Corporate Governance and Earning Management of Deposit Money Banks in Nigeria

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Abstract

This study examines the effect of corporate governance on earnings management of listed deposit money banks in Nigeria for five years (2006- 2015). The data for the study were extracted from the annual reports and accounts of the sampled banks for the study period. Descriptive statistics, Pearson correlation and regression technique were used to analyzed the data with the aid of SPSS version 21. A panel data regression technique was employed since the data has both time series and cross sectional attributes. It was unexpectedly found that reputable audit firms has a positive but insignificant effect on the earnings management of the sampled banks while board size has negative but insignificant effect on the earnings management of the sampled firms. However, independent directors on the board and leverage have a negative and significant effect on earnings management of Deposit Money Banks in Nigeria. Hence, the study recommends the need for effective corporate governance practices in Deposit Money Banks in Nigeria by increasing the number of board of director to maximum size of twenty directors as provided by the CBN Code of Corporate Governance for Banks and Discount Houses in Nigeria,

2014. This will allow more independent directors to be appointed which will enhance financial reporting process.

Keywords: Corporate governance, Earnings management, Independent directors, Board size, Audit firms, Leverage and opportunistic manipulation,

1. Introduction

The soundness of any financial institutions depends on discharge of directors' responsibilities which determines the country's competitive position (CBN Code of Corporate Governance for Banks and Discount Houses in Nigeria, 2014). Such code of conduct brings framework of transparency and effective accountability. However, banks around the world are found to have managed their earnings (Shen and Chih, 2005 as cited in Majid and Liang, 2011). Also, According to Andres and Vallelado (2008) as cited in (Kasumu, Etudaiye, Oyebola and Abdulraheem, 2011) , the relevance of banks in the economic system and the nature of the banking business make the problems involved in their corporate governance highly specific, as are the mechanisms available to deal with such problems.

Earnings management is an attempt by the managers of companies to manipulate financial reporting process in other to achieve certain incentives. It occurs when manager use judgment in financial reporting and structuring transactions to alter financial reports to either mislead some stakeholders about the economic performance of the company or to influence contractual outcomes that depends on reported accounting numbers (Healy and Wahlen, 1999). Managers have the motivation to conduct earnings management for his/her own interests which may be inconsistent with the interest of the shareholders and investors (Jensen and Meckling,1976; Bergstresser, Philipon,2006 as cited in Guo and Ying,2015). Corporate governance is a mechanism that is employed to reduce the agency cost that arises as a result of the conflict of interest that exists between managers and shareholders (Shehu and Abubakar, 2012).

Previous studies such as Hsu and Wen (2015), Kuwara and Saheed (2014), Iraya, Mwangi and Muchoki (2015), Chervenkov (2012) among others, found that significant relationship exist between the board of directors as a component of corporate governance and earnings management. But, there is no agreement among the researchers whether large board size or small board size will effectively mitigate opportunistic attitude of managers. Thus, Hsu and Wen, (2015), conclude that the larger the board size, the more ability for the board to monitor whether the managers conduct earnings management behaviour or not. On the contrary, Junaidu and Abdulrahman, (2014), empirically found that board size is negatively significant. This goes further to show that the total member is seen to be guiding against the accounting sharp practices in the Nigerian petroleum marketing companies. Hence, they made a recommendation of eight to fifteen board members. However, Jensen (1993) argues that small boards are more effective in monitoring a CEO's actions, as large boards have a g reater emphasis on "politeness and courtesy" and are therefore easier for the CEO to control. Also, Yermack (1996) concludes that small boards are more effective monitors than large boards.

Therefore, this study intends to ascertain the extent to which independent directors improve corporate governance, thus, reduce earnings management remain unresolved.

2. Literature Review

Hsu and Ying (2015) examined the influence of the influence of corporate governance in Chinese companies on discretionary accruals and real earnings management. They used data of listed companies in Shangai and Shenzhen stock exchange market over a period of 2002 – 2012, using 11604 samples in the empirical model. They found that the establishing independent directors is ineffective in monitoring the earnings management behavior of the managers and also found out that the larger the board size, the more ability for the board to monitor whether the managers conduct earnings management or not.

Chen and Zhang (2012) examined the impact of the corporate governance code on e arnings management: Evidence from Chinese listed companies. Corporate governance was proxy by institutional ownerships, board independence, audit committee, statutory audit and control variables (sales, size of the firms and Leverage) and earnings management was proxy by discretionary accrual. Discretionary accrual was measured using modified Jones model. They found that in contrast to the existing literature on t he western markets, it was observed that international reputable audit firms (BIG 4) does not contribute to the reduction in earnings management. Moreover, independent directors, existence of audit committee were found to curb earnings management.

Fodio, Ibikunle and Oba, (2013) examined the effect of governance structure on quality of reported earnings in listed Nigeria insurance firms. They used cross sectional variation of the modified model to measure discretionary accruals which is a proxy for earnings quality. A total of 25 insurance firms were randomly selected from year 2007 to 2010. This study found that board size, board independence, audit committee size and firm size have negative association with discretionary accruals while audit committee independence and independent external audit were found to have a positive relationship with discretionary.

Sirine (2012) examined the impact of some governance mechanisms on earnings management published by 20 anonymous listed Tunisian firms during the 2000-2009 period, totalling a number of 200 observations. To this end, earnings management has been operationalized as a function of board directors' size, presence of external directors within the board, the separation between the manager and president of the board roles, the majority shareholder's capital percentage, managers' shareholdings, presence of financial institutions and appointment of the CEO by the state. He found out that presence of external directors within the board, board size and presence of a CEO seem to impact earnings management whereas the other board characteristics are found to be neutral

Shehu and Abubakar (2012) examined the relationship between corporate governance on corporate financial performance when performance is stripped of the discretionery component of accruals. Secondary data were extracted from annual reports of the sample firms for the period (between 2008 to 2010) and univariate OLS multiple regression was used as a tool for data analysis. The study document that corporate governance significantly impact on both the adjusted and unadjusted firm performance in different magnitudes and directions. Specifically, they emperically established that board composition is inversely related with true performance while a positive interraction emerges between executive compensation and firm performance regardless of the performance specification.

Ramlugun and Seewoo, (2011), examine the association between corporate governance and earnings management and also investigate the impact on the behavior of earnings management in the presence of corporate governance practices along with the activities of the board and the audit committee by measuring the level of discretionary accruals. The Modified Cross Sectional Jones Model is used in measure discretionary accruals whereas data about the characteristics of audit committee and board of directors have been collected from annual reports of listed companies of Mauritius. Their Findings reveal that firms having lowest discretionary accruals have better audit committee characteristics, moreover it is observed that where companies have more than two meetings the committee is more likely to be composed of Independent directors and their members have sound financial expertise.

Omoye and Eriki (2014) carried out a study which classified Nigerian quoted companies into high and low earnings management levels and investigated how corporate governance mechanisms relate to these categories of earnings management levels. A sample of 130 companies were drawn from quoted companies on the Nigerian stock exchange over the period of 2005 to 2010 and to identify the unique firm's corporate governance characteristics and control variables that influence firms' decision to engage in earnings management, they conducted descriptive statistics, correlation matrix, diagnostic test and binary regressions analyses of the data. The study revealed that, quoted companies in Nigeria prefer to use high earnings management practices; Board independence had a positive and significant influence on the probability of Nigerian companies adopting absolute high earnings management, Audit committee independence had a negative and significant influence on the probability of Nigerian companies adopting absolute high earnings management, Board gender representation had a negative and significant influence on the probability of Nigerian firms adopting absolute high earnings management and Also Board size and CEO shareholding were found to be statistically not significant in influencing the likelihood of Nigerian quoted companies adopting high earnings management levels. The control variables; firm size, auditors type and industry class were found to be positive and statistically significant in determining absolute high earnings management levels of Nigeria quoted companies. They recommended that stakeholders in quoted companies in Nigeria should promote sound audit independence, intensify the independence of board composition and encourage more female representation on the board.

Iraya, Mwangi, and Muchoki (2015) carried out a study in which its objectives was to establish the effect of corporate governance practices on earnings management of companies listed at the Nairobi Security Exchange (NSE). The target population consisted of the 49 companies that had been continuously and actively trading at the NSE (Nairobi Stock Exchange) between January 2010 and December 2012. Secondary data was used covering the period 2010 to 2012 and analyzed using linear regression to test the effect of the independent variables on the dependent variable. The study found that earnings management is negatively related to ownership concentration, board size and board independence but positively related to board activity and CEO duality.

Thong-her, Catherina, Haiman, and Jing-fong (2012) explore the impact of corporate governance factors to earnings management behaviors. They used modified Jones model to test the free cash flow, discretionary accrual items and some corporate governance factors. Their analysis shows that the discretionary accruals are positively related with free cash flow. They also found that companies that have been audited by the Big-Four CPA firms have less discretionary accrual items. Debt to asset ratio has a negative relationship with discretionary accruals. Results from corporate governance factors indicate that the turnover rate of internal auditors, the number of financial report restatement and the number of earnings forecast are not significantly related with discretionary accrual items. Their analysis also shows different earnings management behaviors between high-tech and traditional industry.

Chen and Zhang, (2012), empirically revealed that international reputable audit firms (BIG 4) does not contribute to the reduction in earnings management in Chinese listed firms which contradict the findings of previous studies in Western countries.

However, there is no agreement among the researchers whether large board size or small board size will effectively mitigate opportunistic attitude of managers. For instance, Hsu and Ying, (2015) conclude that large board size has the ability to control activities of managers to act in the best interest of the stakeholders, but, Yermack, (1996) also concludes that small boards are more effective monitors than large boards.

Moreover, code of corporate governance in Nigeria and countries like Indonesia, China among others, recognize independent directors as one of the powerful tools to tame management actions towards enhancing the stakeholders' value. But, there is no consensus among researchers as to its significant effects on opportunistic attitude of managers.

In the light of the different positions that have been maintained by various studies as reviewed above, it can be argued conveniently that the effect of audit firm reputation, board size, independent directors and earnings management are controversial. Therefore, this study is spurred by the lack of consensus in the existing literatures as a result of mixed reaction on the significant effect of audit firm reputation, board size, and independent directors on earnings management.

2.1 Corporate Governance Theories

Agency theory

In corporate governance debates, the agency theory appears to be the foremost and the most emphasized because it borders on the cost of agency (Okougbo, 2010). Agency costs include monitoring expenditures by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent and residual loss due to divergence of interests between the principal and the agent (Jensen and Meckling, 1976). The theory brings out a clear exposition of the actions of some managers which are not in consonance with the actions they were to take, assuming shareholders' wealth maximization objective is pursued.

Stakeholder's theory

Freeman (1998) as cited in (Branco and Rodrigues, 2007) defined stakeholders as groups and individuals who benefit from, or are harmed by, and whose right are violated or respected by corporate actions. Clarkson (1995) distinguishes primary and secondary stakeholders. Primary stakeholders are those "without whose continuing participation the corporation cannot survive as a going concern" (Shareholders and investors, employees, customers and suppliers, and also government and community that "provides infrastructures and markets, whose laws and regulations must be obey, and to whom taxes and other obligations may be due") Whereas secondary stakeholders are " those who influence or affect, or are influenced or affected by, the corporation, but are not engage in transactions with the corporation and are not essential for its survival.

3. Methodology

The study makes use of secondary data which was obtained from Deposit Money Banks annual report and financial statement over a period of ten (10) years. The annual reports and accounts were sourced from the internet using goggle search engine. The dependent variable which is the earnings management was measured using the absolute value of discretionary accruals of each Bank. However, the independent variables were measured using;

(i) **Reputation of audit firms (X_1):** a dummy variable was used. If the external auditor is one of the BIG 4, it was represented by one (1). But, if otherwise, Zero (0) was used.

(ii) **Board Size (X_2):** Natural logarithm of number of board of Directors was used.

(iii) **Independent Directors (X_3):** it was measured as a p ercentage of independent directors to total number of board of directors.

(iv) **Leverage (X_4):** As a result of the fact that Banks of different sizes are used in the study, there is tendency for other factors, other than the explanatory variables, to influence the discretionary accrual. Leverage is used in this study because Deposit Money Banks are highly geared entities since large percentage of their assets are from demand deposit. Hence, there is likelihood for the debt to have impact on the discretionary accrual.

To investigate earnings management, this study estimated total accruals and subsequently modified and employed the Jones model to investigate discretionary accruals. It estimated Total Accruals (TA) using details from cash flow statements and income statements of banks. Thus;

$$TACC_{it} = NI_{it} - CFOA_{it} \quad \text{……………………………..} \quad \text{(i)}$$

Where;

$TACC_{it}$ =Total Accruals for Bank i at time t.

NI_{it} = Profit before interest and other comprehensive incomes for Bank i at time t.

$CFOA_{it}$ = Cash flow from Operating activities for Banks i at time t

The Modified Jones Model estimates non-discretionary accrual using;

$$NDA_{it} = a0\ (1/TA_{it-1}) + a1\ (\Delta REV - \Delta REC)/TA_{IT-1} + a2\ (PPE)/TA_{it-1} \text{…………………………..(ii)}$$

Where;

NDA= Non Discretionary accruals

TA_{it-1} =Lagged Total Asset or Previous year Total asset

REV = Changes in Revenue

REC = Changes in Receivables

PPE = Gross value of property, Plant and Equipment.

a0, a1, a2, a3 = parameter estimates of the variables.

Moreover, Al-Fayoumi, Abuzayed and Alexander (2010) as cited in (Shehu and Abubakar, 2012) note that change in revenue is included to control for economic circumstances of each firm in the sample, while gross plant, property and equipment are included to control for the total proportion of accruals relating to non-discretionary expenses.

Hence, Discretionary accrual = TA_{it} - NDA_{it} ....(iii)

Clearly, measures of earnings management based on the Jones (1991) model need to be modified for banks or other financial institutions that are not engaged in sales-based businesses (Cohen, et al., 2011 as cited in Onalo, et al.., 2013).Thus, given consideration to the standard Jones (1991) model.

This study modified the Jones model by introducing gross earnings (GE) to replace SALE/REV as used in (Onalo, et al.., 2013). This is because what sales or revenue is on the financial statement of manufacturing firms are gross earnings to banks. Banks total gross earnings is the sum of interest and similar income, fee and commission income, foreign exchange income, trusteeship income, income from investments and other income. In addition, what goods are to manufacturing industry are loans to banking sector. While manufacturing firms sell goods, banks sell loans (Onalo, et al.., 2013). There is ever possibility for loans to go bad. Therefore, Net Loan (_NL) is going to be introduced to replace _REC.

Thus, to estimate discretionary accrual for Deposit Money Banks, the following formula applies:

$ADA_{it} = TACC_{it}/TA_{it-1} - (a0(1/TA_{it-1}) + a1(\Delta GE - \Delta NL)/TA_{IT-1} + a2(PPE)/TA_{it-1})$…..(vi)

Where;

ΔGE= changes in Gross in Earnings

ΔNL= changes in Net Loan

4. Result

Table 1: ANOVA of Model

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.029	4	.007	3.048	.026[b]
	Residual	.106	45	.002		
	Total	.135	49			

a. Dependent Variable: absolute value of discretionary accrual

b. Predictors: (Constant), leverage, log of board of director, reputation of audit firm, proportion of independent directors

Source: Researcher's computation with the aid of SPSS (2017)

Table 1 shows the ANOVA of the model with F statistics of 3.048 and p value of 0.026. This implies that the model is statistically significant at 5% level of significance since $p < 0.05$, thereby establishing that the whole model is fit. Thus, we are therefore 95% confident about the regression results. Hence, this study conclude that the explanatory variables (corporate governance mechanisms and leverage) have significant joint influence on earnings management.

Table 2 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.462[a]	.213	.143	.04855	2.061

a. Predictors: (Constant), leverage, log of board of director, reputation of auditor, proportion of director

b. Dependent Variable: absolute value of discretionary accrual

Source: Researcher's computation with the aid of SPSS (2017)

Table 2 shows the summary of the model. The coefficient of determination (R Square) of 0.213 means that 21.3% of the changes in discretionary accrual (dependent variables) is attributable to the combine efforts of reputation of external auditors, board size, independent directors (independent variables) and leverage (control variable), While the balancing 78.7% (referred to as stochastic error term, designated as e in the model) is attributable to other factors aside the explanatory variables which affect discretionary accrual, which are outside the model.

Moreover, as it is shown in table 2, the technical Durbin –Watson is at a normal level, that is, more than 1.5 and less than 2.5, indicating less autocorrelation in the model. Thus, we can conclude that the errors are dependent from each other.

Table 3 Regression coefficient

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	.451	.177		2.547	.014
reputation of auditor	.041	.030	.189	1.372	.177
log of board of director	-.123	.085	-.213	-1.448	.155
proportion of independent directors	-.233	.103	-.329	-2.263	.028
Leverage	-.315	.165	-.253	-1.905	.063

a. Dependent Variable: absolute value of discretionary accrual

Source: Researcher's computation with the aid of SPSS (2017)

The coefficient of the regressors are displayed in table 3.

The constant, β_0 is 0.451 (p value = 0.014), significant at 5% level of significance. Indicating that if other factors are held to be zero, discretionary accrual will equal to 0.451.

Reputation of audit firms has an unstandardized beta coefficient, β_1 of 0.041. Hence, Auditors' reputation has a positive relationship with earnings management, this was not agreed with a priori expectation though the relationship is insignificant. This suggest that large audit firms encourage earnings management.

The board size has an unstandardized beta coefficient of -0.123, which represent an inverse relationship with earnings management. That is, the larger the size of board of director, the lesser the occurrence of opportunistic manipulation of performance by t he management but this relationship is at insignificant level because its p value is 0.155 which is far greater than 0.05.

The present of independent directors has an inverse significant relationship with earnings management with an unstandardized beta coefficient, β_3 of -0.233, (p value = 0.028), significant at 5% level of significance. Therefore, higher the number of independent directors, lower the presence of discretionary accrual.

The only extraneous variable in this study is leverage. From table 3, it is shown that it has a negative significant relationship with earnings management with an unstandardized beta coefficient (β_4) of -0.315, (p value = 0.063), significant at 10% level of significant. This is expected considering the sensitive nature of financial sector because demand deposit constitute larger percentage of Deposit Money Banks' external source of funds. Therefore, the larger the banks' debt, the lower the tendency to opportunistic manipulate the financial reports of an entity.

Table 4 Multicollinearity test

Variable	Tolerance Value	Variance Inflation Factor (VIF)
REA	**0.927**	**1.086**
BZ	**0.808**	**1.238**
ID	**0.828**	**1.208**
LEV	**0.992**	**1.008**

Source: Researcher's computation with the aid of SPSS (2017)

To test whether there is a problem of multicollinearity, the correlation coefficients may not be greater than 0.6 (or less than -0.6) between any two of the explanatory variables (Bryman and Cramer, 2011 as cited in Gelderen, 2013). Also, Gujarati (2003) as cited in Kajola, Adewumi and Babatolu, (2015) posit that Variance Inflation Factor (VIF) and Tolerance Value can also be used to test multicollinearity problem. A variable with VIF of above 10 or Tolerance value of less than 0.1 s hows existence of high multicollinearity between it and other variables. Table 4 presents the result of the multicollinerity test among variables used in the study. None of the variables has VIF of above 10 or Tolerance value of less than 0.1. Then, we can conclude that there is no problem or existence of high multicolinearity in the model and the regression is valid to performance.

5. Conclusion

This study has examined corporate governance mechanisms and its effect on e arnings management among selected Deposit Money Banks in Nigeria using ordinary least square regression model to find answers to the research questions and statistically test the hypotheses stated in chapter one as corporate governance and earnings management continue to remain an area of debate, any effort to improve understanding in this area may lead to better approach of financial reporting. Consequently, preventing earnings management among Deposit Money Banks in Nigeria through the implementation of corporate governance mechanisms would yield optimal results if policy makers and other stakeholders in banking sector would promote large board size, intensify the presence of independent directors and encourage high quality auditing process of Listed Deposit Money Banks in Nigeria. By this, agency problem could be mitigated and there would be improved users reliance on corporate financial reports of Banks for decision making.

The study recommends the need for effective corporate governance practices in Deposit Money Banks in Nigeria by increasing the number of board of director to maximum size of twenty directors as provided by the CBN Code of Corporate Governance for Banks and Discount Houses in Nigeria, 2014. This will allow more independent directors to be appointed which will enhance financial reporting process. The independent directors are recommended to chair various sensitive committee of the board such as board audit committee, board risk management committee, governance and remuneration committee among others.

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