AN EVALUATION OF PREVAILING ACCOUNTING PRACTICE AROUND PUBLIC OFFERINGS IN NIGERIA

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Abstract

Earnings management has become a popular practice among managers but despite its pervasiveness, it can still be difficult for the investors to detect due to the complexity of accounting rules. The practice has its social consequences that range from loss of investment by shareholders to total corporate failure. The main objective of this study was to investigate the prevailing practice of earnings management when Nigerian firms are about to issue shares to the public and after the issues. Specifically, the study (i) examined Nigeria firms engagement in earnings management when they are about to issue shares; and (ii) examined the extent, Nigeria firms engage in earnings management. The study covered the period between 2004 and 2011. Secondary data were employed and analyzed through panel estimated generalized least square (Cross-section random effects) method of regression analysis. The study found significant levels of earnings management (above 5% of total assets) in all the firms over the period of study, so, the study recommendes among others that the concerned regulatory agencies like The Nigerian Stock Exchange and the Security and Exchange Commission should make it mandatory for any firm that wants to issue shares to the public to include in its prospectus, a statement by the directors or professional accountant that its financial statement is free from managed earnings. The study therefore concludes that if the recommendations are implemented, earnings management before and after public offering could be reduced marginally.

Key Words: Earnings Management, Public offering, Accruals, Accounting, Discretionary.
JEL Code: G23.

Introduction

Earnings management has attracted a great deal of attention from academics, practitioners and economic stakeholders in the recent time, this is due to its social consequences that range from loss of investments by the

shareholders to total corporate failure that have brought about doubt in the mind of the stakeholders about the credibility and reliability of financial reports. Earnings management has become a popular practice among managers but despite its pervasiveness, it can still be difficult for the investors to detect due to the complexity of accounting rules. Evidences of earnings management and their attendant consequences abound all over the world, among them are failure of Enron, WorldCom, Global Crossing, Adelphia Communications on the international scene and cases like that of Cadbury, African Petroleum Plc. and Afribank Plc. in Nigeria (Okolie, 2014). Earnings management is an important accounting issue for academics and practitioners alike.

Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy & Whalen 1998). A firm that is in the process of issuing its shares to the members of the public may be willing to manage earnings opportunistically by reporting high accrual in order to surge the reported earnings ultimately to deceive intending investors and raise stock price. Accrual accounting provides managers with the opportunity to present financial reports that reflect managerial information about underlying economic conditions more accurately than is possible with a strictly mechanical reporting rule. However, a willing manager will find it a ready tool to obscuring true underlying firm performance and ultimately mislead users of financial information. It is difficult for the investors to know if the accounting rules employed by the managers truly reflect underlying performance of the reporting firms. Hence, this study evaluates the prevailing accounting practice on earnings management when Nigerian firms are about to issue shares to the public and after the issue. Specifically, the study sought to:

i. examine Nigeria firms engagement in earnings management when they are about to issue shares; and
ii. examine the extent, Nigeria firms engage in earnings management.

There have been much efforts by researchers to study the level of willingness by the managers to engage in earnings management when they are about to issue shares to the public (Arjan, 2013; Chiraz & Anis, 2013; Islam, Ali & Ahmad, 2011), however, their findings reflect differences from one research to the other, from one period to the other and from one jurisdiction to another. Due to this lack of uniformity in outcomes, it

becomes necessary to find out whether Nigerian managers have any willingness to manage earnings when they are about to issue shares to the public and also to what extent they do this.

The study covered the period between 2004 and 2011, this period was chosen with a view to capture the period of recent events in the capital markets vis-à-vis: 2005 regulatory innovation (Digital investor services and Easy access to loan facilities); 2007 modernisation (Modern electronic trading facilities and significant inflows into the capital market) (Haruna, 2012); 2008 market crash (Sanusi, 2011; Arunma, 2012) and 2011 capital markets reforms (Haruna, 2012). However, the study could not consider the period after 2011 (Post reform period) because there were no public offers in the year 2011, 2012 and 2013 (The Nigerian Stock Exchange, 2011, 2012 & 2013).

Literature Review

Conceptual Issues

Earnings Management Concept

Corporate earning is the net income that represents a company's bottom line which has been recognized as a particularly most significant item in financial statements as they designate or signify the extent to which a company has engaged in value-added activities (Lev, 1989). Earnings signal the direction of resource allocation in capital markets as the theoretical value of a company's stock is the present value of its future earnings. Hence, increased earnings represent an increase in company value, while decreased earnings signal a decrease in the value of a company (Okolie, 2014). Accounting standards guide the way firms report, however, managers have some discretion when reporting earnings. This discretion includes the choice of accounting method, its application, and the timing of cost recognition.

According to Schipper (1989), earnings management refers to a purposeful intervention in the external financial reporting process with the intent of obtaining some private gain. Healy and Wahlen (1999) asserted that earnings management occurs when management uses judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about underlining economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers. Earning management may take the form of either income-increasing or income-decreasing accounting choices. Dechow and Skinner (2000) classified earnings management into three categories, namely:

Fraudulent Accounting, Accruals Management, and Cash Flow earnings management. Fraudulent Accounting involves accounting choices that violate GAAP; Accruals Management involves choices within-GAAP that try to obscure true economic performance. Real earnings management occurs when managers undertake actions that involve changing a firm's underlying operations in an effort to boost current period earnings. Fraudulent accounting and accruals management are not accomplished by changing the underlying economic activities of the firm but through the choice of accounting methods used to represent those underlying activities. Dechow and Skinner (2000) further asserted that Accruals can be used to modify the timing of earnings recognition, thus causing earnings to either increase or decrease.

Literatures mostly view earnings management through two mechanisms vis-a-vis non-discretionary and discretionary accrual. Non-discretionary accounting adjustments are required by accounting standards and statutes, while discretionary accruals represent voluntary adjustments. Financial Accounting Standard Board (FASB), (1985) posited that accrual accounting uses accruals, deferrals, and allocation procedures to relate revenue, expenses, gains and losses to periods to reflect an entity's performance during a period. Accounting choices are made within the framework of GAAP. GAAP are the set of rules, practices, and conventions that describe what is acceptable financial reporting for external stakeholders.
Dechow, Sloan and Sweeney (1995) asserted that the analysis of earnings management often focuses on management's use of discretionary accruals. Accruals models are preferred because this approach captures the subtle income management techniques allegedly used to avoid detection by outsiders. Accruals not only reflect the choice of accounting methods but also the effect of recognition timing for revenues and expenses, asset write-downs and changes in accounting estimates (Islam, Ali & Ahmad, 2011). Managers would have more discretion over short-term rather than over long-term accruals (Chiraz and Anis, 2013).

Earnings Management Estimation

Researchers found it a challenging task to detect or measure earnings management. It is not possible to observe earnings management directly by mere looking at the face of financial reports. Therefore, researchers have conducted studies on two approaches to earnings management, the choice of accounting methods and the management of accruals. Several techniques have been employed for estimating discretionary accruals but the most

common techniques for measuring earnings management attempt to separate discretionary portion from non-discretionary accruals in earnings. The limitations of such techniques were however enumerated by Dechow, Sloan and Sweeney (1995). The techniques lack power for earnings management of plausible magnitudes because of the poor ability of the models to isolate discretionary accruals. Moreover, tests using these techniques are misspecified due to correlated omitted variables in samples with extreme financial performance, a situation that is common in tests for earnings management. Following the observation of Dechow et al. (1995), several efforts have been made to improve the techniques. Dechow and Dichev (2002) and Kothari, Leone and Wasley (2005) for instance proposed alternative techniques for identifying discretionary accruals but those techniques offer minimal improvements over previous models.

Jones (1991) conducted a study on earnings management during import relief investigations by US government using two stage models. The researcher used firm-specific expectation model and a minimum of fourteen year time series data as estimation period. His model popularly known as the standard Jones model is a very popular discretionary model because it is able to decompose accruals into discretionary and non-discretionary accruals. However, Dechow, Sloan and Sweeney (1995) made some modifications to the standard Jones and their model is popularly known as modified Jones model, the model became even more popular in estimating discretionary accruals. The study by Dechow et al. (1995) found that a modified Jones model provides the most powerful test of earnings management compared to standard Jones. However, a recent study by Yoon, Miller and Jiraporn (2006) documented that the Modified Jones model is not effective in measuring discretionary accruals for Korean firms. Yoon et al. (2012) examined the modified Jones model in terms of theoretical and empirical aspects and concluded that the model suffers from some specification problems and then propose two alternative models and compared the performance of the models. They also examine how financial structures (or asset/liability composition) affect earnings management practices.

Yoon et al. (2012) argued that while firms in the same industry may have different firm characteristics based on the point at which a firm is in the entity life cycle, firms that have similar financial structures will have similar firm characteristics and proposed that discretionary accruals be estimated for the firms with similar financial structures. The main argument for the use of financial-structure approach is based on the notion that firms with more operations-related current assets and liabilities will have higher relationships

with current accruals and that firms with more noncurrent assets (possibly noncurrent liabilities also) will have higher relationships with noncurrent accruals. For example, firms with more accounts receivables, inventories, accounts payables and accrued liabilities may tend to have more variability in current accruals, whereas firms with larger fixed assets and intangible assets may have more depreciation and amortization expenses.

Theoretical Framework

This study is built upon Economic and financial theory. According to Cormier and Magnan (1996), the theory assumes that managers are, by nature, rational and opportunistic in the pursuit of their personal interests. These interests are determined by the terms set out in contracts between managers and the company, as well as in contracts between the company and specific external parties such as suppliers, lenders, governments and regulators. Many of these contracts are based on earnings or other financial information issued by the company. For example, senior executives often receive bonuses based on accounting income; and debt often has covenants that state minimum working capital amounts, establish maximum debt-to-equity ratios or restrict dividends based on the amount of retained earnings. An accounting choice that is economically beneficial for managers will be preferred over a choice with negative repercussions: it is assumed that the manager will adopt a strategic approach in his or her accounting choices (Islam, Ali & Ahmad, 2011).

Empirical Review

Researchers have devoted so much to the study of motivation for earnings management; vehicles for earnings management and; development of models for detection and estimation of earnings management. Allen, Larsen and Sloan (2010) and Dechow, Hutton, Kim and Sloan (2011) reported characters consistent with working capital accruals containing both reversing and persisting components. Jones (1991) examined earnings management during import relief investigations by US government using two stage models (Standard Jones Model). The research concluded that managers decreased earnings through earnings management.

Teoh, Wong & Rao, (1998) showed that IPO firms on average allow significantly less for bad debts than the matched firms in the year before going public and during the offering year. Many past literatures such as Loughran and Ritter (1997), Rangan (1998) and Teoh et al (1998a) provided

evidence that managers manage earnings during seasoned equity offerings in the US market. These studies reported that earnings management during seasoned equity offerings causes poor long run stock performance. Shivakumar (2000), however opined that managers of offering firms manipulate earnings not to influence investor valuations but as a rational response to the expected negative market reaction at the announcement. Several other studies have examined earnings reporting around IPOs of common stock. Among others, Teoh et al. (1998b), DuCharme, Malatesta and Sefcik (2000), Abdullah, Susanne and Norman (2004), Yoon & Miller (2002) and Yoon et al., (2006) reported empirical evidence that suggests earnings are managed in anticipation of going public.

Chiraz and Anis (2013) and Roosenboom, van der Goot and Mertens (2003) reported evidence of income-increasing earnings management in the first year as a public company and not in the year before the IPO while Teoh, Welch and Wong (1998) found that, on average, U.S. IPO firms do manage their earnings prior to the IPO event. However, Ball and Shivakumar (2008) suggested that, as firms go through the IPO process, they move from a period of opacity to a period of increased scrutiny regarding earnings. Thus, they have incentives to report conservatively. Using a special sample from U.K. IPO firms, they found support for their hypothesis. Arjan (2013) and Abdullah Susanne and Norman (2004), Teoh et al. (1998a) and Teoh et al. (1998b) showed that firms that manage earnings prior to the IPO are able to artificially inflate the IPO price and thus, they underperform in the long run. Tan (2001) reported a similar result, but with respect to right issues. Kighir, Omar and Mohamed (2014) Studies showed that many companies strive to report high quality earnings.

Akindayomi (2012) studied association between earnings management and the Nigerian banking Crisis of the 1990s and he found that Nigeria banks showed a positive association between earnings before taxes and provisions for loan losses, indicating earnings smoothing, and that healthy banks have smoother earnings than distressed ones while distressed banks deliberately understate loan loss provisions to inflate earnings.

There is no gainsaying that earnings management is an important and interesting aspect of accounting, it has attracted a great deal of attention from academics, practitioners and other stakeholders as can be observed from the reviewed literature. The reviewed literature looked at many aspects of earnings management vis-à-vis development of models for defecting earnings management (Jones, 1991; Dechow, Sloan & Sweeney, 1995; Allen, Larsen & Sloan, 2010; Dechow, Hutton, Kim & Sloan, 2011; Yoon, Kim &

Woodruff, 2012 etc.), existence of earnings management practice in other jurisdictions other than Nigeria (Jones, 1991), earnings management around public offerings in other jurisdictions other than Nigeria (Chiraz & Anis, 2013 & Arjan, 2013), earnings management around public offerings and subsequent performance (Islam, Ali & Ahmad, 2011 & Chiraz & Anis, 2013) and earnings management and banking crises in Nigeria (Akindayomi, 2012). However, none of these studies looked at what is prevailing practice concerning earnings management when Nigerian firms are about to issue shares to the public and after the issues, hence, this research intend to fill this gap.

Methodology

The study used discretionary accrual as proxy to determine the extent of earnings management, however, it is difficult for any stakeholder to read such discretionary accrual by just looking at the face of financial books, so it become necessary to have a model that can help to detect discretionary accruals from annual reports of the sampled firms. The model developed by Yoon et al. (2012) was modified for this study. The model is as follows:

$DA = TA/At\text{-}1 - [\beta_0 + \beta_1 \Delta REV/At\text{-}1 + \beta_2 \Delta NREC/At\text{-}1 + \beta_3 PPEt\text{-}1/At\text{-}1 + \varepsilon]$…….1

The model was modified to account for time series and cross sections errors; the modified model was used to estimate variables' coefficients by regressing total accruals on the model independent variables. The coefficients were further used to estimate non-discretionary accruals (NDA); the estimated non-discretionary accruals were deducted from total accruals (TA) to arrive at discretionary accruals (DA).

$TA = NDA + DA$ …… 2

$NDA = TA/At\text{-}1_{it} = \beta_0 + \beta_1 \Delta REV/At\text{-}1_{it} + \beta_2 \Delta NREC/At\text{-}1_{it} + \beta_3 PPEt\text{-}1/At\text{-}1_{it} + W_{it}$ ……3

Where:

NDA = Non-discretionary accruals

TA = Total accrual, which is profit after tax minus cash flow from operating activities.

REV = Sales revenue (Turnover)

NREC = Net receivables (Receivables minus payables)

PPE*t*-1 = Properties, Plants and Equipments at the beginning of the year (Lag of the properties, plants and equipments)
A*t*-1 = Net assets at the beginning of the year (Lag of net assets), which was used to standardize all the variables to control for heteroscedasticity.
β_0 = Intercept
β_1, β_2 and β_3 = Gradients/Slope
i = Cross-Section
t = Year *t*
Wit = Composite error term (Ɛ*it+ ui*)
ui = Cross-section error term
Ɛit = Combined cross-section and time series error term
Δ = Change operator (between year *t*-1 and year *t*)
DA = TA – NDA ……4

$$DA = TA/At\text{-}1 - [\beta_0 + \beta_1 \Delta REV/At\text{-}1_{it} + \beta_2 \Delta NREC/At\text{-}1_{it} + \beta_3 PPEt\text{-}1/At\text{-}1_{it} + w_{it}] \text{ ..5}$$

The data collected for this study were analysed through panel estimated generalised least square (Cross-section random effects), the method was used after the Hausman test was run and its p-value (0.5534) is not statistically significant implying that random effects model is sufficient and consistent hence preferred over fixed effect model.

Secondary data were used in this study; financial variables that were employed in the study were sourced from the relevant financial statements and prospectus of the selected companies from the Nigerian Stock Exchange, Security and Exchange Commission and websites: africanfinancials.com, nse.com.ng and sec.gov.ng. The population of the study include all the Nigerian listed companies that made public offers between 2004 and 2010, between this period, a total of one hundred and forty-eight (148) public offers were made. Fourteen non-financial firms were selected from the population; selected firms are those whose annual reports are available for the three consecutive years around public offers (pre-offer, offer and post-offer financial years). The sampled companies cut across different sectors that include Conglomerate, Construction/Real estate, Consumer goods, Healthcare, oil and gas and service sectors.

A total of one hundred and forty-eight (148) public issues were made during the period of the study, out of which one hundred and thirteen are made by financial companies (Banks and Insurance firms) while thirty-five were made by non-financial companies. Out of thirty-five (35) issues of non-financial firms, the study was only able to consider only fourteen whose financial

reports are available for the relevant three consecutive years (pre-offer, offer and post offer period) to generate forty-two firm-years. Consistent with previous studies (Llukani, 2013; Islam, Ali & Ahmad, 2011), financial firms were excluded from the sample due to their distinct industry characteristics.

Discussion of Findings

4.1 *Goodness of the Model*

In order to achieve the set objectives, the study employed pooled estimated generalised least square (Cross-section random effects) method of regression analysis by regressing total accrual (Dependent variable) on different independent variables (Revenue, Net receivable and Properties, Plants and Equipments) and used regression residual (error term) as a proxy for discretionary accrual while discretionary accrual was used as a proxy for earnings management. The results of the regression are as contained in the Table 1 below.

Table 1: ***Regression Results***

Test/Variables	***Statistics/Coefficients***
Intercept	-0.725076
Change in Revenue (X1)	0.645048
Change in Net Receivables (X2)	-0.412661
Change in Lag of PPE (Properties, Plant and Equipments) (X3)	-0.316081
R-squared	0.987629
P-value – X1	0.0000
P-value – X2	0.1885
P-value – X3	0.2483
Probability (F-statistic)	0.000000
Durbin-Watson statistic	2.046677
Hausman Test (p-value)	0.5534

Source: Author's Computation, 2015

The regression results revealed that the model estimation power is high as 98% of variation in the total accrual could be explained by the independent variables (R^2 = 0.987629). F-statistic showed that estimated coefficients are significant at 1%, 5% and 10% levels of significance; however, only change in revenue was statistically significant at 1%, 5% and 10% level of significance while other independent variables are not statistically significant. It was also found out that there is a positive relationship between change in revenue (ΔREV) and total accrual as a naira (₦1) increase in change in revenue(ΔREV) would lead to 65 kobo increase in total accrual; both change in net receivable

(ΔNREC) and properties, plants and equipments at the beginning of the year (PPEt-1) have negative relationship with total accrual as a naira (₦1) increase in change in net receivable would lead to 41 kobo decrease in total accrual while a naira (₦1) increase in lag of properties, plants and equipments would lead to 32 kobo decrease in total accrual. There was absence of serial correlation as Durbin-Watson statistic was found to be close to two (Durbin-Watson statistic = 2.046677) while Hausman test p-value (0.5534) was not statistically significant suggesting that random effects model is consistent and sufficient and as such better than fixed effects model.

Table 2 contains relevant statistics of heteroskedasticity test.

Table 2: ***Heteroskedasticity Test Statistics***

Tests	***Statistics***
White Test	4.447506
5% Critical chi square @ 9 degree of freedom	16.9189776046

Source: Author's Computation, 2015

Table 2 shows results of the heteroskedasticity test, the study tested for heteroskedasticity through White test and found evidence for absence of heteroskedasticity. White test statistic was 4.447506 which was lesser than 5% critical x^2 (chisquare) at 9 degree of freedom that was 16.9189776046.

4.2 *Pre-offers Earnings Management*

Table 3: ***Indices of Discretionary Accrual of the Firms between 2004 and 2011***

Firms	**Pre-Offer Year**	**Offer Year**	**Post-Offer Year**
Japaul Oil & Maritime Services Plc.	-0.77293	0.536914	-13.5574
Nigeria Bag Manufacturing Co. Plc.	-2.32363	-2.92377	0.80025
Costain (WA) Plc.	0.054936	1.055287	0.498562
C& I Leasing Plc.	0.551939	0.234337	0.474904
May & Baker Nigeria Plc.	0.566978	-0.17638	0.277056
Ikeja Hotels Plc.	-0.15629	-0.34202	0.777457
Eterna Oil Plc.	-3.91555	1.055355	-0.59114
Nigerian Aviation Handling Co. Plc.	-0.53834	-0.53272	0.220913
African Petroleum Plc. (Now Forte Oil)	-6.92536	-1.73277	-1.81577
Dangote Sugar Refinery	0.298811	0.609776	0.414746
UAC Group	0.430991	0.230856	0.530845
Cement Company of Northern Nigeria	0.122692	-0.36107	0.0169
Neimeth Pharmaceuticals	-1.16208	2.06882	26.10961
RT Briscoe	0.784335	-0.97029	-0.10762

Source: Author's Computation, 2015

Table 3 contains indices of discretionary accruals; the study found presence of earnings management in all the firms over the periods studied. The finding is consistent with findings of (Teoh et al., 1998b; DuCharme et al., 2000; Abdullah, Susanne & Norman, 2004; Yoon & Miller, 2002 & Yoon et al., 2006) but at variance with finding of Ball and Shivakumar (2008). However, pre-offers earnings management direction showed mixed results, while a half of the firms that were sampled managed earnings upwardly implying increase in accruals. The other half managed earnings downwardly implying decrease in accruals. On whether earnings management before public issues would continue for a period after the issues until lock-up period ends or would reverse immediately after the issue the study found no uniform pattern of earnings management amongst the firms. Earnings management was also found to be significant in pre-offer years for all the firms for the period under study; it was well above 5% of net assets in all the pre-offer firm years.

Conclusion and Recommendations

This study examined whether the Nigerian firms do manage earnings when they are about to issue shares to the public and after the issues and the extent they engage in the practice. Based on the research findings, the study concludes that Nigerian firms do manage earnings when they are about to issue shares to the public and after the issues. Although firms do sometime have income decreasing accruals, this does not necessarily means that those firms did not manage earnings upward, they might have engaged in other forms of earnings management like cash flow earnings management or fraudulent accounting since accrual based earnings management is popular and is attracting more attention from the stakeholders.

Based on the findings, this study recommends that:

i. The concerned regulatory agencies like The Nigerian Stock Exchange and the Security and Exchange Commission should make it mandatory for any firm that wants to issue shares to the public to include in its prospectus a statement by the directors or professional accountant acting on their behalf that its financial statement is free from managed earnings;
ii. Accounting standards and other sources of Generally Accepted Accounting Principles (GAAPs) should be continually reviewed with a view to blocking any loopholes uncovered in the existing GAAPs; and

iii. Professional bodies should take ethical issues more seriously, punitive measure should be taking against any member found guilty of illegal earnings management and there should be no sacred cow.

It is believed that earnings management before and after public offers could be reduced marginally if these measures are implemented. However, the fact that this study considered only non-financial firms while more financial firms issued shares during the study period even though these financial firms were excluded from the study because they have distinct industry characteristics makes it difficult and unrealistic to generalize the research findings so, further study is suggested to capture financial firms. Also, because the study is concerned with earnings management around public offers by the Nigerian firms, it was difficult to consider the period after 2011 post capital market crash reforms by the Security and Exchange Commission because there were no public issues in 2011, 2012 and 2013 so, further study is suggested in order to assess the impact of those reforms on the earnings management practice in Nigeria.

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