

# DETERMINANTS OF EARNINGS DISTORTION OF LISTED NON-FINANCIAL COMPANIES IN NIGERIA

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## Abstract

In Nigeria, certain state of affairs like leverage, liquidity, profitability and internal control lapses have been identified as some of the fundamental causes of infractions leading to false disclosure of earnings in financial statements. A hand full of researches has examined companies from different sectors of the Nigerian Stock Exchange NSE to evidence false disclosure. This study differs from these researches because it considered and examined all the sectors that are non-financial. The objective of this study is to empirically examine the determinants of distorted earnings of listed non-financial companies for the period 2009 to 2018. Data were extracted from the financial statements of the companies that made the sample of the study. Multiple regression technique was employed to analysed data collected. Diagnostics test (multicollinearity, heteroscedasticity, and Hausman specification) were run in order to improve the reliability of our statistical inferences and satisfy the assumptions of using the technique of analysis chosen. Findings revealed that high leverage, liquidity, and inadequate control environment of the internal control system relates significantly to distorted earnings. The study recommends that internal control mechanism should direct having more independent non-executive directors on the board of Nigerian companies.

**Keywords:** Earnings distortion, Leverage, Liquidity, Profitability, Internal control system

## Introduction

Listed companies in Nigeria have the capacity or ability to earn income and disclose such information in their financial statements. This is one of their fundamental duties to stakeholders whose concern has always been that, information disclosed should be of good quality that can be relied upon. In other words, the value of earnings reported by firms in their annual reports should reflect the true and fair view of the firms operating result without earnings smoothening

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(Franckzak, 2019; Dabor & Dabor, 2015; Payam, 2013). However, the literature has documented evidence that certain conditions like leverage, liquidity, profitability and control mechanisms can influence earnings smoothening. For example, leverage is the borrowed fund used to finance operations that attracts more income (Priharta & Rahayu, 2019; AL-Asiry, 2017; Agyei-Mensa, 2013; Ahmed, 2012). Liquidity increases earnings too, as it explains a company's' ability to convert current assets into cash in order to meet its day-to-day operations (Amr, 2016; Issa, Husseni & Husseni, 2015). Likewise, profitability is considered as quality earnings of the excess of a company's revenue cover its operating expenses (Echobu, Okika & Mailafiya, 2017; Osemene, Muritala & Olawale, 2014).

The internal control system also plays an important role in quality earnings disclosure; particularly the control environment of the system has the directive from the code of corporate governance (Financial Reporting Council of Nigeria FRCN, 2018; Security and Exchange Commission SEC, 2008 and 2011) to include non-executive directors NEDs and independent non-executive directors INEDs on their board. NEDs are expected to bring to bear their knowledge, expertise and independent judgment on issues of strategy and performance on the Board (FRCN, 2018; Jorge & Jose, 2007). INEDs are also expected to bring a high degree of objectivity to the Board for sustaining stakeholder trust and confidence. NEDs and INEDs are expected to monitor the provision of high quality reliable financial information disclosure. It is important to note here that prior to the general code issued by the financial reporting council of Nigeria in 2018 which took effect from first January 2019 other codes that existed (Security and Exchange Commission SEC, Central Bank of Nigeria CBN, National Insurance Commission NAICOM) have always emphasised the disclosure of quality and reliable earnings information.

However, the biased judgments of some managers in using certain conditions to distort the quality of earnings disclosed is a serious problem inhibiting the disclosure of quality financial information. This problem was revealed with the investigation carried out by SEC on some companies like Stanbic IBTC, Eco, Diamond banks and Oando Plc in 2016, 2017 and 2018 respectively, which confirmed serious infractions and false disclosures. This directed the objective of this study to examine whether, leverage, liquidity, profitability and control mechanism of the internal control system could influence earnings distortions. From this objective, the following hypotheses were formulated and tested.

- H<sub>01</sub> Leverage (LEV) is not significantly related to earnings distortion of Nigerian listed companies
- H<sub>02</sub> Liquidity (LQD) is not significantly related to earnings distortion of Nigerian listed companies
- H<sub>03</sub> Profitability (PRT) is not significantly related to earnings distortion of Nigerian listed companies
- H<sub>04</sub> The internal control system governance mechanism non-executive directors (NEDs) is not significantly related to earnings distortion of Nigerian listed companies and

H<sub>05</sub> The internal control system governance mechanism independent non-executive directors (INEDs) is not significantly related to earnings distortion of Nigerian listed companies

There are studies on determinants of earnings quality (Bhutta, Youtang, Raza; Huynh; Beyer, Guttman, & Marinovic, 2019; Tontiset & Kaiwinit, 2018; Warrad, 2017; Martínez-Ferrero, Shantanu & Sanchez, 2016; Gray, Kang & Lin, 2015). This study offers more proof on the determinants of earnings distortions, this is because to the best of the researchers knowledge, there are virtually little or no studies in Nigeria that have studied all non-financial listed companies, most of the studies are sector specific (Ferry, Umoren, Peters, Wege; Echobu, Okika & Mailafiya, 2017; Hassan & Farouk, 2014; Hassan & Bello 2013; Okolie, Omoye & Eriki, 2014; Okolie, Izedonmi & Enofe, 2013). The findings of the study provide empirical evidence to the security and exchange commission's concern and support for the mandatory disclosure of quality earnings by listed companies.

This study is in five sections. Section one is the introduction in addition to this paragraph; section two discusses the concepts and theory; section three shows the methodology that parades the study's design, variables, model specification, technique of data analysis, diagnostics and robustness tests; section four presents the findings and section five gives the conclusion, recommendation and implications.

## **Literature Review**

### ***Concepts***

This section presents the operational or working definitions of the variables of the study, including the empirical findings of other studies:

***Earnings Distortion EDN:*** Various definitions from the literature have a common tone to explain that earnings are not distorted when reported as credible and reliable (Prayam, 2003), qualitative and quantitatively disclosed according to principles and standards (Salvator & Moores, 2010), reasonably projects a firms economic reality (Bala & Gugong, 2015) and when returns are considered adequate (Tahir & Razali, 2012). This research defines earnings distortion as the precision with which information disclosed in the annual financial statements of a company portrays its true functioning state and its benefit to allow for the prediction of prospective cash flows. In this wise, reported earning that is not free from deliberate errors and biased is considered distorted. Earning of no quality influences investors to wrongly evaluate the quality of past and current earnings and poorly predict future performance of a company.

***Leverage LEV:*** is a company's capital that is called Debt. Leverage reflects the effect on returns of a change in the extent to which the firm's assets are financed with borrowed money. Operationally, it is the company's ability to utilised fixed operating costs to enlarge the effects of fluctuations in sales on its earnings before interest and taxes. Studies have it that company with higher leverage reports quality earnings to satisfy creditors' expectations. The studies of Prihata and Rahayu (2019); AL-Asiry (2017); Alves (2014); Fath, Haji and Ghazali (2013); Rajab and

Handley-Schachler (2009); Park and Shin (2004); Camfferman and Cooke (2002); Bédard, Chtourou and Courteau (2001) established that leverage is not a determinant of quality earning disclosure; but it can be manipulated to distort earnings. Contrarily, studies of Takhtaei, Mousavi, Tamimi and Farahbakhsh (2014); Uyar, Kilic and Bayyurt (2013); Zare, Kiafar, Rasouli, Sadeghi and Behbahani (2013); Ahmed (2012); Elshandidy, Fraser and Hussainey (2011); Murya, Taylor, Tower and Neilson (2010); Lau, Sinnadurai and Wright (2009); Dedman, Stephen, Arun and Hao (2008); Deumes and Knechel (2008); Raffournier (2006); Ferguson, Lam and Lee (2002) posits it can determine quality earning disclosure, particularly firms that disclose huge debt capital and dividend pay-out ability tend not to distort earnings.

**Liquidity LQD:** Is the position of a company to sustainably settle pressing obligations through quick conversion of current assets into cash. According to Khairul and Wan (2014), a liquid firm attracts creditors. More so, Amr (2016) argues that liquidity is a hint of the firm's ability to take care of its short-term debt commitment and as such, any firms with such advantage will be eager to reveal it to the public. Hence, a manager in such organisations lacks the enticement to manipulate earnings. Research of Echobu, Okika and Mailafiya (2017); Amr (2016); Hamidzadeh, Zeinali; Issah, Hussein and Hussein (2015); Hassan and Bello (2014); Hassan, Ageyei-Mesah, Lamiri and Arab (2013); Alfarih (2009) provide evidence that liquidity influences quality earnings reporting, especially when the liquidity level of a company is low. However, Izzalquny, Subroto and Abdulghofar (2019) established that liquidity is not a determinant of quality disclosure of earnings; this implies that it can be used to influence earnings distortion.

**Profitability PRT:** Is when expenses and claims are absorbed by a company's revenue. According to Tulsian (2014), it is the operating efficiency of a company. Profitability reflects how well the managers of companies use the resources at their disposal or real investments to generate profit (Dogan, 2013; Türel & Türel, 2012). Studies of Al-Asiry (2017); Takhtaei, Mousavi, Tamimi and Farahbakhsh (2014); Fathi (2013); Uyar, Kilic and Bayyurt (2013); Dedman, Stephen, Arun and Hao (2008); Raffournier (2006), documented higher profitability influences quality earnings disclosure. However, Eyonobu, Mohammad and Ali (2017); Hosseinzadeh, Kangarlouei and Morteza (2014); Agyei-Mensah, Haji and Ghazali (2013); Vandemaele, Vergauwen and Michels (2009); Abdul Majid and Ismail, (2008); Camfferman and Cooke (2002) revealed it is not influential on quality earnings disclosure.

**Internal Control System ICS:** According to the reports of the committee of sponsoring organisations COSO (2009 & 2013), ICS is a procedure designed by board of directors and affected all levels of administration to offer realistic guarantee concerning the efficacy and proficiency of operations, reliability of financial reporting and compliance with management policies. In Nigeria, the code of corporate governance (2018) requirement of company boards to include independent non-executive directors INEDs and non-executive directors NEDs is

in line with COSO's definition of ICS, particularly as it affects the control environment of the ICS. Non-Executive Directors NEDs bring to bear their acquaintance, capability and autonomous judgment on issues of strategy and performance to the board of directors. They do not participate in the day-to-day administration of the company but they usually involved in policymaking and forecasting exercises. More so, Independent Non-Executive Directors INEDs bring a high degree of neutrality to the Board for supporting stakeholder belief and confidence. They are not connected or related to any member of management, employees, suppliers, creditors and any other association that may impair their objectivity but they also have a shareholding that is less than 1%.

Empirical evidence reveal that where the board has more independent directors, operational performance that can disclose quality earnings are guaranteed (Silalahi, 2017; Joubert & Fakhfakh, 2011; Xie, Davidson & DaDal, 2003). Furthermore, studies of Larcker and Tayan (2016); Klein, Dechow and Dechev (2002); Peasnell, Pope and Young (2000); Jaggi, Leung and Gul (2009); Beasley (1996) found that an independent board is a determinant of quality earning disclosure. Contrarily, Luo and Jayaraj (2019); Mahboub (2017) established that more directors on board without independence cannot guarantee quality but distortions of earnings.

## **Theory**

Three theories; liquidity (Keynes, 1936); Signaling (Spence, 1973) and the positive accounting (Watts and Zimmerman 1986) are adapted by the study to underpin the relationship between leverage, liquidity, profitability, and internal control system and earnings distortions. The choice of selecting these theories is based on the fact that the independent variables of the study are considered determinants of earnings distortion. Keynes (1936) argued that, other things held constant, people hold cash in order to take care of unforeseen circumstances. In this wise, liquidity is that asset held by companies in business that can be easily converted into cash without loss or delay. Spence (1973) stated that a good performing company differentiates itself from nonperforming one by sending good signal about its performance to capital markets and potential investors, especially when they make profit, pay tax and dividend. More so, certain state of company's affairs is required for positive accounting to possibly take place. Subjective managers use condition like the level of leverage, liquidity, profitability or a weak control environment component of the internal control system to distort earnings. Watts and Zimmerman (1986) posits that the higher the firms debt to equity ratio, the more likely managers use accounting methods that increase earnings.

## **Methodology**

### ***Design, Population and Sample***

Expo facto design is adopted for this study because it is a secondary data based research. The population of the study is 115 listed companies from 12 sectors of the Nigerian stock exchange. Because the population of the study is finite or

countable, the Smith (1983) formula  $n = 1 + N(b)^2$  was employed to determine the sample size of the study. Where n is sample, N is the population, b is error of margin. The error of margin was at 72%. The margin was chosen to recognise companies with complete statements; delisted companies and the exclusion of companies from the financial sector of the NSE. Substituting in the formula implies  $1 + 115(0.72)^2 = 60$  companies to make the sample size of the study for the period of 2009 to 2018. The choice of this period is greatly influenced by the margin of error specified due to the filters used for the sample selection.

**Variable and Model Specification**

**Table 1**

Acronym	Nature	Measurement	A priori expectation
Earnings Distortions EDN	Dependent Variable	Absolute value of Residuals (Collins, Pungaliyay & Viih, 2017).	
Leverage LEV	Independent Variable	Total liabilities/Total assets*100 (Uwuigbe, Rantin, & Bernerd, 2015; Fathi, 2013)	+
Liquidity LQD	Independent Variable	Measured as the proportion of current assets to current liabilities (Issah <i>et al</i> , 2015).	+
Profitability PRT	Independent variable	Net income/Total assets*100 (Asegdew, 2016; Osemene, Muritala, & Olawole, 2014)	+
Internal Control System NED	Independent variable	Number of non-executive directors to total number of directors on the board (Bala and Gugong, 2015)	-
Internal Control System INED	Independent variable	Number of independent non-executive directors to total number of directors on the board (Htay, Said & Salman, 2013)	+
$EDN_{it} = \beta_0 + \beta_1 LEV_{it} + \beta_2 LQD_{it} + \beta_3 PRT_{it} + \beta_4 NED_{it} + \beta_5 INED_{it} + \mu_{it}$ Where: it = industry, time $\beta$ = Coefficients of the independent variables $\mu$ = error term			

**Technique of Data Analysis:** Panel data least square regression was used. Hausman specification and Breusch and Pagan Lagragian Multiplier tests directed the selection of the model for interpreting the results of this study. Diagnostics tests multicollinearity test, normality test and heteroscedasticity were carried out to meet the classical OLS assumptions to satisfy the Best Linear Unbiased Estimation.

## Findings and Discussions

Shapiro-wilk test showed that data are not normal p-values are significant at 1%. Multi collinearity test indicates there was none as the VIFs were > 1 but <10. The Brook Pagan/Cook-Weisberg test indicates that chi-square significance level is at 0.000 confirming the presence of the effect of heteroscedasticity. Consequently, GLS of Fixed effects and Random effects were run. The Hausman specification was not significant at 0.39. This implied interpreting the results with the random effects model.

**Table 2: Descriptive and Inferential Results**

Variables	Observations	Descriptive Statistics						Random Effects		Fixed Effects		
		Shapiro-wilk	Std. Error	Mean	Std. Dev	Min	Max	Coefficient	t-Value	P-Value	t-Value	P-Value
EDN	600			0.48	0.386	0.00	5.04					
LEV	600	0.00	.897	0.01	0.019	0.00	0.07	-2.28	-2.550**	0.011	-2.150*	0.032
LQD	600	0.01	.140	1.65	0.158	1.38	1.95	0.37	2.610***	0.009	2.050*	0.041
PRT	600	0.00	.023	0.06	0.065	-0.20	0.21	-0.43	-1.700*	0.090	-0.970	0.332
ICS (NED)	600	0.00	.107	0.51	0.150	0.17	0.86	0.09	0.870	0.384	0.990	0.323
ICS (INED)	600	0.01	.113	0.21	0.138	0.000	0.75	-0.41	-3.620***	0.000	-2.991***	0.003
Tests	Values											
Hetest: chi <sup>2</sup>	543.010											
Hetest P-Value	0.000											
Hausman Test: chi <sup>2</sup>	6.22											
Hausman Chi <sup>2</sup> P-Value	0.399											
R <sup>2</sup> Overall	0.071											
Wald- Chi <sup>2</sup>	39.230											
Prof. Wald- Chi <sup>2</sup>	0.000											

Descriptive statistics from the table shows that, Earnings distortion EDN has a mean value of 0.48 and a minimum and maximum of 0.002 and 5.04, respectively. It implies that the level of distortion within the sampled companies ranges from less than 2% to 500%, which is evidence with an average distortion mean of 48%, hence the higher the values of absolute discretionary accruals reported the lower the quality of earnings indicating distortions and vice versa. Leverage LEV has a mean of 0.01 with a minimum and maximum of 0.00 and 0.07.

This implies that some companies in the sample reported no leverage, indicating they employed more of internal financing and others are only levered at 7%. Liquidity had an average value of 1.65 with a minimum and maximum of 1.38 and 1.95. The mean value of 1.65 indicates that on the average the samples companies are low in liquid but are able to convert current assets to cash not that quickly. Profitability PRT has a mean value of 0.06 and minimum and a maximum of -0.20 and 0.21 respectively. This shows that on the average the sampled companies generated only 6% profit from their total assets, and such generation was impacted by minimum losses of 20% against 21% profits.

In addition, the statistics shows that on the average, the internal control system's control environment has 51% non-executive directors NEDs on the boards of the companies. The boards have 17% minimum and 86% maximum representation. However, for independent non-executive directors INEDs average

representation on the boards of companies is 21%. There is no minimum representation across the boards but a maximum representation of 75% is reported. This is due to the fact that some NEDS double as INED in some companies.

Inferential statistics reveal that the coefficient of determination, which is the overall cumulative  $R^2$  shows the proportion of the total variation in the earnings distortion that is explained jointly by leverage, liquidity, profitability, and internal control system to be 7%. This is quite low, indicating that more determinants are to be included in the model. Notwithstanding, the model is adequate in selecting its explanatory variables and fit because the Wald-  $\chi^2$  probability is significant at 1%.

LEV is with a coefficient of -2.28. We find that for every 1% increase in leverage, earnings distortion will be reduced by only ₦2. The p-value of 0.011 provides evidence to reject the null hypothesis. The result meets our priori expectations and implies that leverage does have a serious influence on earnings distortion. This finding is not in line with Takhtaei et al. (2014); Uyar et al. (2013); Zare et al. (2013); Ahmed (2012); Elshandidy, Fraser & Hussainey (2011). However, aligns with Priharto and Rahayu (2019); AL-Asiry (2017); Alves (2014); Fath, Haji and Ghazali (2013).

LQD is with a coefficient of 0.37. This shows that for every 1% increase in liquidity, earnings distortion will be increased by 37Kobo. The p-value of 0.009 provides evidence to reject the null hypothesis. The result meets our priori expectations and it implies liquidity can influence earnings distortion. This finding is not in line with Echobu, Okika and Mailafiya (2017); Amr (2016); Fathi (2013); Lamiri and Arab (2013); Hassan and Ageyei-Mesah (2013); Ahmad (2012); Alfaraih (2009). More so, the statistic average of 1.65 further proves that a lower level of liquidity can be manipulated to distort earnings. This is in line with Izzalquny, Subroto and Abdulghofar (2019).

PRT is with a coefficient of -0.43. This reveals that for every 1% increase in profitability, earnings distortion will be reduced by 43Kobo. The p-value of 0.09 provides evidence to fail to reject the null hypothesis. The result did not meet our priori expectations it implies that profitability does not influence earnings distortion. This was seen from the statistics mean value average of 0.06% indicating that low profit levels cannot be manipulated to distort earnings. This finding is in line with Eyonobu, Mohammad and Ali (2017); Hosseinzadeh, Kangarlouei and Morteza (2014); Ageyi-Mensah, Haji and Ghazali (2013); Vandemaele, Vergauwen and Michels (2009); Abdul Majid and Ismail (2008); Camfferman and Cooke (2002).

ICS: NEDs is with a coefficient of 0.09. This shows that for every 1 additional director that is not a non-executive director, earnings distortion will be increased by 9Kobo. The p-value of 0.37 provides evidence to fail to reject the null hypothesis. The result meets our priori expectations and it implies that more NEDs that double as INEDs will influence earnings distortions. However, for INEDs a coefficient of -0.41 is recorded. This shows that for every 1 additional independent non-executive director earnings distortions will be reduced by 41Kobo. The p-



value of 0.00 provides evidence to reject the null hypothesis. The result meets our priori expectations because there are some nonexecutive directors that are also considered as independent nonexecutive directors in some of the companies. This finding supports Silalahi (2017); Joubert and Fakhfakh, (2011); Xie, Davidson and DaDal, (2003).

## **Conclusion**

This study was able to establish whether leverage, liquidity, profitability and internal control system's control environment (non-executive director and independent non-executive directors) can determine earning distortion. This study concludes that companies that make losses and have more non-executive directors on their boards cannot influence earnings distortions but companies with high leverage, liquidity and less number of independent non-executive directors can influence earnings distortions. Theoretically, this study proves that disclosing leverage; liquidity and the representation of non-executive directors in financial statement can be used to send signals to existing and potential investors regarding a company's earnings and the extent to which such earnings are distorted. However, this lies in the internal control mechanism put in place. The study recommends more independent non-executive directors on the boards of Nigerian listed companies and the separation of the capacity of a non-executive director from doubling also as independent director. This is in line with the new code of corporate governance, 2018 that became operational from January 2019. The findings of this study can be generalised because nonfinancial listed companies in Nigeria are focused in this study. Future researches should include more explanatory variables and examine all listed companies in Nigeria.

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