ROLES OF REMUNERATION, NOMINATION COMMITTEE AND BLOCK OWNERSHIP IN EARNINGS MANAGEMENT: A CASE STUDY OF FINANCIAL INSTITUTIONS IN NIGERIA.

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ABSTRACT

The study investigated the relationship between corporate governance and earnings management of quoted financial institutions in Nigeria. The population of this study comprised all the banks and insurance companies that are listed on the Nigerian Stock Exchange (NSE) from 2007 to 2011. The study adopted the cross sectional research approach while stratified random sampling technique was used in selecting the respondents. Data collected were analyzed using descriptive statistics and inferential statistics was used to test the hypotheses From the results of the data analysis, it was observed that there is no significant relationship between remuneration and nomination committee independence as well as block ownership with earnings management in financial institutions. In conclusion, the study also established the existence of earnings management practices in financial institutions in Nigeria. One of the recommendations was that the regulatory agencies should create more awareness on the concept of corporate governance mechanisms and its role in developing the financial sub-sector of the economy.

INTRODUCTION

The objective of financial reporting is to provide relevant, understandable, reliable, objective, timely, complete and comparable financial information to users. However, the validity of this objective is being challenged by many users of corporate financial reports because of the probable effects of earnings management on the information contents of such reports. Accounting scandals in both developed and developing countries have been widely reported and the scandals have brought about a major awareness of the need for more transparency, credibility and objectivity in financial reporting by companies in order to protect shareholders and stakeholders alike.

Earnings Management therefore, has received considerable attention in recent years from academics, market participants, and regulators. It continues to receive attention as a result of recent corporate failures linked to opportunistic earnings management that has generated doubts in the minds of shareholders and stakeholders on the credibility and reliability of financial reports. Earnings management occurs when managers use judgment in 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 largely on reported accounting numbers. (Watts and Zimerman, 1986; Healy and Whalen, 1999). Opportunistic earnings management practices which has led to the pervasive failure in the quality of financial information has brought about the need to improve the quality of financial information and to strengthen the control of managers by establishing effective monitoring mechanisms in corporate organizations.

Statement of the Problem

The earnings management problem which has resulted in non objectivity and inaccuracy in financial reporting is caused principally by the latitude allowed by Generally Accepted Accounting Principles (GAAP) that enables managers to exercise judgment in preparing financial statements. Whether managers exercise such discretion in an opportunistic or efficient manner is one of the long-standing questions of positive accounting research.

The consequences of these unethical accounting practices include, but not limited to a yawning gap between the underlying economic condition and the reported position of the firm such that any person placing reliance on such reports for decision making will be misled. The erosion of investors' confidence in corporate entities, attrition of revenue to the government through evasion or avoidance of taxes, reduction in the inflow of foreign direct and portfolio investment are easily achieved through earnings management. Good accounting and financial reporting and society in allocating its resources in the most efficient manner.

Economic resources are attracted to corporate organizations that are shown by accounting measurements to be capable of using the resource to the best advantage. Inadequate and manipulated accounting and inaccurate reporting, on the other hand, conceal waste and inefficiency and thereby prevent our economic resources from being allocated in a rational manner. This study therefore, seeks to examine the relationship between Remuneration and Nomination Committee independence, block ownership and earnings management in financial institutions in Nigeria.

Objectives of the Study

The main objective of this study is to determine the relationship between corporate governance and earnings management of quoted financial institutions in Nigeria.

Specifically, the study seeks to achieve the following objectives;

1. To determine the relationship between Remuneration and Nomination Committee independence and earnings management in financial institutions in Nigeria.
2. To appraise the relationship between block ownership and earnings management in financial institutions in Nigeria.

Hypotheses

The following hypotheses are formulated for the study. All hypotheses to be tested in this study are stated in the null form.

1. There is no relationship between Remuneration and Nomination Committee independence and earnings management in financial institutions in Nigeria.
2. There is no relationship between block ownership and earnings management in financial institutions in Nigeria.

LITERATURE REVIEW

The Concept of Earnings Management

The study of earnings management has now grown into a dynamic body of empirical and conceptual framework. Earnings management has received considerable attention in recent years from academics, market participants, and regulators, and continues to receive attention due to recent corporate failures that has brought doubts in the minds of stakeholders on the credibility and reliability of financial report. Earnings management has been considered as one of the most crucial ethical financial reporting issues, which accountants confront in everyday practices around the world (Armstrong, 1993). In general, since earnings management is a difficult concept to define and measure, it seems that there is no universally-accepted definition. Accounting literature has not accomplished consensus on the definition of earnings management. However, numerous attempts have been made by current studies to understand earnings management practices.

Earnings management is generally attributed to the process by which financial information is manipulated to provide a firm's financial stance and performance. This may involve numerous accounting treatments that are not accommodated within Generally Accepted Accounting Principles (GAAP) and are considered as either aggressive or conservative accounting treatments which mislead users of financial reporting (Xiong, 2006). As posited by Watts and Zimmerman (1986); Healy and Wahlen (1999); earnings management is the deliberate altering of financial information to either mislead investors on the underlying economic status of a firm to gain some contractual benefits that depend largely on accounting numbers. In the views of Bergstresser and Phillippon (2003), accruals are the most important earnings management instruments that are used by managers to either increase or decrease reported income. This is because they are "components of earnings that are not reflected in current cash flows, and a great deal of managerial discretion goes into their construction".

Nomination and Remuneration Committees

Nomination and remuneration committees have not been given as much attention by prior studies as audit committees because most studies consider them to have no direct effect on the quality of financial reporting or performance. However, the principal cause of earnings manipulation ensues from the fact that managers seek to increase their compensation and private benefits from disclosing false earnings by manipulating expenses of shareholders. On the other hand, serious problems may arise when insiders serve on remuneration or nomination committees as this can lead to more interventions in the design of committee structure.

In financial institutions in Nigeria, nomination and remuneration committees are integrated and designed to review the terms and conditions of employment of managers and boards of directors. Perhaps the existence of a CEO or executive serving on nomination and remuneration committees might be an incentive to act opportunistically by obtaining high levels of compensation or exploit his position to make the decisions for the management's benefit. Some prior studies have mentioned the role of such committees; for example, Xie *et al.* (2003) also observed that executive committees might not play a direct role, whereas audit or finance committees might have a more direct impact on controlling earnings management. Laux's (2008) implication is that there is a relationship between the structure of board committees and earnings management. In addition, Sun *et al.* (2009) suggested that intelligent compensation committees are capable of generating strong monitoring which leads to preventing management from controlling earnings management. Petra and Dorata (2008) suggested that independent directors of remuneration committees are better able to accomplish their duties objectively. Moreover, Dahya and McConnell (2007) also found that more outside directors sitting on committees leads to better performance as a result of independence.

Block holder Ownership and Earnings Management

Block holding is the possession of a large number of shares of a company and it is another form of ownership structure that comprises different forms, such as individual investors, pension funds, mutual funds, corporations, private equity firms, fund managers, banks and trusts (Habbash, 2010). A wide-spread ownership structure is common in the United States and the United Kingdom but this is not so in developing countries (Siregar and Utama, 2008). Although there are no sufficient studies regarding the structure of ownership, block holding may be a common type of ownership structure in financial institutions in Nigeria. Prior studies have reported block holder ownership to be an effective mechanism ownership to be an effective mechanism in monitoring managers' behaviour.

However, prior studies have presented two views: the first idea argues that concentration of ownership may create more monitoring mechanisms leading to mitigation of opportunistic behaviour, while the second suggests that the majority shareholders may collude with executives against the minority and stakeholders in order to increase their wealth (Shleifer and Vishny, 1997). In addition, the concentrated ownership may be an incentive for block holders to use accounting information to their own advantage for example through income-decreasing methods, in order to reduce the other shareholders' residual claims (Claessens *et al.,* 2000). Indeed, neither view can be generalized, for example the first view may be a phenomenon in developed countries as a result of rigorous regulation and investors' protection. However, in developing countries such as Nigeria, the second view may be justified for many reasons such as weak regulation, poor governance practice, poor accounting disclosure and investors protection.

Based on agency theory, Zhong *et al.* (2007) divided block holders into small and large and attempted to explain how they act in different situations. They suggested that small block holders tend to sell their shares when the performance of a company is not satisfactory. However, block holders may face difficulties in selling their shares, hence certain forms of monitoring can be adopted such as a long-term strategy to monitor managers and produce more benefits from their equity ownership.

Zhong *et al.* (2007) studied a sample of 5,475 firms using modified Jones model and pooled cross-sectional data to investigate the two issues on the influence of block holders on earnings management. They reported a positive relation between block holder ownership and earnings management. A study by Klein (2002) attempted to determine the influence of corporate governance on earnings management by selecting a sample of 687 US firms and using the modified Jones (1995) cross-sectional model to measure discretionary accruals. They found a negative relationship between 5% block holders sitting on audit committees and earnings management. Although this result is consistent with the general view, they may not have been caused by block holder ownership; the independence of the directors on the audit committees may have been the main reason.

In the UK context, many studies controlled for block holders in their investigation of corporate governance and earnings management. For example, Dechow *et al.* (1996) highlighted a negative association between outside block holders and earnings overstatements that violate GAAP. A study conducted by Peasnell *et al.* (2005) shows that there is no relationship between earnings management and block holders. Moreover, Yu (2008) found a positive relationship between block holders and the incidence of earnings management.

METHOD

Research Design

This study adopted the cross sectional research approach that involved a content analysis of the annual reports of a cross sectional sample of banks and insurance companies from 2007 to 2011 listed on the Nigerian Stock Exchange.

Population of the Study

The study was carried out in the financial sector of the economy. The population of the study for the secondary data therefore is made up of all the banks and insurance companies that are listed on the Nigerian Stock Exchange (NSE) from 2007 to 2011. The total population of the study is 17 banks and 30 insurance companies.

Sampling Procedure and Sample Size

The sample of the financial institutions was selected using a combination of convenience sampling technique and stratified random sampling technique. Using the stratified random sampling technique, a total of 16 banks and 25 insurance companies was used as sample size. The convenience sampling technique ensures that only banks and insurance firms that have the accounts and annual reports from 2007 to 2011 are used for the study. These financial institutions were considered because they are listed in the Nigerian Stock Exchange market which therefore enabled us to have easy accessibility to their annual reports which is the major source of our secondary data. Moreover, the five year period which the study covers is the period financial institutions witnessed financial crisis at alarming rate.

Method of Data Collection

The data for the two independent variables that reflect the characteristics of the board and other corporate governance mechanisms as well as that of the audit quality are hand collected from the financial institutions' annual reports. The financial data used to calculate earnings management was sourced from the annual reports and accounts of 16 banks and 25 insurance firms. There are a total of 205 annual reports of financial institutions listed in the Nigerian Stock Exchange market for the years 2007 to 2011. Similarly, the control variables used in this study were derived from the financial institutions' annual reports. Thus, data collection procedure was systematically done. Cross checking and verifying by research assistants during the comprehensive collection process minimizes omissions and errors.

Method of Data Analysis

The researcher used descriptive statistics to analyse the personal data of the respondents, while inferential statistics was used to test the hypotheses. Such statistical techniques include regression analysis and factor analysis. All the hypotheses were tested at the 0.05 level of significance. The statistical package for social science (SPSS) was used to generate the results. The test was carried out at P>0.05 through the following procedures:

Results and Discussions

Hypothesis One

The null hypothesis states that there is no significant relationship between remuneration and nomination committee independence with earnings management in financial institutions. The variables were subjected to regression analysis in order to generate the R-value. (See table 1).

Table 1: Regression analysis of the relationship between remuneration and nomination committee independence and earnings management in financial institutions

Model	R	R-Square	Adjusted Square	Std Error of the estimate
1	.078[a]	.006	-.019	.45673

P<0.05; n=41; df =39; critical R-value =0.326

Table 1 above presents the result of the data analysis which showed the relationship between remuneration and nomination committee independence and earnings management in financial institutions. From the result of the data analysis, the calculated R-value (0.078) was less than the critical r-value of (0.326) at 0.05 alpha level with 39 degree of freedom. The calculated R- square values (co-efficient) of (0.006) predict (0.6%) of the relationship between remuneration and nomination committee independence with earnings management in financial institutions. This rate of percentage is lowly positive and therefore implies that there is no significant relationship between remuneration and nomination committee independence with earnings management in financial institutions. The non significance of the result is in agreement with the opinion of Klein (2002), who conducted a study employing a dummy variable, found a negative relationship between the presence of the CEO on the nomination committee and earnings management. In other words, the independence of this committee is measured by the presence of the CEO which leads to an impairment of its role due to less independence. The non significance of the result caused the null hypothesis to be accepted while the alternative one was rejected.

Hypothesis two

The null hypothesis states that there is no significant relationship between block ownership and earnings management in financial institutions. In order to test the hypothesis the variables were subjected to regression analysis in order to generate the R-value. (See table 2).

Table 2: Regression analysis of the relationship between block ownership and earnings management in financial institutions

Model	R	R Square	Adjusted Square	Std Error of the estimate
1	.240[a]	.058	.033	.44847

P<0.05; n=41; df =39; critical R-value =0.326

Table 2 above presents the result of the data analysis which showed the relationship between block ownership and earnings management in financial institutions. From the result of the data analysis, the calculated R-value (0.24) was less than the critical r-value of (0.326) at 0.05 alpha level with 39 degree of freedom. The calculated R-square values (co-efficient) of (0.058) predict (5.8%) of the relationship between block ownership and earnings management in financial institutions. This rate of percentage is lowly positive and therefore implies that there is no significant relationship between block ownership with earnings management in financial institutions. The non significance of the result is in agreement with the opinion of Dempsey *et al.* (1993) who stated that owner-managed firms implement less income-increasing earnings management in comparison with externally-controlled firms, indicating that insider block holders have more ability to constrain earnings management than outside or external block holders. The non significance of the result caused the null hypothesis to be accepted while the alternative one was rejected.

Discussion of the Findings

The result of the data analysis in table I and 2 was significant due to the fact that the above calculated R-value (0.88) was greater than the critical R-value of (0.312) at 0.05 level with 39 degree of freedom. This implies that there is significant relationship between governance mechanisms (Directors independence, Remuneration and commitee independence) and earnings management in financial institutions in Nigeria. The significance of the result is in agreement with the opinion of Bhagat and Jefferis (2002) who opined that the independent directors can also play a role of a referee and implement the principles of corporate governance that protect the rights of shareholders. Similarly, the result also agrees with the findings of Peasnell et al. (2000) who in a study conducted to assess the association between board composition and earnings management activity, between the pre and post-cadbury period, a significant negative relationship between earnings management and the proportion of non-executive board members was found in the post-cadbury period, they came up with a suggestion that the higher proportion of non-executive directors helps constrain earnings management activity and appropriately structured boards following the issuance of the Cadbury report. The result finally consents with the opinion of Beasley (1996), who posited that the inclusion of grey directors who have affiliations with management may impair board independence. The independent directors must be solely outside directors who have no other relationship with the company except that of being on the board of directors. The significance of the result caused the null hypothesis to be rejected while the alternative one was accepted.

Conclusions

Based on the findings of the research work, the following conclusions are drawn:

The study has provided both empirical and statistical evidence on the usefulness of remuneration and nomination committee independence and block ownership in explaining and predicting opportunistic earnings management in sampled financial institutions in Nigeria. The study also established the existence of earnings management practices in financial institutions in Nigeria. The result however revealed that remuneration and nomination committee independence as well block ownership individually, has no significant prediction of opportunistic earnings management in sampled financial institutions in Nigeria.

Recommendations

The following recommendations are deemed necessary:

i. The regulatory agencies should create more awareness of the concept of corporate governance mechanisms and its role in developing the financial sub-sector of the economy.
ii. The composition of the board of directors should be done in such a manner that guarantees diversity of experience without trading-off independence and integrity.
iii. The management of financial institution should foster good practice by disseminating information to both institutional shareholders and other shareholders at the same time in such a manner as to ensure that neither group enjoys preferential treatment. This will raise the monitoring capacity of institutional shareholders towards opportunistic tendencies of management and reduce sharp earnings management practices.
iv. The relevant professional bodies and regulatory agencies should facilitate the application of International Financial Reporting Standards (IFRS) in financial institutions in Nigeria as this would improve the quality of financial reporting and reduce earnings management practices.

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