BOARD STRUCTURE AND REAL EARNINGS MANAGEMENT OF LISTED FIRMS IN NIGERIA

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Abstract

Appropriately structured and composed boards can stimulate real earnings management, particularly when such boards possess desirable attributes. This study empirically examines the nexus between board structure and real earnings management of listed firms in Nigeria using forty (40) quoted manufacturing firms in Nigeria over the period, 2012 to 2017. The data were sourced from the annual reports of the listed firms. The choice of the data was dictated by data availability. Employing descriptive statistics, correlation matrix and OLS and multivariate panel data estimation technique, after conducting the Hausmann, test of correlated random samples, wherein the fixed effect model was selected as the appropriate model, the empirical results revealed that board independence, board size, board gender are significant corporate governance variables that influence the real earnings management of listed firms in Nigeria, given their respective t-ratios of 2.106, 2.072 and 2.174 (in absolute values).The study finds evidence that firm size has a significant impact on real earnings management of listed firms in Nigeria. The study recommends the institutionalization of sound corporate governance mechanisms, particularly with respect to the structure, composition and size of board of firms in Nigeria.

Keywords: Board structure, Board independence, Corporate code of governance, Real earnings management, Panel Data,

Introduction

The effect of board composition on earnings management assumed the centre stage of empirical research in recent times. Most companies' goal which is to operate in the foreseeable future is vigorously pursued by efficient corporate governance structure, particularly the composition and structure of boards. To this end, many firms have continued to operate effectively in terms of earnings in spite of inclement economic conditions and the secret has often been linked with the organizational structure at the corporate management level. In the same vein, crashes that have been observed in many firms (especially financial firms) have often been directly linked with failing corporate governance (Sanda, Garba&Mikail, 2008). The germane upshot of these diverse outcomes therefore lies on the patterns

and directions of corporate handling of firms in relation to its earnings management. To meet stakeholders' expectations, management would want to prepare their financial statements in a manner that shows that the company is performing well. Managements in a bid to project the image of the company in a positive light tend to engage in activities that result in the management of earnings (Kao& Chen, 2004).

Real earnings management (REM) involves alterations in the structure or timing of operations, financial transactions, and/or investments that are more difficult to detect and have cash flow consequences and does not reverse itself automatically (Li, 2010). Previous research show that, managers use a variety of 'real' actions to manage reported earnings to meet or beat certain key benchmarks in addition to using financial reporting judgment. As a result of weak corporate governance, managers may manipulate earnings and change the financial reality, thereby misleading the users of financial statement (earnings management) and this can be as a result of weak corporate governance structure (weak internal control, non-independence of board members, and a large number of executive directors in relation to non-executive directors in the board) (Aina&Adejugbe, 2015). This creates opportunistic behavior that result to a fall in the reported earnings quality and investors' confidence in financial reports (Gonzalez & Garcia-Meca, 2014).

Given the rise in the dynamism of the ownership-control relationship, it became imperative for strong institutional mechanism to regulate the separation of ownership of firms from control created the agency problem as identified in the original work of Jensen and Meckling (1976).In the same vein, critical components of corporate governance also constitute the factors that determine its effectiveness in the organization. In particular, the board of directors provide a formidable platform for the corporate organization to thrive. The overall goals and strategic paths of the organization are developed within the confines of the board. Effective board composition thus implies a strong and efficient firm real earning of firms (Osma,2008). In this direction, the nature of the board (board structure) is therefore a critical aspect of corporate governance since it provides the strongest background for the success or failure of corporate organization. Although many other corporate governance factors may play important role in earnings management, the nature or structure of the board still holds the key to effective corporate governance.

Several authors (e.g.Osma, 2008; Susanto, &Pradipta, 2016) present evidence indicating that board structure is of first-order importance in determining real earnings management. In general, the authors attribute this importance to two factors. The first is that expropriation by managers is likely to become more severe during these periods because the expected return on investment falls. The second is that during crises, the quality of corporate governance is likely to attract more scrutiny. Thus, any pre-existing weaknesses are more visible in structure of board and their activities.

The motivation for focusing on the board of directors in the corporate governance study is as follows. First, corporate boards are one of the most important, internal corporate governance mechanisms that monitor and advise management in fulfilling the mandate to protect shareholder interests (see Fama& Jensen, 2008; Hermalin&Weisbach, 2003; Adams and Ferreira, 2007; and Harris and Raviv, 2008). For instance, Mace (1971) states that, "directors serve as a source of advice and counsel, serve as some sort of discipline device, and act in crisis situations." This functions are made possible since the board has a fairly direct link with owners of the firm.

Second, in fulfilling its mandate, a key function of the board is the reviewing and guiding the firm's risk-management policy. In light of the fact that managerial excessive risk-taking behavior has been cited as one of the major causes of the current financial crisis, it indicates that in many companies, both financial and non-financial, boards failed to set up appropriate risk strategies and monitor managers' risk-taking behavior in a timely and effectively manner (Kirkpatrick, 2009). Although weak corporate boards may not be the direct cause of the current crisis, corporate board practices could affect the extent to which firms are vulnerable to the financial crisis. Third, although substantial empirical research exists on the relationship between corporate and real earnings management, the effect of board composition and structure on earnings has not received any known empirical attention. It is the recognition of these facts and the perceived gap in literature that has motivated this study.

Following this introduction, section two of the paper focuses on the review of related literature on board composition and real earnings management. Section three contains the methodology, model specification and data. Section four contains the empirical results and analysis and section five contains the conclusion and policy recommendations.

Literature Review

Conceptual Clarification

Board structure relates to how an organization is managed, it's corporate and other structures, culture, polices and strategies, and the ways in which it deals with its various stakeholders. The need for board structure arises because of the separation of management and ownership in the modern corporations. The need for well- structure and well-composed boards hinges on the agency theory which argues that the managers may have opportunistic tendency to maximize their own welfare(Merrett& Houghton, 1999). This agency problem can be mitigated through the protections derived from good corporate governance structures, and in this context board structure. Corporate boards play a critical role by offering direction and guidance to any corporate entity (Coleman &Biekpe, 2007). Board structures is the system of control mechanisms, through which the supplier of finance to corporations assure themselves of getting a return on their investment,'(Shleifer&Vishny 1997). The classical problem is the separation of ownership and control, that is, the agency cost resulting from a divergence of interest between the owners and the managers of the firm, (Jensen and Meckling 1976).

Real earnings management (REM) on the other is defined as the use of discretion of management over actual operational activities with the purpose of influencing reported earnings (Wilson 2015). Management can employ real earnings management for personal gain, which can be in form of ensuring job security, compensation, promotion and others. These actions may likely mislead investors looking at this information for investment decisions. Tucker and Zarowin (2006) in this direction posits that management can manipulate earnings by utilizing their judgment over accruals to earnings, and Lundholm and Myers (2002) document that mangers can manipulate earnings \ by using their discretion over earnings disclosures. To investors, these manipulated earnings in both cases, increase the usefulness of reported earnings.

Theoretical Framework

The theoretical basis of this study, is the agency theory which suggests that the firm can be viewed as a contractual relationship between resource owners and resource managers. An agency relationship arises wherever one or more individuals, called principals, hire one or more other individuals

called agents, to perform services and also engage in decision- making (Bamberg & Klaus, 1987). Agency theory explains the relationship between principals and their agents. This is a relationship where the principal hires and delegates duties to an agent to perform on his behalf. The theory attempts to deal with two problems: first, to align goals of the principal and agent and make sure these goals are not in conflict (agency problem), and secondly, that the principal and agent reconcile their different level of tolerance to risk (Jensen & Meckling, 1976; 1986; Eisenberg, Sundgren, &, 1998).

The agency problem arises on account of conflict of interest due to the separation of ownership and control, and the fact that management has more insider information, this leads to owners incurring costs in order to monitor the affairs of the agents (managers). The agency theory expects the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals. The managers might put their interests over those of the owners and this might mean overstating or understating numbers reported, corporate governance would help alleviate these agency problems (Chi-Keung & Brossa, 2013).

In agency theory, the agent may succumb to self-interest, opportunistic behaviour and falling short of congruence between the aspirations of the principal and the agent's pursuits. The positive theory of agency argues that the managers may behave opportunistically to maximize their own welfare, (Merrett& Houghton, 1999). This agency problem can be mitigated through the protections derived from good corporate governance structures, (Okeahalam&Akinboade, 2003)(board structure in this context).

Empirical Review

In reviewing the empirical literature the effect of three critical board structure variables on earnings are presented. These are board independence, board size and board gender. This is to accord critical focus to the subject matter

Board Independence

Iraya, Mwangi and Muchoki, (2015) using evidence from Nairobi examine the effect of board independence real earnings management. Their findings show that board dominated by outsiders are better in terms of monitoring

the activities of management. Accordingly, since they are external, this makes them independent of the influence of the organizations management, in addition to their expertise which are effective means of preventing management from acting solely in their own interests. The findings is supported by Peasnell, Pope and Young (2005).Lin and Hwang, (2010) find that the independence of the board of directors has a negative relationship with earnings management.

Greiner (2013) finds that strong corporate governance in the context of board independence signals to investors an efficient reallocation of resources. According to the author, investors may be unable to unravel managers' intentions for REM; their consideration of corporate governance may facilitate efforts in evaluating managers' ability to pursue self-interested activities. Strong independent boards may reduce risk of loss from opportunistic managers attempting to expropriate wealth from investors. Cheng, Lee & Shevlin (2015) found out that independent board has a very stronger effect in very complex firms where key executives play a very important role by examining if these key executives have the ability to hinder the level of them engaging in real earnings management

Other studies which that found the positive effect of board independence on real earnings management include Denis(2001), Iraya et al (2015). Peasnell, Pope, and Young, (2005) show evidence that existence of outside members may provide a useful monitoring tool to the board, as they do not play a direct role in the management of the company, and as a result, may produce higher and better quality financial reports and prevent the distortion of information. Other studies, such as Kao and Chen (2004); Jaggi and Leung (2007) found a significant negative relationship between earnings management and the presences of higher fraction of outside directors, which suggest that a higher fraction of outside board members provides better supervision of management to control earnings management activities. Jesus and Emma (2013) found out that in relation to board independence, a better number of board independence affects earnings management negatively. Susanto & Pradipta(2016) found a significant relationship between board independence and real earnings management.

A number of addresses the effectiveness of outside independent directors on the board in overseeing real activity-based management of earnings within the firms (Kang &Kim, 2012), Visvanathan (2008) finds that except for the proportion of independent directors, most board characteristics that have been found in limiting accrual-type earnings management to be significant

are not significant in limiting real earnings management. Osma (2008) measured real earnings by using discretionary expenditure (opportunistic R&D) to analyze the effectiveness of independent boards at constraining real earnings management and also to monitor the roles of directors over real earnings management. They empirically found out that independent directors are capable of identifying and constraining R&D cutoffs and as result, push the earnings into meeting current period targets.

Board of Directors Gender and Real Earnings Management

In relation to the real earnings management practices, strong and effective board gender are able to minimize opportunistic behavior of managers (Khrishnan & Parsons, 2008). Studies that have examined the relation involving the ratio of female directors on boards and the quality of earnings include Carter, Simkins, & Simpson (2003), Adams et al. (2010) who argued that executives are more likely to be monitored by female directors more effectively and can think independently. This, according to them is an effective control for real earnings management in that firms can lower earnings management and have better earnings quality. Thus, more females on the board, act as essential tool for providing better quality financial information and checking opportunistic activities. Other studies include, Ahmed, Hossain, Adams (2006), García-Meca and Sánchez-Ballesta (2009),Sitthipongpanich and Polsiri, (2013), amongst others. These studies in general found that more female gender on the board has a significant impact on reals earnings management, particularly in enhancing real earnings quality.

Board Size and Real Earnings Management

The board size constitute the number of executive and non-executive directors in the board. The board size is one of the factors mainly used by researchers as a proxy for the strength of corporate governance (Denis, 2001). Jesus and Emma (2013) examining the possible relationship between board size and earnings management, found out that board size positively affects earnings management. Studies such as Song andWindram, (2004) and Peasnell et al (2005), find no significant relationship between board size and earnings management or the possibility of having quality earnings. Other studies which found a significant relationship between board size and real earnings management are Vafeas (2000), Ahmed, Hussain, & Adams, (2006), Pradipta (2011) amongst others.

Methodology

Population and Sample

The population of the study consists of the whole manufacturing firms in the Nigerian Stock Exchange (NSE). However, to constitute sample size out of the population of the study, the purposive non-probability sampling method is adopted in the collection of samples for this research. Based on this method, forty (40) manufacturing firms are selected for the sample from a population of 128 firms. The common criteria used for the selection include type of availability of board information, and accessibility. The concept of non-probabilistic procedure allows more information within the distribution and accords the research work more scientific feature, thereby concretizing the validity of the research findings.

Data Sources

The study utilizes annual time series data mainly from the secondary sources. The underlying data for the variables of interest was obtained from the banks published annual Financial Reports at the Nigerian Stock Exchange (NSE).The period for the study is six (6) years covering 2012 to 2017.

Model Specification

Following the review of theoretical and empirical literature, the model used in this study to examine the relationship between board structure and earnings management is specified functionally as:

REM = f (BIND, BS, BGEND, FS) (1)

Where;

REM=Real earnings management-measured by management experience

BIND= Board independence-measured by number of independent non-executive directors to total number of board members

BS= Board Size-measured-measured by number of directors on the board (total number of board members)

BGEND= Board of directors gender-measured by proportion of female directors to total number of directors

FS=Firm Size-being a firm control variable and is measured total assets

The econometric form of the model can be specified as:

$REM_{it} = \alpha_0 + \alpha_1 BIND_{it} + \alpha_2 BS_{it} + \alpha_3 BGEND_{it} + \alpha_4 FS_{it} + \varepsilon_{it}$(2)

Where all the variables are as earlier defined.

ε_{it} =random error term

Method of Estimation

The model specified in (2) is based on the panel regression analysis procedure that is adopted in this study. The main advantage of the panel data analysis is that it comprehensively takes the individual characteristics of the different firms used in the study. It is generally observed that firm-level behaviour is a strong factor in the determination cross-sectional behavior. This differentiation may bring endogeneity bias into the estimation. The panel data analysis helps to correct this inherent estimation problem. The basic class of models that can be estimated using panel technique may be written as:

$$Y_{it} = f(X_{it}, \beta) + \delta_i + \gamma_t + \epsilon_{it} \quad (3)$$

The leading case involves a linear conditional mean specification, so that we have:

$$Y_{it} = X_{it}'\beta\delta_i + \gamma_t + \epsilon_{it} \quad (4)$$

Where Y_{it} is the dependent variable, and $X_{it}$is a -vector of regressors, and $\epsilon_{it}$are the error terms fo r i = 1, 2,…,M cross-sectional units observed for dated periods t = 1, 2, …, T. The α parameter represents the overall constant in the model, while the δ_i and$\gamma_t$represent cross-section or period specific effects (random or fixed).

A central assumption in random effects estimation is the assumption that the random effects are uncorrelated with the explanatory variables. One common method for testing this assumption is to employ a Hausman test to compare the fixed and random effects estimates of coefficients in order to determine the best model for the financial performance model. This test is also used to examine the randomness of the data distribution in this study. Two techniques are employed in the empirical analysis of this study. These involve the use of descriptive statistics which gives the summary measures and initial characterization of the data series. The second is the panel data estimation in order to investigate the influence of each of the board structure variables earnings management.

Results and Analysis

Descriptive Statistic

The descriptive statistics for the variables used in the analysis is presented in table 1.

Table 1. Descriptive Statistics

	REM	*BIND*	*BS*	*BGEND*	*FS*
Mean	0.22	5.00	7.00	3.05	28.32
Median	0.36	5.27	8.15	3.23	36.00
Maximum	1.73	7.83	12.10	4.00	128.2
Minimum	-0.23	1.00	4.21	0.00	28.72
Std. Dev.	1.47	1.25	076	1.06	15.30
Skewness	1.72	0.16	1.20	0.65	3.16
Jarque-Bera	15.62	2.40	18.20	8.33	28.90

Source: Author's computation

The descriptive statistics show that the mean value of real earnings management is 2.2 percent. Its median value of 3.6 percent, shows a dissimilarity in real earnings management in the cross-sectional firms used. Apparently, more firms have higher real earnings management than the observed mean, while other have extremely low values. The maximum and minimum of 1.73 and -0.23 show divergence between the firms' real earnings management. The standard deviation of 1.47 buttress this variability among real earnings management of the firms. The Jacque-Bera statistic of 15.6 passes that significance test and shows that the real earnings of the firms sampled not uniformly distributed, an indication of non-symmetric distribution.The mean values of board independence, board, board of director's gender and firm size are 5.0. 7.0, 3.05 and 28 9, respectively.In general, the data series show high skewness and kurtosis values. with significant J-B values; an indication of asymmetric distribution and non-nomality of values. The implication of this is that there is heterogeneity among the firms. Endogeneity problem is thus expected, thus necessitating the adoption of the panel data technique for the estimation of the relationships.

Correlation Analysis

In order to examine the nature and degree of relationship among the variables, the correlation analysis is carried out. Table 2 presents the results of the correlation matrix.

Table 2: Correlation Matrix

	REM	*BIND*	*BS*	*BGEND*	*FS*
REM	-				
BIND	0.12	-			
BS	0.25	0.18	-		
BGEND	-0.16	0.13	0.26	-	
FS	0.28	11	0.09	0.15	-

Source: Author's computation

The correlation results show that board independence and board size are positively correlated with real earnings management, while board gender-measure by number of female directors on the board is negatively correlated with real earnings management., Thus, board independence and board size tend to increase real earnings management of firms, while board of directors gender tend to reduce it. Firm size is positively related with real earnings management. Thus, larger firms tend to be associated with higher real earnings management. The correlations among the independent variables show that increase firms size is positively correlated with board independence, board size and board of director's gender. This implies that larger firms tend to have large boards in terms of independence, composition, and size.

Pooled OLS and Multivariate Panel Data Results

We presents the Pooled OLS and Multivariate Panel Data results in Table 3.
The goodness of fit statistics for the model for the OLS estimates are not quite good, given the low coefficient of determination of 0.17, which indicates that only 17percent of the net systematic variations in the real earnings management of listed firms are explained by the explanatory variables. This show low explanatory and predictive power. The coefficient of board independence is significant at the 5 percent level, while that of firm size passes the significance test at the 10 percent level. Next, we employ the Hausman test to select the appropriate strategy for the panel data, given

that the OLS estimates above cannot be relied on for policy directions, since the estimates inherently possess endogeneity issues. The results of the theHausman test is reported in table 2. In the result, the Hausman test (Chi-Square statistic) of 10.72, with a probability value of 0.02 is significant test at the 5 percent level. Thus, we reject the null hypothesis that unobserved firm specific heterogeneity are uncorrelated with regressors, and thus base our analysis on estimates provided by the fixed effect model, as the random effect estimates are likely to be biased and inconsistent. The estimates provided by the fixed effect is thus relied on for policy purpose**.**

In the fixed effect results, the diagnostic statistics show that the adjusted R-squared value is now 0.85, an indication that85 percent of the net systematic variations the in real earnings management of listed firms in Nigeria is explained by the regressors. The F- statistic of 29.6 is highly significant at the 1 percent level, and validates the existence of a significant linear relationship between the explanatory variables and the dependent variable, and suggests that the explanatory variables are jointly significant in the determination of the real earnings management of listed firms in Nigeria. The Durbin Watson statistic of 1.72 shows that there is no serial correlation in the model, implying that the model can be used for structural and policy analysis.

Table 3. Results from Pooled OLS and Panel Multivariate Estimation
Dependent Variable: REM

Variable	**Pooled OLS**		**Fixed Effect**	
	Coefficient	T-Ratio	Coefficient	T-Ratio
C	-1.252	-1.882	-0.272	-1.211
BIND	-0.034	-2.013	-0.071	2-.106**
BS	0.115	1.4622	0.153	2.072**
BGEND	-0.021	-1.143	-0.240	-2.174**
FS	0.083	1.863*	0.314	1.828*
			Haussmann Test= 10.72 (0.02)	
	R^{-2} = 0.17 DW=0.63		R^{-2} = 0.85 F-value =29.6 DW=1.72	

***Statistical significance at the 1%leve

** Statistical significance at the 5 % level
* Statistical significance at the 10% level
Standard errors of coefficients in parentheses
Source: Author's computation

In terms of the individual performance of the variables in the model, the coefficients of the independent variables are appropriately signed in line with theoretical expectations. The coefficient of board independence is negative and statistically significant at the 5 percent. This implies that increase. The coefficient of board size indicated by the number of directors passes the significance test at the 5 percent level an indication that large board size tend to raise real earnings management of listed firms in Nigeria. Invariably, the greater the greater the size of board, the more the discretionary expenses, rising cost and lower return on the part of firms.The coefficient of board of directors gender-indicated by number of female directors on the board is negative and significant at the 5 percent level. The finding is in line with Adams et al. (2010) that executives are more likely to be monitored by female directors more effectively who can think independently. This is an effective control for real earnings management: such that firms can lower earnings management and have better earnings quality. Finally, the coefficient of firm size is positive, although passes the significance test at the 10 percent level. The implication is that larger firms tend to have more real earnings management than lower firms.

Conclusion

The importance of well composed, structured and organize board for real earnings management in terms of financial reporting quality, oversight functions cannot be over-emphasized. As a strong corporate governance mechanism, corporate boards are one of the, most important, internal corporate governance mechanisms that monitor and advise management in fulfilling the corporate mandate in and resolving the supposed agency problem- where there is conflict of interest between shareholders and mangers. As a strong institutional and regulatory mechanism, greater emphasis is placed on the structure, composition and size of board by the Security and Exchange Commission (SEC). The empirical findings of this study has clearly shown that effect board structure which is an integral component of corporate governance is important to managing real earnings of firm, and by extension, firms earnings quality. Without strong board structure that is able to minimize manager opportunistic behavious and irrationality, corporate organizational crises may arise, leading to poor performance and in the extreme, financial crisis, due to managerial excessive risk-taking behavior. In this regard, weak corporate boards could trigger crisis.

Policy Recommendations

With respect to the empirical findings of this study, the following policy recommendations are made:

(i) Effective corporate governance mechanism should be instituted in firm, with respect to the board structure, composition and size.
(ii) Independence of boards should be instituted through appropriate institutionalization in order to enhance earnings management.
(iii) The regulatory role of Securities and Exchange Commission (SEC) in setting an unwavering standard (Corporate Governance Code) as effective internal control is important. It is when strong and effective mechanism such as these are put in place that the corporate image, credibility of the firms are enhanced to attract greater investors to the firms equities.

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