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# EARNINGS BEHAVIOUR AND FIRM SIZE IN NIGERIA: THE MEDIATING EFFECT OF CORPORATE BOARD ATTRIBUTES

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**ABSTRACT**

*This paper seeks to investigate the mediating effect of corporate board attributes in the relationship between earnings behaviour and firm size of selected quoted manufacturing firms in Nigeria. Ex-post facto research design was adopted and the study population comprised of quoted manufacturing firms on the Nigerian Stock Exchange (NSE). A sample of thirty-nine (39) firms were obtained via purposive sampling technique. Data of board size, non-executive directors, board structure, CEO duality, firm size and earnings quality were obtained during the period 2010-2019 and Structural Equation Modelling was employed. The findings support for mediation of board size, board independence, and board structure on the relationship between firm size and earnings behaviour; however, partial support was found for CEO duality. The study recommends that large firm with complex activities may seek adequate representation from a large board size. Again, there is need for strengthening the board monitoring function via inclusion of a proportionate share of independent non-executive directors relative to size of the firm.*

***Keywords:*** *Board attributes; Earnings behaviour; Firm size; CEO duality; Board structure; Non-executive director; Board size*

***JEL Classification:*** *G34; M49*

## 1. INTRODUCTION

Earning is one of the most significant items in a financial statement (Abata & Migiro, 2016). Earnings management is a mechanism used by corporate managers to intentionally alter financial statements results, i.e. income statement, statement of financial position and statement of cash flows, in some desired amount and/or some desired direction (Otuya, Donwa, & Egware, 2017). Its vital position stems from the fact that it could be used to tell the truth but also could be used in cheating or misleading (Li, 2009). And there is anecdotal evidence to show that companies in both developing and developed countries manage their earnings (Waweru & Riro, 2013). Previous research has shown inconsistent results on the relationship of firm size and earnings management (Amertha, Ulupui, & Dwija, 2014).

Few studies have examined the relationship of firm size and earnings management in developing countries (Llukani, 2013). The views are broadly divided into two streams. Studies which document a positive effect and find support for large firms document the following reasons: Large firms usually have strong internal control systems and governance mechanisms (Kim, Liu, & Rhee, 2003) and are likely audited by the big 4 auditing firms, with more experienced auditors which could enhance the accuracy of the audit report and avoid earnings misrepresentation. There is limited empirical support on whether quality corporate governance practices minimize earnings management in developing nations (Waweru & Riro, 2013). Specifically, in Nigeria, there is a paucity of studies on the roles of board on earnings management (Samaila & Zaharaddeen, 2015).

Boards are responsible for controlling the behaviour of management (Lefort & Urzua, 2008; Boediono, 2005). The primary role of boards is that of trusteeship to protect and enhance shareholders value through strategic supervision. The board of directors represent one key internal governance system in modern corporations (Al-Taleb, 2012). Lack of strong board is often attributed to the failure of many corporations (Rahman & Ali, 2006). This was evidenced in the case of Enron, HealthSouth, Tyco, Adelphia, WorldCom, African Petroleum Plc., Spring Bank, Wema Bank, Savanna Bank, Gulf Bank, Benue Cement, Cadbury Plc., among others (Sama'ila & Zaharaddeen, 2015). Studies show mixed findings on the association between board attributes and earnings management (Yasser & Mamun, 2016; Holtz & Neto, 2014; Reyna, 2012). The present study therefore investigates the mediating effect of corporate board attributes on the association between firm size and earnings behaviour of manufacturing firms in Nigeria from 2010-2019. On the basis of the above, the following research hypotheses were formulated:

$Ho_1$: Board size do not mediate in the relationship between firm size and earnings behaviour
$Ho_2$: Non-executive directors do not mediate in the relationship between firm size and earnings behaviour
$Ho_3$: Board structure do not mediate in the relationship between firm size and earnings behaviour
$Ho_4$: CEO duality do not mediate in the relationship between firm size and earnings behaviour

## 2. LITERATURE REVIEW

### 2.1 Conceptual Review

#### *2.2.1 Board Size*

Studies have shown mixed findings on the connection between board size and earnings management. Ching, Firth, and Rui (2007) reported a positive association between board size and earnings management, whereas; Xie, Davidson, and DaDalt (2003) reported a negative relationship. Other studies have shown that smaller boards are positively associated to a high value of the company (De Andres, Azofra, & Lopez, 2005; Mak & Kusnadi, 2005; Eisenberg, Sundgren, & Wells, 1998; Yermack, 1996; Jensen, 1993). Smaller boards are easier to coordinate; quicker in making decisions; less likely to have free-rider problems; and less likely to oppose innovation (Dimitropoulos & Asteriou, 2010). Smaller boards also accelerate the influential exchange of beliefs between firm and its directors and are less likely to exacerbate the coalition costs among board members (Vafeas, 2000). Board efficiency involves the issue of increases in coalition costs between members and the fact that boards with more members have greater difficulty finding time to discuss and reach consensus on issues pertaining to the company's organizational structure (Firth, Fung, &Rui, 2007).

One reason for lack of consequential discourse on boards is their size. Boards with more than ten members, make it difficult for everyone to express their views and ideas given the limited time available for meetings. Moreover, larger boards can experience the issue of free-riding in the sense that the members of the board depend on each other to monitor management. Jensen (1993) believes that as the number of directors' increases, the boards efficiency decreases, and internal conflicts can arise. Larger board, provide better supervision of the management team, higher quality of corporate decisions, better monitoring since they have better environmental links and more expertise (Dalton, Daily, Johnson, & Ellstrand, 1999; Zahra & Pearce, 1989). Davila and Watkins (2009) found that if the board size is very minute, monitoring of management team is minute too, thus resulting to increased discretion in obtaining higher remuneration as well as information asymmetry.

#### *2.1.2 Board Independence*

A fundamental factor that may influence the ability of the board to monitor firm's management is its structure and proportion of independent directors on the board (Fields & Keys, 2003; Beasley, 1996). Board independence is the extent to which a board is comprised of non-executive directors who have no connection with the firm outside the role of director (Davidson, Goodwin-Stewart, & Kent, 2005). A non-executive director refers to a director who is not employed in the firm's activities and whose role is to provide an outsider's contribution and oversight to the board of directors. A non-executive director who is wholly independent from management is deemed to provide shareholders, the utmost protection in monitoring

management. This can be linked to the incentive to maintain their reputes in the external labour market (Fama & Jensen, 1983).

Independent monitoring function of non-executive directors reduces earnings management, hence decreases agency problems (Klein, 2002; Peasnell, Pope, & Young, 2000; Fama, 1980). This is because in the absence of any significant benefits accruing to non-executive directors from earnings management, the associated costs are predicted to provide them with powerful incentives to monitor the financial reporting process (Peasnell, Pope, & Young, 2000). Non-executive directors face potentially significant costs from earnings management, such as loss of reputation as effective monitors (Fama & Jensen, 1983; Fama, 1980).

Studies document mixed findings on the connection between board independence and earnings management. Reyna (2012) hypothesized that independent board members have a significant positive effect on discretionary accruals. On the other hand, Davidson, Goodwin-Stewart, and Kent (2005) found support for effective role of independent directors in coercing earnings management. Also, Bradbury, Mark, and Tan (2006) did not find any significant relationship between earnings management and board independence. Contrarily, a study by Beasley (1996) finds firms suffering from financial statement fraud are associated with the small nature of outside directors on the board. Dechow, Sloan, and Sweeney (1996) report similar findings when studying the governance structures of firms that are the subject of SEC enforcement actions.

### *2.1.3 Chief Executive Officer (CEO) Duality*

CEO duality implies a situation in which a particular person serves two positions simultaneously: the CEO and the chairperson of the board (Vintila & Duca, 2013; Daily & Schwenk, 1996). Segregation of the two roles can improve efficiency and effectiveness of internal governance systems, and offers the necessary checks and balances of power and authority on management behaviour. When the chairman of the board also takes the role of CEO, it becomes difficult to monitor top management (Firth, Fung, & Rui, 2007). The occupation of the roles of chairman and executive director by the same person can reduce the independence of the board as well as its ability to control managers effectively (Holtz & Neto, 2014).

One effect could be a decreased dissemination of timely and relevant information to external stakeholders. However, those in favour of duality argue that consolidation of these two views provides a single focal point for company leadership (Anderson & Anthony, 1986). There is evidence to support that numerous firms which combined the role of chairman and CEO have the capacity to keep top management in check. Studies provide mixed findings on the relationship between CEO duality and earnings management. On the other hand, Said, Hj Zainuddin, and Haron (2009) found an insignificant relationship between duality and disclosure. A study by Bliss (2011) reports a positive connection between audit fees and board independence. The positive relationship was present in firms without CEO duality, indicating that CEO duality hinders board independence.

### *2.1.4 Board Structure*

Kesner (1988) maintains that the most fundamental board decisions emanate at the committee level. Vance (1983) argues that there are four (4) board committees that intensely affect corporate activities namely executive, audit, compensation, nomination committee. However, Klein (1998) finds that board composition is irrelevant to a firm's performance but that the composition of the finance committees is relevant to a firm's performance.

Similarly, Davidson, Pilger, and Szakmary (1998) suggest that the composition of a firm's compensation committee affects the market perception of golden parachute adoption. The insight in these studies suggest that outside directors may be more fundamental on committees that handle agency concerns (e.g., audit committees and compensation), and insiders may best employ their firm's knowledge on committees that focus on firm-specific concerns (e.g., investment and finance committees).

### *2.5 Firm Size*

Previous research has shown inconsistent results on the connection between firm size and earnings management (Amertha, Ulupui, & Dwija, 2014). The views are broadly divided into two streams. First, studies which document a positive effect and find support for large firms document the following reasons: Large firms usually have strong internal control systems and governance mechanisms (Kim, Liu, & Rhee, 2003) and are likely audited by the big 4 auditing firms, with more experienced auditors which could enhance the accuracy of the audit report and avoid earnings misrepresentation. Lennox (1999) posits that audit reports issued by the big 4 are more informative. Large firms are accompanied by more financial analysts, and take into cognizance, the repute costs when engaging in earnings management. Therefore, their concern about reputations may prevent them from manipulating earnings (Kim, Liu, & Rhee, 2003).

The opposing views, indicates that large firms face more pressures to meet or beat analysts' expectations therefore likely to engage in earnings management (Barton & Simko, 2002). Second, large firms usually have greater negotiating supremacy with auditors; as such auditors are more probable to waive earnings management efforts by large firms (Nelson, Elliott, & Tarpley, 2002). Third, large firms have more room to manoeuvre given wide range of accounting treatments available. Fourth, large-sized firms have sturdier management control. Even though sturdy internal control systems do exist, management may dominate the internal control system in order manipulate earnings to outstrip the thresholds. Finally, large firms may manage earnings in order to reduce political costs (Kim, Liu, & Rhee, 2003).

### *2.6 Earnings Management*

Earnings management is a mechanism used by corporate managers to intentionally alter financial statements results, i.e. income statement, statement of financial position and statement of cash flows, in some desired amount and/or some desired direction with the view to systematically misrepresent the true income and assets so as to mislead some stakeholders or to influence contractual outcomes (Otuya, Donwa, & Egware, 2017). Ronen and Yaari (2008) see earnings management as a compendium of managerial decisions that result in not reporting the true short-term, value-maximizing earnings known to firm's management.

In the view of Akers, Giacomino and Bellovary (2007), earnings management is the attempt by a firm's management to manipulate reported earnings by using specific accounting methods and choices, identifying one-time items not recurring, accelerating expense/revenue, or employing other means designed to manipulate short-term earnings. Scott (2003) defines earnings management as giving management diverse choices from a set of accounting policies. Naturally, management will choose accounting policies that will help them maximize their own utility and/or the market value of the firm ".

### *2.7 Theoretical Review*

This study is anchored on the agency theory. The agency theory paradigm was first formulated by Ross in the 70s (Ross, 1973). The term was first associated with agency costs by Jensen and Meckling in 1976 (Jensen & Meckling, 1976; Shapiro, 2005). Agency theory addresses the problem that occurs when goals of cooperating parties differ (Ross, 1973; Jensen & Meckling 1976). According to Jensen and Meckling (1976) agency association is a contract under which one or more individuals (principal(s)) engage another individual (agent) to perform some service on their behalf which involves entrusting some decision-making authority to the agent.

Agency theory offers a useful way of illustrating the relationship where the parties' interests are at odds and can be brought more into alignment via effective monitoring and a well-planned system of compensation. There are two streams of the theory which have been developed over time: *principal-agent* where both act in concert and the *positivist* perspective where they are likely to have conflicting goals. The agency problem arises when desires or goals of the principal and agent conflicts and when it is cumbersome for the principal to verify what the agent is actually doing.

### *2.8 Review of Some Prior Studies*

Quite a number of studies have investigated the mediating effect of corporate board attributes on the connection between firm size and earnings behaviour. Saftiana, Mukhtaruddin, Putri, and Ferina (2017) examined the effect of good corporate governance firm size, and leverage on earnings management. Governance variables of managerial and institutional ownerships, frequency of board meetings and audit committee meetings were used. Data of some selected firms in Indonesia Stock Exchange during 2010-2014 and multiple regression were employed. The results showed that partially, only leverage has significant impact on earnings management while institutional and managerial ownership, frequency of board meeting, audit committee meetings, and firm size have insignificant effect on earnings management.

Yasser and Mamun (2016) explored the connection between board-leadership structure and earnings management in Asia-Pacific nations of 110 firms from Australia, Malaysia, Philippines and Pakistan during the period 2011 to 2013. Findings of the study indicated board leadership structure is not related with firm performance and financial reporting quality. Besides, Female CEOs negatively affect firm performance in Malaysia, Philippines and Pakistan. More importantly, large boards provided a healthier reporting quality in Australia and Malaysia except Philippines.

Smit (2015) examined the impact of board monitoring role on quality of reported earnings on a sample of firms during the period 2008-2011. The regression results showed no evidence that boards and non-executive directors of small and medium-sized firms are inclined to adopt conservative accounting practices that result in asymmetric timeliness of earnings.

Samaila and Zaharaddeen (2015) assessed the impact of board structure on earnings management of listed cement firms in Nigeria during the period 2004-2013. Regression statistical tool was used and findings suggest that board size has a positive and significant impact on earnings management while board independence had a negative but significant impact. In addition, it was found that female directors have a negative but insignificant impact on earnings management.

Egbunike, Ezelibe, and Aroh (2015) explored the influence of corporate governance on earnings management practices of Nigerian quoted firms. Governance variables employed in this study comprised of board size, independence and strength of audit committee, while earnings management was measured via Jones Model. The study data spanned 2011-2014 and regression statistical tool was used. The study finds a significant coefficient for board size, insignificant coefficient for board independence, and a significant coefficient for audit committee strength.

Amertha, Ulupui, and Dwija (2014) evaluated the effect of firm size, leverage, and corporate governance on earnings management among forty-seven (47) firms quoted on the Indonesia Most Trusted Companies list from 2009 to 2011. Earnings management was measured by discretionary accrual and the Moderated Regression Analysis (MRA) and residual test were used to analyse the data. The result showed that firm size and corporate governance variables have significant effect on earnings management, whereas leverage have an insignificant effect. The results also indicated that corporate governance moderates the connection between firm size and leverage on earnings management practices.

Awaisu (2014) explored the association between board characteristics and earnings management among quoted Nigerian firms. A sample of seventy-nine (79) listed firms in Nigerian Stock Exchange were obtained for the period 2012 and the study finds board size to positively and significantly influence earnings management.

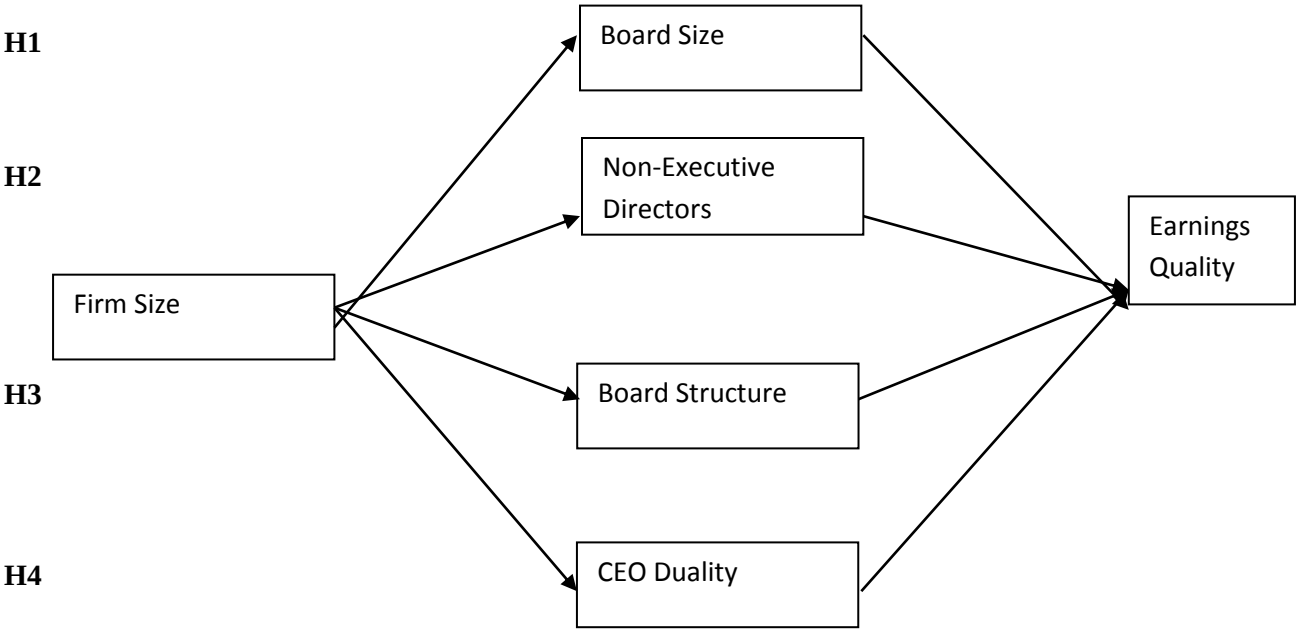
Hassan (2013) examined the effect of board monitoring characteristics on financial reporting quality of listed manufacturing firms in Nigeria. Financial reporting quality was measured using the modified Dechow and Dichevs (2002) model. The study estimated a panel OLS and controlled for fixed/random effects. The result

revealed a significant positive association between monitoring characteristics such as leverage, independent directors, audit committee, institutional, block and managerial shareholdings and financial reporting quality.

## 3. MATERIAL AND METHOD

The study adopts the ex-post facto research design. The study population comprised of all thirty-nine (39) conglomerates, consumer and industrial goods companies quoted on the floor of the Nigerian Stock Exchange. However, the study took its sample from all thirty-nine (39) companies classified as conglomerates, consumer goods, and industrial goods (NSE, 2019). The data for the study were extracted from the Annual Reports of manufacturing companies during the period 2010-2019. The structural equation modelling was used to analyze the obtained data:

**Conceptual Model of the Study**




***Source: Compiled by the Researchers***

**The model takes into cognizance, the** mediating effect of corporate board attributes (board size, non-executive directors, board structure, and CEO duality) on the relationship between firm size and earnings behaviour. The dependent variable is earnings behaviour, the mediating variables are the corporate board attributes and the independent variable is firm size. Firm size was measured using the natural logarithm of total assets while earnings behaviour by earnings quality. The empirical model of the study is given as:

Earnings quality = f (board size, non-executive directors, board structure, CEO duality, firm size) - eq, .1

$EQ = a_0 + BS_{it} + NED_{it} + BDS_{it} + CEODUA_{it} + FS_{it} + \mu_{it}$ - eq, .2

Where EQ = Earnings quality; BS= Board size; NED = Non-executive directors; BDS = Board structure; CEODUA = CEO duality; FS = Firm size; $_{it}$= Individual manufacturing firms; and $\mu_t$ = Error term. The AMOS statistical package was used in the carrying out the analysis of the study.

## 4. RESULT AND DISCUSSIONS

**Table 1: Descriptive Statistics for Board Attributes**

| | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|
| Board Size | 4 | 17 | 9.01 | 2.413 |
| Non-Executive Directors | 0 | 11 | 4.69 | 2.836 |
| Board Structure | 2 | 6 | 3.28 | 1.000 |
| CEO Duality | 0 | 1 | .79 | .405 |

Source: Compiled by the Researchers, 2021

**Table 2: Descriptive Statistics for Earnings Behaviour**

| | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|
| CFO | -10536074000 | 1056132604000 | 34529393250.00 | 93842772810.000 |
| Net Income | -7217001000 | 196678391000 | 8021768603.00 | 23466240760.000 |
| Average Asset | 0 | 2887646270000 | 147773927500.00 | 339731767500.000 |
| Earnings Quality | -34 | 9 | -.76 | 3.894 |

Source: Compiled by the Researchers, 2021

Tables 1 & 2 shows the descriptive statistics of the variables used in the analysis: the dependent variable (earnings behaviour), independent variable (firm size), mediator variables (board size, non-executive directors, board structure, CEO duality). The results indicate that the mean board size is 9, which indicates that on average the sampled companies had 9 directors sitting on the board, average non-executive directors for the studied companies were approximately 5, board structure which is reflection of number of sub committees within the corporate board had an average value of 3, while CEO duality had an average of .79, i.e., 79% of the studied companies had CEO in the position of chief executive and chairman of board

**Table 3: Summary of model fitness**

| Goodness of fit index | Cut-off value | Research model |
|---|---|---|
| *Df* | Positive | 19 |
| *p*-Value | ≥0.05 | 0.238 |
| RMSEA | ≤0.08 | 0.034 |
| GFI | ≥0.90 | 0.943 |
| CFI | ≥0.90 | 0.982 |
| RChisq/df | ≤2.00 | 1.765 |
| Total result | Good | Good |

Source: Compiled by the Researchers, 2021

Determining whether a particular model agrees with the data is a crucial juncture in SEM, as it finalizes whether or not the model will be accepted/rejected. Model fit is defined as the extent a model agrees with the data (Arbuckle, 1997). According to Barki and Hartwick (2001) AMOS can be used to confirm whether or not the proposed model meets the criteria of an excellent structural equation model: $X^2$ (Chi Square Statistic) and Probability, value of Chi Square /DF is ≤2.0 or 3.0, p-value must be ≥0.05, Degrees of Freedom (Degree of Freedom) must be Positive, Goodness of Fit Index (GFI) must be ≥0.90, CFI (Comparative Fit Index) must be ≥0.90, RMSEA (Root Mean Square Error of Approximation) must be ≤0.08.

**Table 4: Mediating SEM result for Earnings Behaviour**

| **Board Attributes (X) → Firm Size (M) → Earnings Behaviour (Y)** | | | | | |
|---|---|---|---|---|---|
| **Model(s)** | **Description** | **Total effect** | **Indirect effect** | **Direct effect** | **Conclusion** |
| 1 | BS → FS → EB | 0.012 | 0.023 | 0.043 | Full mediation |
| 2 | BI → FS → EB | 0.032 | 0.045 | 0.016 | Full mediation |
| 3 | BSt → FS → EB | 0.019 | 0.013 | 0.044 | Full mediation |
| 4 | CD → FS → EB | 0.567 | 0.047 | 0.671 | Indirect |

Source: Compiled by the Researchers, 2021

The study found that firm size has a significant impact on earnings management. In a related study, Amertha, Ulupui, and Dwija (2014) showed that firm size and corporate governance have a significant impact on earnings management and that corporate governance moderates the connection between size and leverage on earnings management. Yasser and Mamun (2016) showed that large boards provided a healthier reporting quality in Australia and Malaysia. In Nigeria, Abata and Migiro (2016) showed that board size is insignificantly negatively connected with earnings management.

Contrary to this, Samaila and Zaharaddeen (2015) on a sample of listed cement companies report that board size has a positive and significant impact on earnings management. Similarly, Egbunike, Ezelibe, and Aroh (2015) showed a significant coefficient for board size. Awaisu (2014) finds that board size positively and significantly influences earnings management. Chaharsoughi and Rahman (2013) showed that there is an insignificant negative connection between board size and earnings quality.

Similarly, studies have shown no significant difference in earnings management of small and large companies; Llukani (2013) in Albania. Yasser and Mamun (2016) revealed that board leadership structure is not associated with firm performance and financial reporting quality. Large boards provided a healthier reporting quality in Australia and Malaysia. Contrary to this, Samaila and Zaharaddeen (2015) report that board independence had a negative and significant effect on earnings management on a sample of listed cement firms in Nigeria. Similarly, Egbunike, Ezelibe, and Aroh (2015) reported a non- significant coefficient for board independence.

Studies have shown that board independence is associated with high quality of accounting information (Abdoli & Royaee, 2012; Dimitropoulos & Asteriou, 2010; Marra, Mazzola, & Prencipe, 2009; Firth, Fung, & Rui, 2007). Waweru and Riro (2013) in Kenya showed that ownership structure and board composition were significant, while independence of the audit committee was not. Abdoli and Royaee (2012) in Iran reported a significant relationship between ceo duality and earnings quality.

## 5.CONCLUSION AND RECOMMENDATIONS

This study investigated the mediating effect of corporate board attributes on the connection between firm size and earnings behaviour of some selected quoted manufacturing firms on the Nigerian Stock Exchange. Studies have revealed that firm size is correlated with earnings management. They presented opposing views on the subject. However, the study seeks to fill the gap from a developing nation perspective.

The study recommends that a large firm with complex activities may seek adequate representation from a large board size. A large board size can entail that a wide array of resources is made available to the firm. In addition, there is the need to further strengthen the board monitoring function through inclusion of a proportionate share of independent non-executive directors relative to size of the firm. They help check mate the activities of the executive directors, therefore providing a safeguard against self-seeking behaviour of managers.

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