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# The Effect of Earnings Management on Earnings and Book-Value per Share: A Study of Selected Quoted Companies in Nigeria

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**Abstract**
Purpose:The main objective of this study is to examine the effect of earnings management on EPS and BVPS. The issue of earnings management is becoming quite rampant in organisations, following notable failures of companies as Enron, WorldCom, Tyco, etc. and moreover, the Cadbury, African Petroleum, and failed Banks in Nigeria. Design/Methodology: The study was descriptive in nature and made use of ex-post facto research design. The population of the study was drawn from companies quoted under the conglomerates section of the Nigerian Stock Exchange (NSE) as shown in the Stock Exchange Factbook of 2013. Earnings Management was estimated using Jones (1991) Model. Our dependent variables were Earnings Per Share (EPS) and Book Value Per Share (BVPS). Findings:The results show that for firms with high discretionary accruals, earnings management positively affects earnings per share; and, book value per share of the firms. Recommendations:Based on this the study recommends that the establishment and implementation of policies and practices that can curtail earnings management in Nigerians firms; and, the safeguard of investor return through the adoption and use of International Financial Reporting Standards in other sectors.

## BACKGROUND OF THE STUDY

According to Sun and Rath (2008) the primary role of financial statements is to disclose a company's financial information to internal and external users in a timely and reliable manner. This was further reiterated by the International Accounting Standard Board [IASB] (2001) that the objective of a financial report is to - provide information about the financial position, performance and change in financial position of an entity that is useful to a wide range of users in making economic decisions. According to Sun and Rath (2008) in a perfect market, there is no role for financial disclosures and thus no demand for accounting discretion (see, Watts & Zimmerman, 1978, 1986; Holthausen & Leftwich, 1983). However, with market imperfections such as information asymmetry and agency conflicts, financial reporting is necessary for efficient contracting (Neffati, Ben Fredj, & Schalck, 2011).

In the preparation of financial reports, managers are free to select accounting and reporting methods (Algharaballi, 2013). This as in most cases leads to the selection of reporting methods that could be misleading to the users of such information. According to Sayari, Finet, & Fayçal Mraihi (2013) managers are led to maximise their financial communication policy and presenting the market the most successful image, by exploiting insufficiencies of accounting rules. Managers play all tricks, both at the level of form or content, to respond to markets expectations and requirements (Sayari et al., 2013). Accounting choices are made within the framework of GAAP. GAAP are the set of rules, practices, and conventions that describe what is an acceptable financial reporting for external stakeholders. The problem with many accounting choices is that there is no clear limit beyond which a choice is obviously illegal. The act of manipulating the company's earnings is known as earnings management (Nuryaman, 2013) and in such cases, the earnings figure may no longer be a true and fair reflection of firm performance (Whelan & McNamara, 2004).

According to Fang (n.d.) earnings play two roles: [1] the informative and [2] the stewardship role. The informative role arises from investors demand for information to predict future cash flows and assess their risk while the stewardship role comes from the separation of ownership and management in public firms which puts the manager in a position of a steward to shareholders. Over the years the issue of earnings management has been examined extensively in the literature. Despite the increasing interest of researchers in examining earnings management activities, few studies have examined its effect on investor returns in Nigeria, mostly studies focus on corporate governance related issues (see Dabor & Adeyemi, 2009; Adenikinju & Ayorinde, 2001; Olayinka, 2012; Isenmila & Afensimi, 2012). Okolie (2014) documents a major scandals in Nigeria related to poor audit quality and earnings manipulations: Cadbury Nigeria Plc and African Petroleum (AP) (Okolie & Agboma, 2008); Savannah Bank and African International Bank (Odia, 2007); Wema Bank, Nampak, Finbank and Spring Bank (Adeyemi & Fagbemi, 2010); and more recently, Intercontinental Bank Plc., Bank PHB, Oceanic Bank Plc. and AfriBank Plc.

Numerous studies support the use of reported earnings and book value of a firm as a basis for firm valuation (see Easton & Harris 1991; Wild, 1992; Ohlson, 1995; Penman, 1998; Ou & Sepe, 2002). According to Whelan and McNamara (2004) firms that do not manage earnings exhibit higher stock price, earnings per share and book value per share than firms that manage earnings. Also, firms using long-term discretionary accruals to manage earnings display lower stock price, earnings per share and book value per share than firms using short-

 

term discretionary accruals.

Against this backdrop, this paper therefore seeks to empirically examine the effect of earnings management on earnings per share and book value per share among selected firms in Nigeria. This paper is organised as follows: the next section states the objective of the study and justification for the study; following this is the literature review on earnings management, after this is the methodology, and finally the summary of findings, conclusion and recommendations.

**OBJECTIVES OF THE STUDY**

Specifically, the study shall address the following:

1. To determine the effect of earnings management on earnings per share of Nigerian firms.
2. To determine the effect of earnings management on book value per share of Nigerian firms.

**JUSTIFICATION FOR THE STUDY**

Investors [Shareholders]: They constitute a significant proportion of the external stakeholder group and are also one of the primary users of financial statements. If the financial statements are distorted and do not present a true and fair view, knowledge gained from it can be misleading and detrimental to the investors. This work is therefore intended to enlighten investors on the issue of earnings management and how it could erode the value of their investment in the firm.

## REVIEW OF RELATED LITERATURE

### 2.1 CONCEPTUAL FRAMEWORK

#### 2.1.1 The Concept of Earnings Management

According to Omoye and Eriki (2014) earnings management is recognized as attempts by management to influence or manipulate reported earnings by using specific accounting methods or accelerating expense or revenue transactions, or using other methods designed to influence short-term -earnings. Earnings management occurs when managers use judgment in financial reporting in structuring transactions to alter financial reports, to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting information (Omoye & Eriki, 2014).

According to Healy and Wahlen (1999) as cited in Algharaballi (2013) earnings management can be defined as follows:

> "Earnings management occurs when managers use judgment in the financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers"

According to Algharaballi (2013) these definition represent two common views of company management. The first view holds that management needs to exercise judgment in business operations and financial reporting since GAAP clearly requires management to make wise estimates and judgments. The second view is known as that of opportunistic earnings management, i.e. managers base their judgments and decisions on whether they will result in personal private gain (see Boubakri, Boyer & Ghalleb, 2008; Healy & Wahlen, 1999; Jiraporn, Miller, Yoon, & Kim, 2008).

Scott (2003) defines earnings management as follows: "Given that managers can choose from a set of accounting policies (for example, GAAP), it is natural to expect that they will choose policies so as to maximize their own utility and / or the market value of the firm ". Also, Belkaoui (2006) defines earnings management as the ability to "manipulate" the options available and make the right choices in order to achieve the expected level of profit.

According to Dechow and Skinner (2000) earnings management can be classified into three categories, namely: Fraudulent Accounting, Accruals Management, and Cash Flow Earnings Management (CFEM) which is more often referred to as Real Earnings Management (REM).

Fraudulent Accounting involves accounting choices that violate GAAP; Accruals Management involves choices within-GAAP that try to "obscure" or "mask" true economic performance. Real Earnings Management occurs when managers undertake actions that involve changing a firm's underlying operations in an effort to boost current period earnings. Fraudulent accounting and accruals management are not accomplished by changing the underlying economic activities of the firm but through the choice of accounting methods used to represent those underlying activities (Dechow & Skinner, 2000).

Two key attributes of accruals result in earnings management being the main mechanism by which earnings management is operationalised in the literature, namely; Non-discretionary and Discretionary accrual. Non-discretionary accounting adjustments are required by accounting standards and statutes, while discretionary accruals represent voluntary adjustments. FASB (1985) posits that accrual accounting uses accruals, deferrals, and allocation procedures to relate revenue, expenses, gains and losses to periods to report an entity's

performance during a period. Accounting choices are made within the framework of GAAP. GAAP are the set of rules, practices, and conventions that describe what is acceptable financial reporting for external stakeholders. The main sources of GAAP for quoted companies in Nigeria are:

1. Statements of Accounting Standards (SAS) previously issued by the Nigerian Accounting Standards Board (NASB) now the Financial Reporting Council of Nigeria (FRCN) requiring the compliance with IFRSs and IASs issued by IASB;
2. The Companies and Allied Matters Act (CAMA), 2004; and
3. Several other sources.

#### 2.1.2 Earnings Management as Opportunism

Some authors conjecture that earnings management reflects managers opportunistically adjusting earnings to transfer wealth from shareholders to themselves (see O'Glove, 1987; Bernstein, 1993; Wang, Smith, & Lobo, 1993; Ali & Hwang, 1994; Warfield, Wild, & Wild, 1995). If this earnings management argument is applied to earnings smoothing, discretionary earnings smoothing reflects managers' attempts to transfer wealth to themselves. In this case, earnings smoothing could be associated with a lower (not higher) multiplier on current period earnings (Hunt, Moyer, & Shevlin, 2000). From an agency theory viewpoint, earnings management is opportunistic. The dichotomy between owners and managers creates moral hazard and adverse selection challenges. These situations motivate managers to engage in earnings management (Dabor & Ibadin, 2013).

Every investor expects high return on his or her investment. Market return, according to (Elton, Gruber, Brown, & Goetzmann, 2011): "Market Return is the results obtained from investments. Return can be either real return, which has happened, or expected return, which have not happened yet but expected to happen in the future". Abnormal Return is used to measure the market reaction against an event for which information is published as an announcement. "Abnormal return is the excess of actual return against the normal return". If the announcement contains information, then the market is expected to react as the announcement is welcomed by the market. Market reaction is indicated by the existence of price changes on the concerned securities (Elton, Gruber, Brown, & Goetzmann, 2011).

A study by Chan, Chan, Jegadeesh, and Lakonishok (2001) based on US capital market data over a 25 year period indicated an inverse relationship between accruals and future stock return, i.e. an increase in earnings along with a high degree of accruals which are indicators of low earning quality will lead to weak stock return.

Also, DuCharme, Malatesta and Sefcik (2001) examined 171 U.S. IPO manufacturing firms, found a negative relationship between abnormal accruals around the offer date (pre-IPO year and IPO year) and later stock returns. They concluded that aggressive pre-IPO earnings management not only increases IPO proceeds but also decreases investors' future returns.

In Nigeria, attempts have also been made to study earnings management and corporate governance of quoted companies empirically, this includes: Olayinka (2012) which used questionnaire to examine some corporate governance mechanism and earnings management relationship; Dabor and Adeyemi (2009) that examine corporate governance and the credibility of financial reports; Isenmila and Afensimi (2012) examine the relationship between earnings management and ownership structure of Nigerian quoted banks.

#### 2.1.3 Earnings Management Measures

Studies in this field have focused on developing and employing mostly three predominant research methods (Algharaballi, 2013). These are:

1. The aggregate accrual method developed and used by Healy (1985), DeAngelo (1986), Jones (1991), Dechow, Sloan and Sweeney (1995), Kang and Sivaramakrishnan (1995), Kasznik (1999) and Kothari, Leone and Wasley (2005);
2. The specific accrual method developed and used by Petroni (1992), Beaver and Engel (1996), Beneish (1997), Beaver and McNichols (1998) and Phillips, Pincus and Rego (2003); and
3. The distribution method developed and used by Burgstahler and Dichev (1997) and Degeorge, Patel and Zeckhauser (1999).

Although no existing method is perfect in measuring earnings management, the most common method used is the aggregate accrual method (Algharaballi, 2013). Aggregate accruals compose of discretionary and non-discretionary accruals. As the discretionary component of accruals provides management with the opportunity to manipulate earnings, they are used as a measure of earnings management (Jones, 1991; Boynton, Dobbins, & Plesko, 1992; DeFond & Jimbalvo, 1994; Dechow , Sloan, & Sweeney, 1995; Bartov, Gul, & Tsui, 2001; Bowman & Navissi 2003).

## METHODOLOGY

### 3.1 Research Design

The study made use of descriptive and ex-post facto research design. Kerlinger and Rint (1986) an ex post facto investigation seeks to reveal possible relationships by observing an existing condition or state of affairs and searching back in time for plausible contributing factors.

### 3.2 Duration of the Study

The duration of the study is for a period of 10 years, comprising a total of 15 (6 Conglomerates, 9 Consumer Goods Companies) randomly selected and quoted on the floor of the Nigerian Stock Exchange (NSE) as at 2013.

### 3.3 Measuring Earnings Management:

3.3.1 The Jones Model:

Jones (1991) proposes a model that attempts to control for the effects of changes in a firm's economic circumstances on nondiscretionary accruals (Gul & Tsui, 2000). The Jones Model for nondiscretionary accruals in the event year is:

$NDAt = \alpha 1 \ (1 / At - 1) + \alpha 2 \ (\Lambda REVt / At - 1) + \alpha 3 \ (PPEt / At - 1)$

Where:

NDAt is nondiscretionary accruals in year t scaled by lagged total assets;

ΛREVt is revenues in year t less revenues in year t - 1;

PPEt is gross property plant and equipment at the end of year t;

At - 1 is total assets at the end of year t - 1; and

α1, α2, α3 are firm-specific parameters.

Estimates of the firm-specific parameters, α1, α2, and α3 are obtained by using the following model in the estimation period:

$TAt / At - 1 = a1(1/At - 1) + a2(\Lambda REVt / At - 1) + a3(PPEt / At - 1) + \varepsilon t$

Where:

a1, a2, and a3 denote the OLS estimates of α1, α2, and α3, and

TAt is total accruals in year t.

εt is the residual, which represents the firm-specific discretionary portion of total accruals.

**DATA PRESENTATION AND ANALYSIS**

**Table 1: Descriptive Statistics of Secondary Data**

| | Mean | Std. Deviation |
|---|---|---|
| At-1 | 55036036.47 | 63909636.881 |
| ΛREVt | 4092305.24 | 8497796.747 |
| PPEt | 22249003.944444444000 | 29088552.5776573200000 |
| Total Assets | 68688223.777777790000 | 74473057.0115906900000 |
| Net Income | 3057488.777777777500 | 3505596.9321319430000 |
| CFO | 5567109.88 | 9100040.494 |
| Total Accruals[TA] | -2343194.2353 | 7425174.08789 |
| Valid N (listwise) | | |

Source: SPSS Ver. 22

Total accruals are determined directly as the difference between earnings before extraordinary items and cash flow from operations.

$TAj,t = EARNj,t - CFOj,t$

Where

TAj,t = Total Accruals for firm j in year t

EARNj,t = Earnings before extraordinary Items for firm j in year t

CFOj,t = Cash Flows from Operations for firm j in year t

This method results in less measurement error than the balance sheet approach for estimating accruals, due to certain non-operating items that impact on the current accounts without flowing through the income statement. Such items include reclassifications, acquisitions, divestitures, and foreign currency transactions (Hribar & Collins, 2002, as cited in Whelan & McNamara, 2004).

**Result of the Jones model:**

Our Jones Model showed Adjusted R-Squared value of 0.81, and the P value of all the selected companies were below 0.10. According to Whelan and McNamara (2004) discretionary accruals may be either positive or negative, however, the magnitude rather than the direction of the accruals that is of interest. High discretionary accruals are more likely to reflect opportunistic behavior than conservative discretionary accruals and thus signal low reliability of earnings (Healy, 1985; DeAngelo, 1986; Jones, 1991).

In line with Whelan and McNamara (2004) high discretionary accruals are used as the indicator of earnings management in this study. The firms will then be allocated to one of two groups representing (1) Earnings Management and (2) No Earnings Management.

**Test of Hypotheses**

The study made use of the Pooled Ordinary Least Squares (POLS) regression to estimate the models used in this study. Results were only presented for firms with high discretionary accruals.

**Hypothesis One**

$H_1$: There is a significant effect of earnings management on earnings per share of Nigerian firms

**Table 2: Model Summary (Hypothesis 1)**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .606[a] | .367 | .209 | 93.07402 |

Source: SPSS Ver. 22

**Table 3: ANOVA[a] (Hypothesis 1)**

| Model | | Sum of Squares | Df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 40154.540 | 2 | 20077.270 | 6.318 | .016[b] |
| | Residual | 69302.187 | 8 | 8662.773 | | |
| | Total | 109456.727 | 10 | | | |

Source: SPSS Ver. 22

From the Model Summary Table, $R^2$ which measures the overall goodness of fit of the regression equation recorded a value of .367; this shows that the independent variables in the model explain 36.7% variation in the dependent variable. In addition the p value was less than .05 [.016], F-6.318; the coefficient of earnings management $\beta_1$ is 4.87 (p .041) we reject the null hypothesis and accept the alternate, thus 'There is a significant effect of earnings management on earnings per share of Nigerian firms'.

**Hypothesis Two**

$H_1$: There is a significant effect of earnings management on book value per share of Nigerian firms

**Table 4: Model Summary (Hypothesis 2)**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .560[a] | .314 | .161 | 10.48833 |

Source: SPSS Ver. 22

**Table 5: ANOVA[a](Hypothesis 2)**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 452.377 | 2 | 226.189 | 5.056 | .018[b] |
| | Residual | 990.046 | 9 | 110.005 | | |
| | Total | 1442.423 | 11 | | | |

Source: SPSS Ver. 22

From the Model Summary Table, $R^2$ which measures the overall goodness of fit of the regression equation recorded a value of .314; this shows that the independent variables in the model explain 31.4% variation in the dependent variable. In addition the p value was less than .05 [.018], F-5.056; the coefficient of earnings management $\beta_1$ is 6.12 (p .033) we reject the null hypothesis and accept the alternate, thus 'There is a significant effect of earnings management on book value per share of Nigerian firms'.

**CONCLSUION**

This study was set out to determine the effect of earnings management on investor returns among selected Nigerian firms. The International Accounting Standard Board (IASB) (2001) clearly states that the objective of a financial report is to provide information about the financial position, performance and change in financial position of an entity that is useful to a wide range of users in making economic decisions'. However, the issue of earnings management has led to a compromise of the above objective as earnings management lead to a distortion of the corporate financial profile. Notable scandals include Enron, WorldCom and Cadbury and AP case in Nigeria. Specifically this study assessed the effect of earnings management on earnings per share and book value per share both useful measures of return to corporate investors**.** The study therefore recommends:

The country's regulatory agencies should establish policies capable of exposing managerial exploitative practices aimed at investor deception. Corporate governance mechanisms aimed at exposing malicious board practices should also be adopted, according to Okolie (2014) the existing corporate governance code in Nigeria amended in 2007, restrictively focuses on the banking sector. Recently studies have suggested the need for mandatory rotation of auditors in their audit engagement, this has been argued to safeguard the independence of the auditor. In this light, an examination of the potential impact of this trend is encouraged. The encouragement of the adoption and use of International Financial Reporting Standards [IFRSs], in this regard the effort of Nigerian Financial Reporting Council is acknowledged though the level of adoption in other sectors is

not quite as progressed as it is in the banking sector. Other new technological advancements such as XBRL are also encouraged as means of ensuring transparency to investors.The limitations of the present study include the number of observations, 30 company observations over a 5 year period.

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