between corporate governance mechanisms such as Ownership concentration, Board Size and Board Composition and Cash-basedearnings management among oil and gas and ICT companies listed on the Nigerian Stock Exchange. Furthermore, ownership concentration and board composition are critical elements of corporate governance mechanism aimed at minimizing earnings management in corporate organizations. However, an interactive effect of the two critical elements of corporate governance mechanism has not been investigated empirically by previous studies. The current study in addition examined the interactive effect of the two corporate governance mechanisms to ascertain statistically the effect it has on cash-based earnings management.

1.2 Objectives of the Study

The primary focus is to ascertain whether the pressure of corporate governance mechanisms can effectively regulate cash-based earnings management in oil and gas and ICT companies listed on the Nigerian Stock Exchange.

Specifically, the study seeks to achieve the following objectives:

1. To examine the relationship between Ownership Concentration and real earnings management.
2. To examine the relationship between Board Size and real earnings management.
3. To examine the relationship between Board Composition and real earnings management.
4. To ascertain the interaction effect of ownership concentration and board composition on real earnings management.

1.3 Research Questions

1. To what extent does ownership concentration influence cash-based earnings management?
2. To what extent does board size affect cash-based earnings management?
3. To what extent does board composition affect cash-based earnings management?
4. To what extent does the interaction effect of ownership concentration and board composition affect cash-based earnings management of companies in Nigeria?

1.4 Statement of Hypotheses

The following hypotheses guided the study:

H_{O1}: There is no significant relationship between Ownership Concentration and real earnings management.

H_{O2}: There is no significant relationship between Board Size and real earnings management.

$H_{O3:}$ There is no significant relationship between Board Composition and real earningsmanagement.

$H_{O4:}$Ownership concentration and board composition interaction has no significant effect with real earnings management.

II. Literature Review

2.1Theoretical Review

Two theories provided the theoretical base for the study as discussed under.

2.1.1 Agency Theory

Since the early work of Berle and Means in 1932on corporate governance focused on the separation of ownership and pedals which results in principal-agent problems arising from the dispersed ownership in the modern corporation. They regarded corporate governance as a mechanism where board of directors is a crucial monitoring device to minimize the problems brought about by the principal-agent relationship. In this context, agents are the managers, principals are the owners and the board of directors act as the monitoring mechanism (Mallin, 2004). Moreover, literature on corporate governance attributes two factors to agency theory. The first factor is that corporations are reduced to two participants, managers and shareholders whose interests are

assumed to be both clear and consistent. A second notion is that humans are self-interested and disinclined to sacrifice their personal interests for the interests of the others (Daily, Dalton &Cannella, 2003).

The seminal papers of Alchian and Demstez (1972) and Jensen and Meckling (1976) describe the firm as a nexus of contracts among individual factors of production resulting in the emergence of the agency theory. The firm is not an individual but a legal fiction, where conflicting objectives of individuals are brought into equilibrium within a framework of contractual relationships. These contractual relationships are not only with employees, but with suppliers, customers and creditors (Jenson &Meckling, 1976). The intension of the contracts is that all the parties acting in their self-interest are motivated to maximize the value of the organization, reducing the agency costs and adopting accounting methods that most efficiently reflect their own performance (Deegan, 2004).

2.1.2 Stakeholder Theory

This theory centers on the issues concerning the stakeholders in an institution. It stipulates that a corporate entity invariably seeks to provide a balance between the interests of its diverse stakeholders in order to ensure that each interest constituency receives some degree of satisfaction (Abrams, 1951). However, there is an argument that the theory is narrow (Coleman, Hacking, Stover, Fisher- Yoshida & Nowak, 2008) because it identifies the shareholders as the only interest group of a corporate entity. However, the stakeholder theory is better in explaining the role of corporate governance than the agency theory by highlighting different constituents of a firm (Coleman et al., 2008).

Stakeholder theory has become more prominent because many researchers have recognized that the activities of a corporate entity impact on the external environment requiring accountability of the organization to a wider audience than simply its shareholders. For instance, McDonald and Puxty (1979) proposed that companies are no longer the instrument of shareholders alone but exist within society and, therefore, has responsibilities to that society. One must however point out that large recognition of this fact has rather been a recent phenomenon. Indeed,it has been realized that economic value is created by people who voluntarily come together and cooperate to improve everyone’s position (Freeman, Wicks &Parmar, 2004). Jensen (2001) critiques the stakeholder theory for assuming a single-value objective (gains that accrue to a firm’s constituency). The argument of Jensen (2001) suggests that the performance of a firm is not and should not be measured only by gains to its stakeholders. Other key issues such as flow of information from senior management to lower ranks, interpersonal relations, working environment, etc. are all critical issues that should be considered. Some of these otherissues provided a platform for other arguments. An extension of the theory called an enlightened stakeholder theory was proposed. However, problems relating to empirical testing of the extension have limited its relevance (Sanda, Mikailu&Garba, 2005).

2.2 Conceptual Framework

The following concepts relating to the study were reviewed.

2.2.1 Corporate Governance

Dignam and Galanis (2009) view corporate governance as the process of an institutional balancing whereby conflicting interests of a corporation’s stakeholders (shareholders, employees, creditors, government, local community and more recently the environment) are accounted for and/ or prioritized in order to produce benefit for society. ToOso and Semiu (2012), the essential ingredients of corporate governance include honesty, trust and integrity, complete transparency, accountability and responsibility, protection of stakeholders’ interests and satisfaction, participation, business ethics and values, performance orientation, openness, mutual respect and commitment to organization. These qualities are convincing that adherence would pave way for the sustenance of Business Corporation, realization of corporate goals, good and appreciable turn-out and a veritable global market place. Corporate governance according to Fatimoh (2012) is based on the level of corporate responsibility a company exhibits with regard to accountability, transparency and ethical values. These assertions indicate that corporate governance safeguard the stakeholders’ interest when there is a separation between the owners of the business and managers of the business.

2.2.2 Earnings Management

Akers, Giacomino and Bellovary (2007) define earnings management as attempts by management to influence or manipulate reported earnings by using specific accounting methods (or changing methods), recognizing one-time non-recurring items, deferring or accelerating expense or revenue transactions, or using other methods designed to influence short-term earnings.Earnings management therefore has to do with the deliberate altering of financial information to either mislead investors on the underlying economic status of a firm or to gain some contractual benefits that depend largely on accounting numbers (Kurawa&Saheed, 2014).There are two perspectives on earnings management: The opportunistic perspective holds that managers seek to mislead investors, and the informative perspective, first enunciated by Holthausen and Leftwich(1983),

under which managerial discretion is a means for managers to reveal to investors their private expectations about the firm's future cash flows.

2.2.3Composition 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 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, Iskandah&Rahmat, 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.

2.2.4 Corporate Governance and Earnings Management in Nigeria

One issue that has come to the forefront of recent debate on corporate failures regarding unethical behavior is that of earnings management. However, earnings management is not always alleged as wrongdoing. 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 (Uadiale, 2012). 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. It has been argued that the practice of earnings management is quite extensive among publicly traded companies (Barth, Landsman & Lang, 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. Recently, a series of well-publicized cases of accounting improprieties in Nigeria (for example, such as is reported in relation to Wema Bank, NAMPAK, Fin Bank and Spring Bank) 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).

2.3Empirical Review

Cornett, Marcus andTehranian (2007), examined the impact of corporate governance and pay-for-performance on earnings management. Using 100 largest firms in the U.S. as ranked by S & P between 1994 and 2003, they found that the presence of independent outside directors reduce earnings management. Similarly, Cornet, McNutt andTehranian (2009), investigated how corporate governance mechanism affects earnings and earnings management at large publicly traded U.S. companies for the period 1994-2002. The study finds that largely independent boards constrain managers' discretionary behaviour. The research conducted by RoodPoshti and Chashmi (2011) for the period 2004-2008 in Iran, using 196 firms listed on Tehran stock Exchange, revealed a negative association between board independence and earnings management.

On the contrary, Hashim and Devi (2008) examined the relationship between board independence, CEO duality and accrual management in Malaysia. Using 200 top non-financial companies listed on Malaysian Stock Exchange, they found that large proportions of independent executive directors are associated with higher income-increasing earnings management. More so, Shah, Zafar and Durrani (2009), investigated the relationship between board composition and earnings management in Pakistani listed companies for the period between 2003 and 2007. They find no significant relationship between board composition and earnings management. All the above studies relate to countries that have different regulatory frameworks and different levels of sophistication of corporate governance structure with that of Nigeria.

Aded, Al-Attar, and Suwaidan (2012) examined the relationship between earnings management and characteristics of corporate governance mechanism for a sample of Jordanian non-financial firms during the period 2006-2009. The results of their study revealed that the size of board of directors is the only variable that has a significant relation with earnings management. The findings of this study have important policy

implications since they support encouraging applying corporate governance principles in order to control the behaviors of the board of directors which may lead to distortion in reported financial annual reports.

Rajgopal, Venkatachalam and Jiambalvo (1999) researched on whether institutional ownership associated with earnings management and the extent to which stock prices reflect future earnings. This paper showed, however, that the absolute value of discretionary accruals declines with institutional ownership. The result is consistent with managers recognizing that institutional owners are better informed than individual investors, which reduces the perceived benefit of managing accruals. We also find that as institutional ownership increases, stock prices tend to reflect a greater proportion of the information in future earnings relative to current earnings. This result is consistent with institutional investors looking beyond current earnings compared to individual investors. Collectively, the results offer strong evidence that managers do not manipulate earnings due to pressure from institutional investors who are not overly focused on short-term profitability.

III. Methodology

The study adopted a correlational research design suitable for explaining relations between two or more variables.The population of the study consisted of oil and gas companies and information communication technology companies listed on Nigerian stock exchange. The sample consisted of five companies from each sector that have published their annual statements consistently over the study period for ease of accessibility. Sources of data were secondary based. Secondary data were obtained from published annual reports of the sampled companies. Descriptive statistics and multiple regression were used for analysis of the data collected.

Table 1 Summary of Variables and their measurement

S/N	Variables	Definition	Type	Measurement
1.	CBEM	Cash-Based Earnings Management	Dependent	Abn.CFO+Abn.prod.cost+Abn. Disex.
2.	ONC	Ownership concentration	Independent	% of the shares of the firm that is 5% and above that is been held by shareholders
3.	BOS	Board Size	Independent	The total number of directors on the board
4.	BOC	Board Composition	Independent	% of independent directors to total directors on the board
5.	ONC*BOC	Ownership concentration and board composition interaction	Independent	Ownership concentration multiplied board composition

Source: Compiled by the Researcher.

3.1Model Specification

$CBEM_{it} = \alpha_0 + \beta_1 ONC_{it} + \beta_2 BOS_{it} + \beta_3 BOC_{it} + \beta_4 ONC*BOC_{it} + e_{it}$

Where:

$CBEM_{it}$= Cash –Based Earnings Management of each firm i for the time period t

ONC_{it} = Owners Concentration of each firm i for the time period

BOS_{it}= Board Size of each firm for the time period t

BOC_{it}=Board Composition of each firm i for the time period t

$ONC*BOC_{it}$= An interaction of ownership concentration and board composition of each firm i for the time period t

β_1, β_2 and β_3 = the coefficients of the independent variables

e_{it} = error term in the prediction process of each firm i for time period t

IV. Results And Discussion

4.1Descriptive Statistics

VARIABLE	MEAN	STD. DEV	MIN.	MAX.
CBEM	-0.08	0.61	-1.86	3.01
ONC	10.72	0.47	9.49	11.70
BOS	8.76	2.19	4	14
BOC	0.00	0.12	-0.35	0.36
BOS*BOC	9.05	11.40	0	65.31

Source**: Stata output**

The table above shows a summary of the independent and dependent variables used in the study.It also shows an interaction between two of the independent variables (ownership concentration and board composition) of two critical sectors of Nigerian Stock Exchange (Oil and gas and ICT). It shows a standard deviation of cash based earnings management of 0.61 and a negative mean of -0.08.It also shows -1.86 and 3.01

as the minimum and maximum values of cash based management of the study companies.The ownership concentration shows 10.72 as mean values, 0.47 as standard deviation while the minimum and maximum values stood at 9.49 and 11.70 respectively. Board size has a mean of 8.76, standard deviation of 2.19 with minimum and maximum values as 4 and 14 respectively. Board composition also has a mean value of 0.00, standard deviation of 0.12, minimum and maximum values of -0.35 and 0.36 respectively.The interaction between ownership concentration and board composition has a mean value of 9.05, standard deviation of 11.40 and minimum and maximum values of 0 and 65.31 respectively.The mean values shows on average the data used while the standard deviation indicates the variation around the mean values.

4.2 Regression

A number of tests were performed on the sampled data to ascertain degree of normality, heteroskedasticity, multicollinearity among the study variables. Hauman specification test was also carried out to determine the appropriate model for analysis of regression results. The results of the various tests indicate that the data used was normally distributed,the Breusch-Pagan/Cook-Weisberg test of heteroskedasticityrevealed absence of heteroskedasticity and the VIF for multicollinearity equally shows absence of multicollinearity in the data used.Hausman specification test was carried out to decide between fixed and random effects models. The result indicates that fixed effect model is the most appropriate model. However, a Langrangian Multiplier test was further conducted to decide between pooled OLS and fixed effect models, the result revealed that pooled OLS is the most appropriate model. Consequently, pooled OLS regression model was used for analysis as presented and analyzed below:

Table 3: Summary of Pooled Ordinary Least Square Regression Result

Variable	Beta Coef.	t-values	Prob.>t
ONC	0.5941985	2.87	0.006
BOS	0.0010627	0.02	0.982
BOC	-0.3516199	-0.46	0.648
ONC*BOC	0.0079807	1.11	0.271
R2			0.2171
F-value			3.12
Prob.>F			0.0239

Source: **Stata Output**

From the table above, the prediction power of the independent variables in relation to the dependent variable is shown by R^2. The r^2 indicates that 21% of the total variation in the dependent variable is accounted for by the independent variables used in the study. The F-Statistics of 3.12 with Probability of F-value 0.0239 suggests fitness of the model. The r^2 also shows that 79% of the variation in the dependent variable is accounted for by variables not included in the study.

4.4 Discussion

The table above shows a negative relationship between cash-based earnings management and the independent variables used in the study. The relationship is negative andsignificant at 1 percent level of significance. The relationship is associated with decreasing earnings management amongst companies in the two sectors being studied. Hence, shareholders confidence in the management of the resources entrusted in the hands of the managers and the reliability of the annual statements produced. A negative relationship subsists between board composition and earnings management of the listed companies in Nigeria while two other variables (ownership concentration and board composition) demonstrated positive relationship with cash-based earnings management. It further shows that with ownership concentration and composition, cash-based earnings management will rather increase. The finding is based on beta coefficientof 0.5941985 for ownership concentration and 0.0010627 for board composition.The result in respect of interaction between board size and board compositionequally indicates increased earnings management by management of the sampled companies thereby eroding investors' confidence of their investment. The positive association of ownership concentration and board composition interaction is however insignificant based on beta coefficient of 0.0079807, t- value of 1.11 and significant levels of 0.271. The result did not support the null hypothesis in respect of the interaction of ownership concentration and board composition.

V. Conclusion and Recommendations

5.1 Conclusions

The effect of good corporate governance on the opportunistic tendencies of managers was evaluated through the use of the statistical tool of multiple regressions using the Ordinary Least Square (OLS) in two sectors (Oil and gas and ICT) Nigerian Stock Exchange.The results of the study show that apart from Ownership

concentration,other variables (Board Size, Board Composition as well as interaction of ownership concentration and board composition)have no significant relationship with real earnings management. The positive relationship between ownership concentration and board size means real earnings management increases with increase in managerial share ownership and the number of members on the board alongside the interaction between ownership concentration and board composition.Board Composition has a negative relationship with Cash-Based Earnings Management. This means thatthe composition of the board is associated with decreasing real earnings management.The conclusiondrawn is that governance variables constrain the opportunistic tendencies of managers.

5.3 Recommendations

Based on the above, the following recommendations were made:

1. The interaction of ownership concentration and board composition is associated with increasing cash-based earnings management and should not be condoned for purposes of effective and sustained operations.
2. Directors of the sampled companies should be precluded from buying and selling any security in breach of their fiduciary duty and other relationship of trust and confidence while in possession of material, privileged, non-public, and price-sensitive information in order to prevent managers with privileged information to pursue their own interest at the expense of the shareholders.
3. A competent board size of between eight and twenty members should be encouraged, so as to ensure complete compliance to the Code of Corporate Governance(2009). Moreover, board size should be adequate relative to the scale and complexity of the company's operations and be composed in such a way to ensure best practices and diversity of experience without compromising competence, independence, integrity and availability of members to attend and participate effectively at meetings. Emphasis on independent outside directors should be shifted away from number to competence.
4. Independent outside directors of the board should have core competencies and entrepreneurial spirit to drive their organizations. They should have a record of tangible achievement and should be knowledgeable in board matters with a sense of accountability and integrity.
5. Institutional shareholders with a substantial amount of shares(5% and above) should seek to influence positively the standard of corporate governance in the companies in which they invest by not only demanding compliance with the principles and provisions of the code but also seek explanations whenever there are issues of non-compliance.

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