CORPORATE GOVERNANCE CHARACTERISTICS AND EARNINGS MANAGEMENT

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Abstract

This study examined the corporate governance characteristics and earnings management of publicly traded companies in Nigeria. To achieve the objective of this study, the Altman Z-score was used to filter quoted companies at the floor of Nigeria Exchange Group as of 2024 into strata (healthy, gray and distress companies) before examination. The panel vector error correction mechanism (PEVCM) regression technique was employed to examine the effect of corporate governance characteristics on earnings management of the aforementioned strata companies in Nigeria. The choice of the PEVCM is premised on the results of the panel unit root tests for all the variables and because, it helped to account for individual-specific heterogeneity and dynamic nature of our observations and minimizes the effects of aggregation bias from aggregating sampled firms into a large group.

This study found that, in terms of discretionary accruals, corporate governance does not exert significant effect on the earnings management of healthy firms in Nigeria. Also, it was discovered that, apart from board independence, all other corporate governance characteristics examined affect earnings management of the healthy firms. Hence, this study recommends that firms need not accommodate discretionary accruals in their actual income statements to remain healthy.

Keywords: Corporate Governance, Earnings Management, Healthy Firms, Financial Performance

JEL Classification: M20, M31, M41.

1. INTRODUCTION

Earnings management is a substantial aspect of contemporary accounting research, especially after the detection of accounting scandals that came to light during the last decade, precedent to the global financial debt crisis. Consequently, various studies have focused on this subject to investigate its origins, the motives behind applying those practices and the consequences for the firm's financial reporting quality. The relevance of companies' earnings to the various stakeholders of a company cannot be overemphasized as the whole faith of the company and consequently of its stakeholders generally depends on this concept. It is therefore of interest for accounting researchers to know that this significant variable continues to maintain its relevance in the decision making of different interest holders in a company. Financial statement is a mean by which a company presents its financial performance and management's accountability to various stakeholders. Therefore, earning information is a pivotal tool used to evaluate performance of company's activities. For investors, earning is a growing economic value that will be obtained via dividend payment. So, the earnings information is employed by investors as an appraisal device to forecast earnings power, and to predict future earnings of a company. Financial record, especially earning information, are part of the investors' concerns in evaluating achievement or failure of business. The major interests of investors are earnings, which often motivates those who are saddled with responsibilities to engage in actions that benefit a particular party (Rice, 2016). These actions are part of the deviations that are used by managers to influence information in financial statement which is otherwise known as earnings management.

Earnings management takes place when a company uses the loopholes built in the accounting system to manipulate the financial performance of an entity to deceive some account records users about economic performance underlies the firm or to influence a contract outcome that relies on the presented accounting figure. Thus, earnings management can boost prejudiced information within financial records, and it can mislead the user who relies on such earnings reported. This adjustment negatively influences the firm's future, and capable of eroding the trust of existing and potential investors. The problem of earnings-driven emotion of the stakeholders and the force of the current economic slump around the world has created motivation for corporate directors to use earnings supervision. Moreover, the lines of accounting indignities over recent years expose the ethical breakdown and underline the substance of transparency as well as credibility via sound corporate governance arrangement (Poli, 2017).

The significant economic cost from this disreputable exercise all over the world gave relevance and request for sound corporate governance. Thus, effective and sound corporate governance is especially important in emerging economy like Nigeria which is still trying to regain the confidence of investors from domestic and international arenas.

The financial health of companies quoted in any given Stock Exchange differs, and this largely can influence the level of companies' earnings management. If this is the case, it means that the effects of corporate governance mechanisms could at the same time differ among firms in the same market. To identify the financial health of companies, the application of Altman (1968) Z- Score is relevant. This Z-Score is a compound evaluation of default peril that reveals the probability of a company collapse. The Altman model is a pointer to the general financial soundness of a company (Agrawal & Chatterjee, 2015). In effect, using Altman Z- Score application, companies can be sorted into distress, gray and strong zone companies. A company is termed distressed when it is tending towards bankruptcy; that is, unable to meet up its financial obligations and the Altman Z-Score value is less than 1.81); gray when it may or may not experience bankruptcy and the Altman Z-Score value ranging within 1.8 and 2.99), and strong or healthy when it is financially viable without a smell of be bankrupt with the Altman score value above 2.99). These three categories of companies are predisposed to different financial environments and risks because of their different level of operations. These dissimilar zone companies are not homogenous. Hence, grouping them together and examining the effect of corporate governance characteristics on earnings management will not produce a valid and reliable statistical result if the peculiarities of these are not taken into cognizance. The dispute is that the financial state of an entity can affects the level of earnings management practice by management; and this can vary the impacts of corporate governance characteristics on earnings management among companies in the same marketplace. To support this ideal, Agrawal and Chatterjee (2015) opine that, companies witnessing poor financial situation, particularly those moving towards insolvency, make frantic effort to improve their financial condition by employing drastic operating decisions to lessen negative profit and restructure their future projection. Therefore, companies with lesser Z-Scores (distress firms) could have increased level of earnings management behavior since such entities are characterized by bad state of health.

Another conflicting argument is that more solvent companies are more competent in administrating earnings due to the greater level of easiness to diverge from best possible operation in the light of its solvent situation (Zang, 2012). According to Agrawal and Chatterjee (2015), companies experiencing lesser monetary distress may have a higher tendency to keep their real economic state and therefore propose that creditors should be precautious. In essence, many studies have not been conducted in this area of comparative empirical analysis on the earnings management practices among healthy, gray, and distress firms in a single study particularly in the context of Nigeria.

The studies that have examined corporate governance and earnings management are both expansive and diverse (Ajayi & Madhumathi 2016; Enofe et al., 2017; Faghani & Ameoi 2023; Ibadin & Dabor 2022; Omoye & Eriki 2014; Iyafekhe, 2019). It is worthy to note that, one locally close study to this study is that of Erah (2017), who did a study on distress firms. The author examines the effect of selected corporate governance variables on earnings management. In his findings, he asserts that troubled firms are less proficient in earnings manipulation given that they exhaust the avenues that can enable them to engage in earnings management practices before the occurrence of distress upon his analysis and findings. Nevertheless, the author's research did not extend its scope to gray and healthy firms..

The approaches employed in the aforementioned studies do not take into cognizance the influence which the health of the firm has on management practices, which include the kind and the degree of earnings management managers engage in. To enable us to achieve the objective of this study, the following null hypotheses guided the study.

1 Board independence has no significant effect on earnings management of healthy firms.
2 Board gender diversity effect on earnings management is not significant for healthy firms.
3 Audit committee meeting has no significant effect on earnings management of healthy firms
4 Managerial ownerships have no significant effect on earnings management of healthy firms.

2. LITERATURE REVIEW

Board Independent and Earnings management

Independent board, according to Muth and Donaldson (1998), is the proportion of non-executive in the entire board member of company. From the agency theory point of view, the greater number of non-executive directors participating in board decision-making, the more efficient and effective is board in her monitoring function (Jensen & Meckling, 1976; Fama & Jensen, 1983). The levels of independent directors play a major role in arbitrating conflicts between management and shareholders, thereby enhancing the transparency and compliance of accounting reports in an organization. In view of agency theory, board with most outside directors will better oversee the management and reduce likelihood of earnings management. Moreover, Fama and Jensen (1983) also state that outside directors are assumed to be less influenced by management and seemingly more concerned about their own prestige and reputation with other external stakeholders. This is somehow consistent with proposition of stakeholder theory which recommends that the company should be accountable to the entire body of stakeholders. Higher proportion of outside directors who possess different backgrounds and technical knowledge will help the board to perform its monitoring function better, reducing the risks the managers act in their own favor and maximizing the shareholders' benefits (Nicholson & Kiel; 2007). This statement concerning knowledge spillover effects is definitely in line with dependence theory.

Daghsni et al. (2016) report that board independence is one of the most important determinants of board effectiveness in decreasing managers' discretion and thus earnings management. Therefore, to increase the effectiveness and activity of a board of directors in terms of its monitoring functions, agency theory suggests inclusion of independent directors (non-executive) in a company board. In addition, prior studies suggest that board independence increases board control of companies and thus decreases earnings management. In this regard, several studies have found a negative relationship between board independence and earnings management (Alqatan, Imad & Khaled, 2019; Dabor & Dabor, 2014).

Board diversity and earnings management

Obigbemi,(2016) and Eze (2022) posit that women on the board provide greater motivation because, among other aspects, they have moral values that reduce the firm's earnings management because they follow more conservative earnings management strategies. Also, Sanda et al. (2006) findings show that, in some developing countries, women comprise less than five percent of directorship and CEOs positions due to their management's conservativeness. Sanda et al. (2008) findings equally showed clear evidence that, where there is gender diversity within the firm, earnings management becomes effective because the gender parity is conservative, and they are cautious about spending and other forms of management.

However, Al-Mamun et al. (2013); Guedes et al. (2018) findings show that there is no direct connection between gender diversity in the boardrooms or that the firm's management enhances good management skills in the earnings management to prevent unnecessary spending and similarly promotes good monitoring. An earlier study that shows similar results was Choi and Rainey (2010), they drew conclusions that there was no positive relationship between gender parity and earnings management. More so, Strobl, Rama and Mishra (2016) findings equally reveal that, especially for top management, gender diversity is not directly correlated with better earnings. This implies that pressure to achieve equality in the representation of women may be counterproductive. Therefore, earnings management and gender parity are a firm's independent variables, and one does not necessarily affect the other. There are mixed results between board diversity and earnings management because of leverage; this is because some have high and others have low leverage. However, in either situation, all Nigerian banks have the same earnings manipulations in Nigeria banks (Isa & Farouk 2018). A group of authors, such as Lakhal et al. (2015), Susanto (2016) and Omoye and Eriki (2014) found a negative relationship between gender diversity and the probability of company engagement in a high earnings management practice.

Like the above positive and reducing effect of gender diversity on earnings management, Clikean, Geiger and Connell (2001); Enofe *et al*. (2017); Triki Damak (2018) and Zalata *et al*. (2018), found the same results that gender diversity reduced the earnings management. A corroborated study by Omoye and Eriki (2014) explained that the reason for the reduction in earnings management is because, women in the boards are more conservative in behavior to avoid risk in financial decisions.

Audit Committee Meeting and Earnings Management

Audit committee meeting frequency is concerned with the number of meetings held by the committee during the year. Regulators and others have expressed a strong preference for an audit committee that meets frequently. The audit committee is responsible for ensuring compliance with generally accepted accounting principles, to maintain the credibility of a firm's financial statements (Lin & Hwang, 2010). The audit committee is responsible for supervising the accounting process and works as a coordinator between external and internal auditors (Piot & Janin, 2007). It is an important part of the decision control system, with respect to the internal monitoring by the board of directors and has the delegated responsibility of protecting and progressing shareholders' interests (Fama & Jensen, 198). It ensures that accurate financial information is provided to decision-makers by monitoring management's possible opportunistic behavior (Chen & Zhang, 2014).

The frequency of meetings between audit committee members enhances the communication process. This showed in the study of Bedard et al. (2004) which states that frequency is an indicator of diligence and effectiveness of audit committee. Audit committees should allocate sufficient time to discuss key financial issues of the firm. An active audit committee can rectify any problem immediately and is in a better position to accomplish its monitoring role. This results in higher quality financial reporting and thus less EM (Sierra et al., 2012; Katmon & Farooque, 2017). Various codes and recommendations, such as the UK Corporate Governance Code and the Nigerian Code of Corporate Governance (2016) state that audit committee meetings should not be less than three or four times per year and should correspond to important financial reporting dates and the audit cycle.

Managerial Ownership and Earnings Management

Recent study by Ayadi and Boujelbene (2014) examines the relationship between earnings quality and ownership structure. The study employs a sample of 117 French firms for the period of nine years with a Panel Corrected Standard Errors, the result shows that managerial ownership has a positive effect on the level of earnings management, that, managers with higher equity ownership are more likely to act opportunistically and manage firm earnings. Still in this direction, Saftiana et al. (2017) verified the impact of managerial ownership on earnings manipulation in Indonesia Stock Exchange for the period of five (5) years. The study used a purposive sampling technique to obtain 21 firms as a sample size along with a multiple linear regression analysis. Managerial ownership was measured by dummy variable while earnings management was calculated by discretionary accrual computed using the popular earnings management model (Modified Jones model). The outcome of the study reveals that managerial ownership has no significant effect on earnings manipulation. The question is: amidst these various findings, will the result be the same in healthy, gray and distressed companies despite their different peculiarities? Again, this motivated us to consider this variable in this study.

Theoretical Framework

Positive accounting theories. According to this theory, opportunistic behavior can be observed on management choices concerning their decisions relevant with the firms' maximization of their personal gain. Consistent with this theory, earnings management activity is strongly associated with significant gains and advantages for the firm as an entity and concerning relevant managerial issues (Madison et al., 2016). In summary, among the various theories discussed, positive accounting theory are more pivotal and popular in addressing the underlining theoretical issues in earnings management as relating to financial reporting, as evidenced in prior study (Aguilera & Jackson, 2010). Agency theory has been the primary basis for the development of corporate governance standards, principles, and codes. All corporate governance theoretical perspectives are complements to positive accounting and agency theories (Daily *et al*., 2003).

3. RESEARCH DESIGN

The study employed a longitudinal research design, as it involves repeated observations of the same variables over long periods of time unlike the cross-sectional design that only examines variable at a point in time. The design covered non-financial companies listed at the floor of Nigerian Stock Exchange for the range of 2021 - 2024.

In this study, the population of the study comprises all listed companies on the floor of the Nigeria Stock Exchange as at December 2024 (NSE, 2024). The data filtering technique was employed to arrive at our sample size. So, out of one hundred and seventy (170) quoted companies on the floor of the Nigeria Stock Exchange as of 2019 financial year end, one hundred and fourteen (114) constitute the non-financial companies after the deduction of fifty-six (56) financial and service companies (deposit banks, insurance, and micro finance banks). Therefore, these 114 companies form our sample size, as they were readily available for our assessment. The choice for manufacturing companies in this study was to ensure the homogeneity of financial statements of sampled companies.

Data collected for the purpose of this study were analyzed using descriptive and inferential statistics. This study used the panel vector error correction mechanism (PEVCM) regression technique to examine the relationship between corporate governance characteristics and earnings management of the selected firms in Nigeria. The choice of the PEVCM is premised on the results of the panel unit root tests for all the variables and because it helped to account for individual-specific heterogeneity and dynamic nature of our observations and minimizes the effects of aggregation bias from aggregating sampled firms into a large group.

The model for this study is first expressed as a relationship between corporate governance characteristics and earnings management of publicly traded companies in Nigeria. In the form

DACC = f (CGC) ………………………………………………… (3.2)

Where DACC is the discretionary accruals and CGC are corporate governance characteristics. CGC is further decomposed as shown equation (3.2)

CGC = f (BID, BGD, ACM, and MOW) ……………………… (3.3)

Stated in econometrics form, the general model for this study becomes

$DACC_{it} = \Omega + \beta_1 BID_{it} + \beta_2 BGD_{it} + \beta_3 ACM_{it} + \beta_4 MOW_{it} + \varepsilon_{it}$…. (3.4)

However, this study examined Healthy firms; equation (3.3)

For healthy firms:

$DACC_{itH} = \Omega + \beta_1 BID_{it} + \beta_2 BGD_{it} + \beta_3 ACM_{it} + \beta_4 MOW_{it} + \varepsilon_{it}$…. (3.5)

Where:

Ω = Constant term
β_1 to β_7= Coefficients of the independent variables
$DACC_{it}$ = Discretionary accruals (Earnings management) of healthy firms in (i) at time (t), a proxy for earnings management
BID = Board Independence measured as the ratio of non-executive directors/ total board size of firm (i) at time (t).
BGD = Female board director measured by the ratio of female board members/ total board size.
ACM = Audit Committee measured by numbers of meeting held in a firm (i) at time (t).
MOW = Managerial ownership is the proportion of share held by management in a firm (i) at time (t).

4. DATA ANALYSES AND INTERPRETATION

Descriptive Statistics: Healthy Firms

Table 1 contains the descriptive statistics of healthy firms' data. Emphasis will be placed on the Jarque –Bera normality test, direction of skewness and the kurtosis of the variables.

Table 1: *Descriptive Statistics – Healthy Firms*

	DACC	BID	BGD	ACM	MOW
Mean	-0.023781	66.57294	9.010000	3.630923	0.161673
Median	-0.037000	66.67000	9.090000	4.000000	0.011900
Maximum	1.833000	93.33000	71.43000	6.000000	2.550000
Minimum	-2.081000	0.000000	0.000000	1.000000	0.000000
Std. Dev.	0.225921	17.06307	9.812703	0.792743	0.339753
Skewness	-0.033182	-0.917473	1.340345	-0.389430	4.293172
Kurtosis	33.96603	4.289401	6.769853	3.672272	27.28232
Jarque-Bera	16021.61	84.03596	357.5231	17.68696	11083.58
Probability	0.000000	0.000000	0.000000	0.000144	0.000000
Sum	-9.536000	26695.75	3613.010	1456.000	64.83080
Sum Sq. Dev.	20.41614	116459.4	38515.66	251.3766	46.17289
Observations	401	401	401	401	401

Source: Author's computation (2024)

From Table 1, the descriptive statistics show that, in the healthy firms' group, while DACC, BID and is skewed to the left with coefficients -0.033182, -0.917473, and -0.389430 respectively, BGD, ACM, MOW are all skewed to the right of the bell-shaped distribution. The Kurtosis of the variables are 33.96603, 4.289401, 6.769853, 3.672272, and 27.28232. For DACC, BID, BGD, BDS, and MOW, respectively. This implies that while DACC, BID, BGD, ACM, and MOW are all leptokurtic (greater than 3), BDS and FZE are platykurtic (lower than 3). The Jarque-Bera (JB) statistics show that all the variables are not normally distributed based on their respective probabilities that are all less than 0.5 for all the variables under study.

Correlation between DACC and Independent Variables – Healthy Firms

The correlation matrix shows the movement between one variable and the other. Table 2 is the summary of correlation coefficients among the variables under study.

***Table 2**: Correlation Matrix – Healthy Firms*

	DACC	BID	BGD	ACM	MOW
DACC	1.000000	-0.054823	0.022437	0.035630	-0.056394
BID	-0.054823	1.000000	-0.094885	0.034696	-0.057009
BGD	0.022437	-0.094885	1.000000	0.119226	0.060792
ACM	0.035630	0.034696	0.119226	1.000000	-0.049614
MOW	-0.056394	-0.057009	0.060792	-0.049614	1.000000

Source: Author's computation (2024)

Table 2 reveals that all the independent variables have very low correlation coefficients with the dependent variables. As shown the coefficients -0.054823, 0.022437, 0.035630, -0.056394 for BID, BGD, ACM, and MOW respectively imply that the variables do not suffer the problem of multi-collinearity Brooks (2008).

***Table 3:** Panel Vector Error Correction Mechanism (VECM) – Healthy Firms.*

	Dependent variable DACC					
Variable	Coefficient	Std. Error	t-Statistic	Prob.	Prob F-S	DW Stat
D(BID(-1)	-0.00022	0.001240	-0.18101	0.8566	0.000000	
D(BGD(-1)	-0.001207	0.001952	-0.61839	0.5372	0.000000	(R^2) 55
D(ACM(-1)	-0.00762	0.024895	-0.30600	0.7600	0.000000	
D(MOW(-1)	-0.114849	0.124800	-0.92027	0.3588	0.000000	2.029612

Source: Authors' computation (2024).

The null hypothesis guiding estimates of the PVECM is that there exists no significant relationship between dependent and each of the independent variables. From table 3, a unit change in BID, BGD, ACM, and MOW will bring a reduction of 0.00022, 0.001207, -0.00762 and 0.114849 in DACC respectively. The *P*-value of all the other explanatory variables is not statistically significant. All the coefficients of multiple determination (R^2) show that the explanatory variables explain at least 55% of the variations in DACC while the Durbin-Watson statistics show that none of the variables have problem with serial autocorrelation as they all hover around the benchmark of 2. Finally, the probabilities of F-Statistics are all 0.000000 revealing that the model used in this study is valid and reliable in its entire entirety.

5. DISCUSSION OF FINDINGS

This study set out to examine the relationship between corporate governance characteristics and earning management of non-financial firms quoted on the Nigerian Stock Exchange. The firms were divided into three groups depending on their Z-Score: Healthy, Gray and Distress Firms. The goal of the study is to compare the effects of the corporate governance characteristics on earning management among the three. Particular attention is placed on differences in the effects of corporate governance on earnings management among the three firm groups and the implications of effects that are statistically significant. Results show that:

First, on the effect of board independence on the discretionary accruals of healthy firms; though not statistically significant, all the effects are negative, signifying that healthy firms do not depend on discretionary accruals for survival. On the contrary, the healthier a firm is, the less it accommodates discretionary accruals.

Second, board gender diversity exerts a negative but statistically insignificant effect on earnings management in both healthy firms, again, in reference to previous findings, the findings on board gender diversity and earnings management in healthy firms agreed with the negative and insignificant effect of Lakhal et al. (2015); Susanto (2016); Omoye (2014) Guedes et al. (2018) on this same variable.

Third, while audit committee meetings have negative and positive but statistically insignificant effects on discretionary accruals of healthy firms. Also, these findings have again deviate from the general conclusion of the positive and significant findings of Sierra, Ruiz and Orta (2012); Katmon and Farooque (2017) and the non-effect studies of Bedard *et al.* (2004) and Yang and Krishnan (2005) irrespective of firms' health status.

Finally, managerial ownership exerts a negative but statistically insignificant effect on discretionary accruals of healthy firms and positive firms. However, its effect on the distressed firms' group is negative and statistically significant. Attempts to transform gray to healthy firms can encourage the number of management owners to increase as discretionary accruals increase, hence the positive and significant effect.

6. SUMMARY OF FINDINGS

The results of panel vector error correction mechanism used to estimate the effect of corporate governance characteristics on earnings management of selected revealed that, in the healthy firms' group, though these characteristics have negative effect on the discretionary accruals, none of the variables' effect has a significant effect on it. Specifically, the study finds that:

1.In comparing the effect of corporate governance characteristics on earnings management of non-financial firms, board independence has the same effect of negative but statistically insignificant effect on earnings management on healthy firms.

2. Board gender diversity has a negative but statistically insignificant effect on earnings management in healthy firms.

3. Audit committee meetings have negative and positive but statistically insignificant effects on earnings management of health.

4. Finally, managerial ownership exerts a negative but statistically insignificant effect on earnings management of healthy firms.

7. CONCLUSION

This study was carried out to examine the nature of relationship that exists between corporate governance characteristics and earnings management of non-financial firms listed on the Nigerian exchange group between 2019 to 2024. Based on the findings of the research, it is concluded that first, in terms of discretionary accruals, corporate governance does not exert significant effect on the earnings management of healthy firms in Nigeria.

Policy Recommendations

In view of the conclusion drawn from this study, the researcher recommends that:

Firms need not accommodate discretionary accruals in their actual income statements to remain healthy. Since board characteristics have negative (though insignificant) effect on discretionary accruals of healthy firms, management of such firms should continue to be conservative in allowing discretionary accruals to form part of their actual incomes that are meant for planning purposes. A good way to handle this is to develop accounting and budgeting systems that will make firms depend less on yet-to-be earned incomes for planning and operation purposes.

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