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Firms' Profitability and Board's Influence On Its Management

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ABSTRACT

The relationship between directors' efficiency in the management of the firms' profitability is the focus of this study. The earnings reported by companies have been said to convey information which are not in tandem with the actual results of the firms. The problem here is that the directors of these companies are not efficient in managing and reporting such earnings. These manipulations have affected the way and manner the earnings of such firms are evaluated. It is generally the directors that take responsibility for such reports. Management is often faced with the obligation to report positive growth in earnings so as to satisfy the expectations of shareholders. Correlation research method was adopted as the research design. Fifteen firms were sampled to establish the relation in the variables. Data were collected from the Annual Reports of companies which are listed on the Nigerian Stock Exchange list for the period 2013 to 2016. Multiple linear regression analysis was employed for data using the 13.9 STATA software model. Results obtained showed that a proper mix of directors in organizations poses no significant effect on the earnings management of firms. It is therefore recommended that the boards' composition should be subjective as this does not affect the management's capability on the firms' earnings.

Keywords: Management, profitability, software, shareholders.

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1. INTRODUCTION

Earnings management refers to the process of manipulating the accounting records with a view to achieving an earnings position that is suitable to the dictates and expectations of both directors in particular and other stakeholders in general. Earnings management can also be described as a situation where a wide range of accounting techniques is employed in a company to achieve a specific purpose (Uwuigbe, Uwuigbe and Okorie, 2015). In a clearer perspective, earnings management can be said to be a deliberate attempt to manipulate the financial records of an enterprise with a view to creating an impression of high and profitable managerial outlook to stakeholders or users of such accounting information. Earnings management has resulted into a number of corporate scandals (Uwuigbe, 2013) including those of Tyco, Enron, Worldom, Hollinger, Adecco, Health South, TV Azteca, Global Crossing, Parmalat, et cetera. To curb this menace, some corporate codes such as those of Securities and Exchange Commission (SEC), Central Bank of Nigeria (CBN) and National Insurance Commission (NAICOM) on corporate governance and regulation have been put into operation (Idornigie, 2010). It is therefore important that the board should consist of executive and non-executive members in its composition.

Such composition will bring about good governance by the board which will be essential for improvement on the quality of financial reporting. In corporate governance as viewed by Parker(2014), could refer to as a fore front knowledge which is unique and a growing field of study which has gained enough ground due to the un-fancied fraud occurrence in the last thirty and half years. In recounting the experience of the nature of fraud involving the likes of Eron, World Comm. and the rest of it in the United State of America and its business environment. There is also the need for the selected firms to embrace the code of corporate governance which regulates board composition of companies. In line with the view expressed by (Voorn et. Al 2019), he viewed cooperate governance and its structure as steps to link the principal agent relationship in order to secure the firm's financial and other resources for a better result.

The fast moving consumer goods sector is the focus of this study. This sector is a part of the manufacturing industry in Nigeria that is involved in the production and marketing of food and beverages as well as personal care products. The products from this sector generate significant portion of the gross domestic product of many countries in Africa including Nigeria. Therefore the need for a regulated board composition cannot be over-emphasized. According to (Bala & Kumai, 2015) the earnings of such companies are essentially expected to have high-level reliability and relevance as the entire faith of the firm and subsequently of its stakeholders rely on their financial reports.

1.1 Objective of the study

The purpose of this study is to examine the relationship of board composition on the listed firms in the Nigerian economy on the earnings management of such firms. With respect to the functions of the board of the listed firms (Gulzar & Zongjun, 2011; Kouki, Elkhaldi, Atri and Souid, 2011; Nugroho and Eko, 2011) attempt shall be made to measure the relationship between board composition and earnings management of such organizations.

1.2 Research Question

What is the relationship between board composition and earnings management in the selected firms?

1.3 Research Hypothesis

The null hypothesis stated below shall be used to test the relationship between board composition and the earnings management of the selected firms in Nigeria.

Ho: There is no significant relationship between board composition and earnings management of the listed firms in Nigeria.

2. Theoretical Framework

Earnings are vital indicators of a firm's engagement in value-added activities (Musfiqur, Mohammed and Jamil, 2013). Hence the theoretical value of a firm's stock is the present value of its future earnings. Therefore, companies with positive and higher earnings will automatically have higher share price than those with low earnings prospect. On the other hand, earnings management may be defined as the distortion of the application of generally accepted accounting principles to suit the expectations of the board as well as the firm's stakeholders. However, Rudra & Bhattacharjee, (2012) assert that earnings management may not always be wrong, the generally accepted view among accountants, regulators and standard setters is that, more often than not, earnings management is disadvantageous and may be misleading.

Significantly, the concept of Generally Accepted Accounting Principles (GAAP) has been set as landmark for the practice of accounting. The concept refers to a common set of accounting principles, standards and procedures which are set aside to guide the practice of accounting from time to time by those qualified to practice accountancy. The complexity of issues confronting firms listed on the Nigeria Stock Exchange indicates the expansion of the roles of the board of directors as their many activities require much more oversight. Experience is seen to be important in the performance of the board of directors.

For this reason, the code of corporate governance provides that there is no limit to the concurrent positions that should be held by the directors of a company as long as they are disclosed for shareholders to assess their sustainability for appointment into the board, that is, multiple directorships. But, the code discourages cross membership on the board of two or more companies and out rightly disallows cross memberships of boards of competing companies. This calls for a need to measure beyond the board composition and other vital characteristics of the board the effect of multi-chairmanship on earnings management.

2.1 Board Composition and Earnings Management

The code of corporate governance states that the board should comprise of a mix of executive and non-executive directors. The majority of board members should be non-executive directors, and at least one of them should be an independent director. (IFC, 2011) states that executives are the people directly involved with the management of the entire firm. Independent directors are commonly defined as non-executive or outside directors on the board. Executive directors are required on the board as they possess more critical information about the company than outside directors but their dominance of the board puts the interest of stockholders at risk because wealth could be transferred to managers. Therefore, non-executive directors are appointed on the board mainly to obtain independent monitoring mechanism over the board process thereby reducing agency conflicts and improve performance. According to Kent, Routledge and Stewart, (2010) external directors play a major role in arbitrating the conflicts between management and shareholders and enhancing the transparency and compliance of accounting reports.

It has also been noted that higher proportion of independent directors on the board of directors is related to greater confidence in the firm's financial reporting system. Kent *et al.,* (2010) collaborate that extant research implemented in Anglo-Saxon area reflects a negative association between the proportion of independent directors and earnings management. They assert that higher degree of board independence creates obstacles for managers to engage in earnings manipulation in 392 listed Australian companies for the years 2000–2006. Gonzalez and Meca (2014) confirm that the increased degree of board independence diminishes the likelihood of earnings management based on a sample of 435 listed firms in Latin American markets from 2006 to 2009. Earnings management is therefore less likely to occur in companies whose board has more independent directors.

It is however believed that independent directors perform little role in monitoring the board because they lack real independence, time, and adequate information. To be effective therefore, independent non-executive directors are expected to have both strong incentives to monitor the board, and the capabilities to identify earnings management. Since most of them are familiar with financial reporting issues by holding senior management positions in other firms, they can be seen to have the capabilities to detect earnings management. Moreover, there is no tangible benefit that accrues to the independent non-executive directors with respect to earnings management.

2.2 Corporate Financial Reporting and Fraud

Earnings management and financial reporting processes indicate that the best way to separate earnings management from frauds is to adequately comply with laid down standards and financial reporting rules. According to Stolowy and Breton (2004), earnings manipulation can be defined as the use of management's discretion to make accounting choices or to design transactions so as to affect the possibilities of wealth transfer between the company and managers on one hand and funds providers and society on the other. As viewed in Glossary, GRC(2017) cooperate governance is seen as the act of using control procedures to direct and evaluate the operation of entity and the way such an entity manages its resources and decision making processes its adopt. They concluded that a distinction can be made between earnings management and fraud. This differentiation can be based on the possibility of wealth transfer from one stakeholder to another resulting from the fundamental asymmetry of information between managers and other categories.

In observing how different types of managerial choice can be characterized, Dechow & Skinner (2000) emphasized that there is a clear conceptual distinction between fraudulent accounting practices and earnings management. According to them, fraudulent accounting practices are carried out with a clear intent to deceive while earnings management comprises of those judgments and estimates that fall within Generally Accepted Accounting Principles GAAP depending on managerial intent. However, they state that, without some objective evidence of intent, distinguishing between the two may be difficult or even impossible.

2.3 Influence of earnings management

It has been argued that some factors do affect the management of earnings. Such factors may include the following:

i) **Income Smoothing**

Since existing and potential investors prefer to see a continuous income growth, managers use certain techniques to reduce the fluctuations in the company's earnings. Moreover, investors are more willing to invest in companies or stocks that have steady and predictable earnings streams than those with wild fluctuations. Income is then made smoother so that the company can appear to have steady and continuous growth in earnings.

ii) **Financial Window Dressing**

In order to have a good financial report at the end of a period especially for obtaining new financing facilities, companies and financial managers may manipulate the reports by taking actions to improve the presentation of the financial statements.

iii) **Internal expectations**

Departments and units in an organization set targets to ensure efficiency and the overall success of the company quarterly or annually. During periods when it is impossible to meet the set targets, managers or heads of departments are motivated to manage the firm's earnings to meet the targets. Inability to meet a target could cause loss of expected revenue or in extreme cases, the removal of the unit or departmental head.

iv) **External expectations**

Shareholders and potential investors' expectations may put managers on their toes and the fear of not meeting these expectations may force them to manage the companies' earnings to suite the expectations of investors.

Stakeholders' Theory

In the study of the effect of board composition on the management of firms' earnings, the Stakeholders' theory was adopted. The theory suggests that the managers owe a duty of performance to all stakeholders in the company. It further asserts that the relationship in an organization is not literally limited to only shareholders but to all stakeholders in the organization. According to the theory, every stakeholder has the right and the managers have the obligation to interact generally on all matters concerning the business enterprise. This stance is embedded in the corporate governance codes (Shleifer & Vishny (1997) which are designed to comply with satisfying stakeholders' interests. It would also include the effective management, use and allocation of the firm's resources for maximum earnings. Furthermore, it ensures the inflow of capital from stakeholders and provides mechanisms to mitigate against the risks which stakeholders shall be likely exposed to as a result of insider frauds. Stakeholders may also be referred to as any group or individuals who can affect or is affected by the achievement of a corporate organization. These would include various resource providers such as unions, shareholders, employees, suppliers, creditors, consumers, regulatory agencies, et cetera. Stakeholders play important roles in leveraging a firm's productivity and competitiveness. According to (IFC, 2011), firms should in addition to their normal role of value creation, maintain long-term cooperation with their stakeholders. Further corporate governance responsibilities such as legal framework, rules and functions which would balance the interests of shareholders and stakeholders while sustaining the long-run wealth maximization of the firm should be encouraged.

The stakeholder theory posits that a company should be accountable to the entire body of stakeholders. On the contrary, the stakeholder's theory has been criticized as strongly overemphasizing on the major role of managers as being mainly accountable to stakeholders only without stating the avenue for creating harmonious co-existence between the managers and the stakeholders. It has also been further argued that since the theory presumes that managers and all relevant stakeholders have available intrinsic values, decision-making processes exercised by managers are therefore governed by the interactions of all the stakeholders in the organization. Thus, managers are responsible for protecting the benefits and interests of stakeholders as well as retaining a proportion of the stakes in the enterprise.

3. METHODOLOGY

This study employed descriptive statistics with pooled ordinary least square regression using a sample of 15 listed Nigerian firms. The annual reports of the firms covering a period of 2013 and 2016 were used.

3.1 Research Design

Correlation research design is used in this study. It is a quantitative method of research used to describe the relationship between board composition and firms' earnings management as research variables. Correlation is used for this study because it describes the statistical relationship between two or more variables and this study seeks to measure the relationship between the selected board composition (independent variables) and earnings management of listed firms in Nigeria (dependent variable).

3.2 Population of study

The target population of this research work consists of all firms in Nigeria as listed on the Nigerian Stock Exchange financial reports for the period under study.

3.3 Sample size

Fifteen (15) companies listed on the floor of the Nigeria Stock Exchange were sampled using the purposive technique. The companies were chosen based on the availability of complete financial information as published in their annual reports for the period under review.

3.4 Descriptive Analysis

Table 1: Summary of Means and Standard Deviation for the variables

Variable	Obs.	Mean	Std. Dev.	Min	Max
DACC	60	5.43656	3.799389	.4051202	13.47925
BC	60	.9333333	.2515489	0	1

Source: Researcher's output

Table 1 shows a summary of the descriptive statistics of the dependent and independent variables for the selected firms. The table shows the average of each of the variables, that is, the mean, the standard deviation, the minimum and maximum of the variables. Discretionary Accrual (DACC) variable of the listed firms has a maximum of 13.479 and a minimum value of 0.405. A mean value of 5.436 with standard deviation of 3.799 was recorded as the Discretionary Accruals (DACC) for the selected firms. This means that on the average, the selected firms' earnings management is increasing. This result indicates that the deviation between the selected companies is quite large.

Table 1 further show a mean value of 0.933 and a standard deviation of 0.251 on the Board Composition (BC) using a number of directors. A maximum value of 1 was recorded as a dummy variable and a minimum value of 0.

3.5 Regression Analysis

Table 2: Ordinary Least Square Regression Analysis

Source	SS	df	MS
Model	401.284855	6	66.8808092
Residual	450.40137	53	8.49813905
Total	851.686225	59	14.4353597

Number of obs	60
F(6, 53)	7.87
Prob > F	0.0000
R-squared	0.4712
Adj R-squared	0.4113
Root MSE	2.9152

DACC	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
BS	.3889951	.210659	1.85	0.070	-.0335334	.8115235
BM	1.227109	.4095176	3.00	0.004	.4057206	2.048497
BC	2.311355	1.601922	1.44	0.155	-.9016934	5.524404
BFE	-1.283151	1.394392	-0.92	0.362	-4.079947	1.513644
MC	-.8875122	1.144119	-0.78	0.441	-3.182325	1.407301
FSIZE	-1.216314	.2903681	-4.19	0.000	-1.798719	-.6339097
_cons	15.78107	4.758864	3.32	0.002	6.236	25.32614

Researcher's output
Note: Only Board Composition (BC) is relevant here. All other variables should be isolated.

3.6 Testing of Hypothesis

H_0: There is no significant relationship between board composition and earnings management of listed firms in Nigeria.

The P>|t| (Prob) value for board composition above is 0.155. The correlation analysis shows an insignificant positive association through the regression. This is because the Prob value, P>|t| for BC is not significant at 10%. The null hypothesis that the proportion of non-executive directors on the board is not significantly related to earnings management in the listed firms is accepted since the P-value exceeds 0.1, 0.05 and 0.01. This is in line with Xie, Davidson & Dadalt (2003) who suggest that the percentage of external directors is insignificantly related to discretionary accruals. This means that the proportion of independent directors are not significantly related to earnings management because they perform little role in monitoring the board. This is because of their lack of real independence, time, and adequate information about the organization.

4. CONCLUSION

From the foregoing analyses, it could therefore be concluded that there exists no significant relationship between the board composition and earnings management.

5. RECOMMENDATION

From the above analyses, it is recommended that management should liberalise the composition of its board since this will not affect the firm's earnings management.

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APPENDIX

LIST OF SAMPLED COMPANIES

1) Champion Breweries
2) Flour Mills
3) Dangote Flourmills
4) Dangote Cement
5) Eterna Oil
6) Nigerian Breweries
7) Glaxo Smithkline
8) Unilever
9) Nasco Biscuits
10) Honeywell Flourmills
11) Golden Guinea Breweries
12) Cadbury
13) International Breweries
14) Vitafoam