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DISCOURSES ON CORPORATE GOVERNANCE AND EARNINGS MANAGEMENT: A THEORETICAL APPROACH

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Abstract- The latitude created by generally accepted accounting principles for accountants to adopt alternative treatments for financial accounting transactions has paved way for financial reporting malfeasances. Corporate managers now cosmetically present financial statements to massage their self interest at the expense of capital providers and other stakeholders. This phenomenon, otherwise referred to as earnings management has found dominance in academic and professional discourse following the collapse of world gigantic corporate empires. As a result of the misalignment of interest between managers and shareholders, there has been an international trend towards developing and implementing corporate governance to fight against managers' opportunistic behaviours that have undermined investors' credibility in financial report. Corporate governance attributes help investors by aligning the interest of managers with the interest of shareholders thereby enhancing the reliability of financial information and the integrity of financial reporting process. Against this background, this paper examines the influence of corporate governance practice on earnings management.
Keywords- corporate governance, earnings management, financial information

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Introduction

The appropriateness and disclosure of corporate earnings are paramount to stakeholders who have vested interest in corporate entities. The management of public companies all over the world is mainly concentrated in the hands of hired managers who are saddled with the responsibility of generating wealth and maintaining same for the benefit of resource owners. Corporate managers are esstopped by enabling laws to play by the rules of engagement. However the recent corporate scandals that permeated major multi-billion dollars corporations indicate preponderances of accounting improprieties and high level earnings management.

The FASB [1] refers to earnings management as the distortion of the reliability, relevance and predictive value of information presented in financial statement. Conger, et al [2] defines earnings management as 'the process of taking deliberate steps within the constraint of Generally Accepted Accounting Principles (GAAP) to bring about a desired level of reported income. Healy & Wahlen [3] see earnings management as when managers use judgment in financial reporting in structuring transactions to alter financial reports, either to mislead some stakeholders or to influence contractual outcomes that depend on reported accounting about the underlying economic performance of the company.

The connection between corporate governance and earnings management has been the subject of an ongoing debate. It is believed that the diffuseness of a firm's ownership structure plausibly serves the firm's shareholders better than a concentrated ownership structure. The users of financial information are of the notion that managers of organizations utilize earnings management opportunistically for selfish reasons rather than for the benefit of the stakeholders. This misalignment of stakeholders and manager's interest has cited a basis for the occurrence of earnings management as managers could use the latitude provided by accounting standards to manage income opportunistically therefore, creating a distortion in reported earnings. The very nature of accounting accruals gives managers a great deal of discretion in determining the earnings a firm reports in any given period because of the information asymmetry between managers and owners. Accounting earnings are more reliable and more informative when managers opportunistic behaviours are controlled through a variety of monitoring systems [4].

As a result of the misalignment of interest between managers and shareholders, there has been an international trend towards developing and implementing corporate governance to fight against the opportunistic behaviours that have undermined investors' credibility in financial report. Corporate governance help investors by aligning the interest of managers with the interest of shareholders and also by enhancing the reliability of financial information and integrity of the financial reporting process [5].

It is against this background that this study is undertaken to theoretically examine the relationship between corporate governance and earnings management in Nigeria.

Concept of Corporate Governance

The system of rules, practices and processes by which a company is directed and controlled is referred to as corporate governance. It essentially involves balancing the interest of the many stakeholders in a company - these include its shareholders, management, customers, suppliers, financiers, government and the community. It encompasses practically every sphere of management, from action plan and internal controls to performance measurement and corporate disclosure. A relationship exists between corporate governance attributes or variables and firm behavior. Such variables include audit quality, board effectiveness, board independence, and capital versus debt financing amongst others.

Corporate governance became a pressing issue following the 1992 introduction of the Sarbanes-Oxley Act in the US which was ushered in to restore public confidence in companies and markets after accounting fraud obliterated high-profiled companies such as Enron and Worldcom. The Act was passed by U.S congress in 2002 to protect investors from the possibility of fraudulent accounting activities by corporations. The Sarbanes Oxley Act (SOX) mandated strict reforms to improve financial disclosures from corporations and prevent accounting fraud. SOX was enacted in response to the accounting scandals in 2000. Scandals such as Enron, Tyco, and Worldcom shook investor's confidence in financial statements and require an overhaul of regulatory standards.

Concept of Earnings Management

The term "earnings management" is the use of accounting techniques to produce financial reports that tend to present an overly positive picture of a company's performance and financial position. Companies use earnings management to smoothen out fluctuations in earnings and/or to meet stock analysts' earnings projections. Large fluctuations in income and expenses may be a normal part of a company's operations, but the changes may alarm investors who prefer to see stability and growth, tempting managers to take advantage of accounting gimmicks. Earnings management has assumed various terminologies. These include: "earnings manipulation", "income smoothening", "creative accounting", "cosmetic accounting" and "big bath accounting". A large body of academic research has examined the existence of earnings management, in particular, around specific corporate events in which agency problem is most likely to occur. Perry & Thomas [6] provides evidence of managers' manipulation of earnings in the predicted direction in the year preceding the public announcement of management's buyout intention. Erickson & Wang [7] find that acquiring firms manipulate accounting earnings upward prior to stock for stock corporate mergers.

Earnings Quality and Corporate Governance

The relationship between corporate governance and earnings quality is an issue that has proved elusive and often contentious among accounting researchers. Part of the reason is that the empirical literature that examines earnings quality and corporate governance has found weak and inconsistent results [8]. A more fundamental reason is that, theoretically, the relation differs both in terms of expected causation and expected sign, depending on the perspective one takes on earnings quality, i.e., whether one views earnings quality as primarily innate or primarily discretionary in nature [9]. In the former case the firm is endowed with innate earnings quality issues, by virtue of its business model and operating characteristics, to which it builds countervailing corporate governance structures [10]; that is, poor earnings quality is associated with better governance. The relationship between selected corporate governance characteristics and earnings management is presented below.

Board Composition and Earnings Management

There is a considerable literature regarding the effect of the composition of the board of directors (i.e., inside versus outside directors). Agency theory supports the idea that board independence should be denominated by outside director. Dunn [11] highlights that board dominated by outsiders is in a better position to monitor and control managers. Fama & Jensen [12] argue that the role of the board of directors is to protect shareholder interests by monitoring managers. According to Fama & Jensen [12] independent directors on boards make boards more effective in monitoring managers and exercising control on behalf of shareholders. An important aspect of effective corporate governance is the recognition that the specific interests of the executive management and the wider interests of the company may at times diverge". Therefore board independence from management is one of the important factors determining the board effectiveness and monitoring ability. Hence, we expect to see that board independence has a positive relationship with the board effectiveness in limiting earnings management.

An important factor that may affect the board's ability to monitor the firm's managers is its composition and the percentage of independent directors on the board. A number of studies have linked the proportion of outside directors to financial performance and shareholder wealth [13] Moreover, the dominance of non-executive directors is more effective in monitoring management. Klein [14] provides evidence concerning board independence and earnings manipulation and found that companies with independent boards are less likely to report abnormal accruals. Conversely, Larcker, et al[8] and Abdul Rahman & Ali [15] found no relationship between outsider directors and earnings management. On the other hand, other studies proposing that completely independent boards may not be effective in monitoring management. For example, Agrawal & Knoeber [16] found a negative relationship between independent board and firm performance, leading them to conclude that boards that have too many outsiders lose the expertise associated with officers serving on the board.

Audit Quality and Earnings Management

The agency problems associated with the separation of ownership and control, along within formation asymmetry between management and absentee owners, create the demand for external audit. External auditors are responsible for verifying that the financial statements are fairly stated in conformity with GAAP and that these statements reflect the 'true' economic condition and operating results of the entity. Thus, the external auditor's verification adds credibility to the company's financial statements. Also, the external auditors are required by auditing standards to discuss and communicate with the audit committee about the quality, not just the acceptability, of accounting principles applied by the client company. Therefore, a quality audit is expected to constrain opportunistic earnings management as well as to reduce information risk that the financial reports contain material misstatements or omissions.

The guidelines and measures for the quality of the external auditor's performance are set forth in generally accepted auditing standards, such as competence, independence and exercise of due professional care. Obviously, the quality of the auditor's performance is multi-dimensional as set forth in the auditing standards, and differences in audit quality are to be expected. 'Audit quality differences result in variation in credibility offered by the auditors, and in the earnings quality of their audit clients. Because auditor quality is multidimensional and inherently unobservable, no single auditor characteristic can be used to proxy for it' [17]. Since audit quality may be affected by a number of factors, it is not surprising that researchers have used various measures to proxy for audit quality in prior studies.

For example, researchers have examined the effects of auditor brand name (auditor size) and industry specialization, auditor tenure, provision of various services by the auditor and auditor independence on a number of issues directly or indirectly related to financial reporting. Empirical evidence on these audit quality measures has been mixed. Thus, a high-quality auditor acts as an effective deterrent to earnings manipulation because management's reputation is likely to be damaged and firm value reduced if misreporting is detected and revealed. DeAngelo [18] demonstrates analytically that larger audit firms have greater incentives to detect and reveal management misreporting. Dopuch & Simunic [19] model also suggests that audit firm size is a proxy for audit quality.

Board Effectiveness and Earnings Management

Recently, many financial and academic publications have criticized that directors have too little time to attend meeting regularly and this will limit their ability to monitor management well. Conger, et al [10] suggest that board meeting time is an important resource for improving the effectiveness of board. Vafeas [20] empirically tests the relationship between board activity, which is measured by board meeting frequency, and the firm performance. He finds that the increase in board meetings leads to improved firm performance, and this result suggests that frequent board meeting can help to make up the limited director interaction time. Vafeas [20] finds that a greater level of involvement and oversight by the board of directors is characteristic of firms that are value maximizers for their owners. Specifically, he finds that a greater number of board meetings per year are associated with increased firm performance. Conger & Lawler [21] suggest that the number of times a board meets is an important resource in improving the effectiveness of a board. However, Vafeas [20] finds that that the annual number of board meetings is inversely related to firm value, which is due to increases in board activity following share price declines. He further finds that operating performance improves following years of abnormal board activity. These studies suggest that board activity is an important dimension of board operations. Therefore, effective boards should meet regularly (even frequently) to stay on top of accounting and control-related matters, remain informed and vigilant, and thus ensure that the financial reporting process is functioning properly. We expect that boards of directors that meet frequently will be more effective in monitoring the integrity of financial reporting, and thus more likely to constrain earnings management by commercial banks.

In summary, board size, independence and meeting frequency all influence the effectiveness of a board, which in turn are related to levels of earnings management by organizations. Pertinent to this study, previous findings suggest that if frequent board meetings lead to more effective monitoring in a firm they would also be associated with less earnings management.

Conclusion

As observed earlier, corporate governance and earnings management has attracted a good deal of public interest because of its apparent importance for the economic health of corporations in particular and society in general. Consequently, it has received considerable attention in recent years from academics, market participants, and regulators. In Nigeria, several attempts have been made at the institutional level to ensure that corporate governance is effective and results in improved financial reporting. This has culminated into the "code of corporate governance" issued in November 2003 and the new code in 2011 provides further insight into the relationship between earnings management and corporate governance in the Nigerian environment especially after the adoption and acceptance of the code of corporate governance issued in 2003 and then 2011 for quoted companies. Regulators of companies in Nigeria should ensure strict compliance to the code of corporate governance and sanction defaulters.

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