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The Effect of Board the Size and Audit Committee the Size on Earnings Management in Nigerian Consumer Industries Companies

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Abstract:
Board and audit committee the size are important governance mechanisms that affect companies' reported earnings due to the managers' effort to manipulate the earnings in order to meet their predetermined target. The objective of this study is to examine the relationship between board the size, the audit committee the size and earnings management in Nigerian consumer industries companies. A total of 29 companies in the consumer sector of the Nigerian stock exchange were analyzed using multiple linear regressions. Data was obtained from secondary sources alone using annual report and account of the companies for the periods of 2010 to 2013. The results show that audit committee the size is negatively and significantly affects earnings management, the result further suggests that larger board is not efficient to minimize the tendency of managing earnings, therefore it is recommended that the audit committee should be increased to minimize the likelihood of earnings management.

Keywords: *Audit committee the size, board the size, earnings management*

1. Introduction

Board Governance characteristics play a crucial and indispensable role in the way quoted companies are managed not only in the Nigerian economy but also globally, thereby detecting whether management employed some mechanisms to manipulate their reported earnings become an issue of discussion in accounting literature, since managers are presumed to be in a self- interested way. For instance, managers may focus on development over productivity, because their incentives rely on companies' magnitude, or build up strategy that bond complexity for the owners to substitutes their offices (Gulzar, 2011; Healy & Wahlen,1999; Watts & Zimmerman, 1986).

Board Governance characteristics are the set of relationship among organizations' management, its board, owners and all other interested parties for measuring the direction of organizations' movement, such as boards' committees, members, meetings, the size, independency, etc. But the most important ones are the the size of the board and presence of independent audit committee with professional knowledge for making effective and efficient decisions which in turn reflect the companies' growth and mitigating the agency problems, such as managing earnings practices (Mansourinis, et al., 2013).

The the size of members included in the companies' BOD as well as audit committee is a vital aspect in assessing the efficiency of such board (TSE, 1994). Unfavorably, accounting and finance literature suggest disagreement concerning the trend of the correlation among the size of the board and its efficiency. Smaller boards are not expected to perform efficiently (Jensen, 1993) while a larger board presents enhanced environmental links and more competence (Johnson, Daily, & Ellstrand, 1996). Similarly, companies listed in the Nigerian Stock Exchange are required under Section 359 (3) and (4)of the (CAMA, 1990) to establish an audit committee, comprising three (3) directors and three (3) shareholders' representatives making a total number of the committee members to be six (6).

Nowadays the quality of companies earnings reported happen to be an issue of vast concern, organization may neglect "big bath", such as "restructuring charges, premature revenue recognition, reserves and write- offs of purchased in process of research and development, these practices perhaps threaten the credibility of financial reporting" as well as the company's ability
to audit the quality of their earnings in order to effectively restricts income manipulation or
earnings management, however, in the Nigerian context accounting scandals and fraudulent issues are many such as the case of FCMB and their Chief Executive Officer, Keystone Bank (former Bank PHB) and their Managing Director, Fin Bank and their Managing Director, Nigeria Maritime Administration and Safety Agency (NIMASA) and their Director General, First Bank and their Chief Executive Officer, Bank of the North (Now merged in Unity Bank) and their Managing Director, Cadbury Nigeria Plc,

AfriBank Plc, and Oceanic Bank Plc are well recognized publically accounted cases resulting in misleading financial reports, as such there is need to ensure the quality of accounting income. Moreover, earnings discretionary accruals is motivated by given a number of earnings and / or accounting manipulation as well as its allocation made, this might be done for a number of reason, like amplifying reward, evade debt covenants, assemble analyst forecasts, etc (Subramanyam, 2014). This adjustment become necessary for the corporation in order to ensure that financial statement have reveal and disclose a true and correct picture of the corporate activities financially. In addition, to ensure that the accounting earnings are computed and reported in accordance with (GAAP) thought companies can violate the provision of the GAAP practically, but still not considered as fraud, since such violation is allowed in form of different accounting choices, thereby reflecting companies' engagement in earnings management.

Although accounting manipulation might be mutually for advantageous or disadvantageous to the organizations depending on the way executives make use of it, in spite of the fact that, there is no any specific direction to establish its either effects, thereby this study is at examining whether governance system can significantly constrain or minimize the negative and /or disadvantageous effects of earnings management of listed companies in Nigeria, as well as ascertaining and establishing whether considerable correlation exist among selected board characteristics thus: (board the size, audit committee the size) and earnings management of quoted companies in Nigeria.

It is observed that there are different means of detecting earnings management and measuring its quality, which has several implications depending on the approaches used by companies'

managers, as such the researcher wishes to do an examination of board characteristics (specifically on boards the size and audit committee the size) and its effects on the earnings management for the companies quoted in the consumer industry sector of the Nigerian Stock Exchange.

This paper is organized in seven sections, section one is the introduction, section two is the review of the related literature and hypothesis development, section three was the methodology employed in this study, section four is the results and its discussions, section five is the conclusion, section six is the recommendations and finally, section seven was the references.

2. Literature Review and Hypothesis Development

2.1. Board The size

According to the SEC, CCG, 2003 all listed companies in the NSE should have a sufficient board the size relative to the scale and complexity of the company's operation and be composed in such a way to ensure diversity of experience without compromising independence, compatibility, integrity and availability of members to attend meeting, also the the size should not be less than five (5) comprising executives and non-executives members.

Several prior studies investigate the association of different board characteristics (board the size inclusive) and earnings management in different context, such as Ali, Salleh and Hassan (2010) that examines the association between managerial ownership and managing earnings activities among listed firms in Malaysia within the periods of 2002 as well as 2003. The result shows a negative association among board the size and managing earnings practices. Similarly, Dimitropoulos (2011) analyze the effect of the size of the board, directors' independence, etc. on the accounting manipulation among football clubs companies in some selected Europeans Union countries. The result from 268 firm year observation shows that the size of the board is positively associated with accounting manipulation. Aygun, Ic and Arvas (2010) ascertain the relationship between board governance and managing earnings activities. The result shows a negative relationship between the size of the board and accounting manipulation.

Nor Haron, Nik Saleh and Abdulrashid (2011) ascertain the relationship among the percentage of family members on board and managing earnings activities among the sample of 236 listed companies in Malaysia for the 2009. The regression analysis result appears that the size of the board is positively correlated to accounting manipulation. Emna, Trabelsi and Mataousi (2011) observe the interaction between directors' independence, the size of the board and real window dressing among the sample of 4170 U.S Initial Public Offering (IPO) during 1998 to 2011. The result indicates the size of the board is negatively associated to accounting manipulation.

According to agency theory, board the size of a firm is organized depending on the scope and complexity of the firms' production process, that is to say larger complex processes lead to the larger firms (Fama & Jensen, 1983). Abdulrahman and Mohamed Ali (2006) observed that board characteristics have an effect on earnings management. But some studies suggested that smaller board that ranges from four to six may have more effective decision (Pearce & Zahra, 1992)

Ghosh, Marra and Moon (2010) investigate, audit committee and accounting manipulation. The result found that the size of the board is positively related to accounting manipulation. Chekili (2012) also found the size of the board is positively related to earnings management in Tunisian firms. Kumari and Puttana (2014) examine board characteristics as control mechanisms for managing earnings, the result shows that the size of the board is positively and significantly associated to accounting manipulation practices.

Similarly, Zgarni, Halioui and Zehri (2014) assessed the interactions of BOD characteristics in the mitigating level of accounting manipulation in emerging markets. Result found a positive significant between the size of the board and accounting manipulation. Therefore, the hypothesis is constructed as follows:

- H1: There is a positive relationship between the board size and earnings management.

2.2. Audit Committee The size

Audit committee (AC) is a committee to be established by all listed companies in the Nigerian stock exchange, which is charged with the responsibility of overseeing the integrity of financial statements produced by the companies, as well as its compliance with legal requirement (SEC-CCG, 2003). According to SEC Code of Corporate Governance 2003, the audit committee should consist not less than three directors of which independent directors should have the majority, and the committee is chaired by independent non-executive director. Cadbury Committee (1992) and Al-Matari, Al-Swidi, Fadzil and Al-Matari (2012) described the size of the audit committee as a characteristic that is regarded to be significant for the successful discharge of its duties. The the size of at least of three (3) executives has been suggested by corporate governance reports (BRC, 1999; New York Stock Exchange, 2002; CMA, 2006).

Sun, Lan and Liu (2014) explore the efficiency of independent audit committee characteristics in mitigating the level of earnings management activities for United States firms. The study sampled 5037 firms' year observation for the period of 2007 to 2010. The result shows that the size of the audit committees has a positive relationship with earnings management. Nugroho and Eko (2012) re-assess the effects of audit committee, CEO duality; board the size, among others, on the earnings management of Indonesian securities market companies for the period of 2004 to 2008. The overall result shows that the size of the audit committee is positively and insignificantly affecting earnings management practices. Similarly, Soliman and Regab (2013) discovered that the size of the audit committee has an insignificant relationship with earnings management in a negative direction.

Kim and Yoon (2005) analyze whether there is progress by board governance mechanisms in limiting managing earnings practices among Korean listed companies between the period of 2004 and 2005. Its result reveals that the size of the audit committee is positively and insignificantly related to earnings management. Hamdam, Al-Hayale and Aboayela (2009) explore the effects of AC's and its financial expertise on earnings management among the sample of 50 Jordanian listed industrial firms for the period of 2004 to 2009. The study used pooled data analysis, and the result appears that the size of the audit committee is negatively and insignificantly related to earnings management. Chandrasegaram, Rahimansa, Rahman, Abdullahi and Nik Mat (2013) ascertain the effect of audit committee the size, independence and its meetings among 153 public listed Malaysian companies for the period of 2011. The result shows a negative relationship between the size of the audit committee and earnings management.

Several empirical studies were conducted in different context, and the result showed contradicting findings, such as Ghosh et al. (2010) also studied the association of corporate board characteristics and earnings management and found that the size of the audit committee was positively related to earnings management. The finding also suggested that firms with smaller audit committee would have larger earnings management practices. Visvanathan (2008)

Studied the association of audit committee and accounting manipulation. The results finding showed that audit committees' the size had a negative significant relationship with the level of earnings management. Alves (2011) also studied the association between board characteristics and earnings management. The result showed that the size of the audit committee was negatively related to earnings management. Similarly, Soliman and Regab (2012), Hamdan et al., (2009), Hutchinson and Percy (2008), and Chandrasegaram et al. (2013) found audit committee the size had negative relationship with earnings management. Therefore, hypothesis is constructed as follows:

- H2: There is a Negative relationship between audit committee the size and earnings management.

2.3. Control Variables

To control the relationship of other factors which possibly associated with earnings management, this study employed three (3) control variables in the regression model: Leverage, Profitability and Firm The size. For the companies with high or strong, firm the size managers tend to manipulate earnings, perhaps for the political reasons. Therefore, this study predicts a positive relationship between earnings management and leverage, and mixed of predictions among earnings management with profitability and firm the size.

2.4. Measurement of the Variables

<u>2.4.1. Earnings Management</u>

Discretionary accruals were used as a proxy to establish the extent of earnings management, which is attained by deducting Non-discretionary accruals from total accruals. Non discretionary accruals are projected using a regression model that regresses total accruals on numerous explanatory variables.

The most accepted accrual models is that of Jones (1991) model, which is able to decompose accrual into discretionary and non-discretionary, when changes in sales are adjusted for the changes in receivables.

<u>2.4.2. Board the Size</u>

This study measured the size of the board by the number of member/directors on the board of directors of the company (Xie, Davidson & DaDalt, 2003; Peasnell, Rope & Young, 2001; Fama & Jensen, 1983).

<u>2.4.3. Audit Committee the Size</u>

The the size of the audit committee is measured by the number of members/directors on the audit committee as adopted from Anderson et al. (2003) and Al-Matari et al. (2012).

2.4.4. Leverage
Leverage is the proportion of book value of equity averaged above past four years. Extremely leveraged companies have low capability to practice international diversification since they face restriction on extra borrowing to finance acquisition. Therefore, leverage in this study is measured as a proportion of long-term debt to Capital i.e. Debt and Equity (Anderson et al. 2003).

$$LEVERAGE = \frac{LONG\ TERM\ DEBT}{DEBT + EQUITY}$$

2.4.5. Profitability
Singhvi and Desai (1971) observed that non-profitable corporations may disclose less information to cover up losses and declining profit, whereas profitable ones will want to demonstrate their capability to stakeholders in financial institutions by disclosing more information so as to enable them gain access to capital on competitive terms (Meek et al. 1995). Company managers do not want to disclose non-profitable information on negative investment or product, hence they may decide not to disclose or where it exists, disclose lump profit attributable to the entire company. Therefore, this study defines and measure profitability as the:
The proportion of income before tax to shareholders' equity that is

$$PROFITABILTY = \frac{INCOME\ BEFORE\ TAX}{SHAREHOLDERS'\ EQUITY}$$

2.4.6. Firm The Size
Firm the size is the book value of total assets using its natural log (Akpuru 2007). Therefore this study measured the size of the firm as:
Log total assets (Anderson et al., 2003)

2.5. Model Specification
The variables used in this study are derived through a review of the related literature, for example, (Jones 1991; Saleh et al. 2006; Dechow, et al., 1996; Islam, Ali &Ahmad, 2011; Healy 1985; Deangelo 1986; Rangan 1998; Teoh, Welch, & Wong, 1998a; 1998b). Therefore, to establish the occurrence of accounting manipulation, this study make use of Jones (1991) model which designed its modification in order to eradicate the speculated tendency of the model to measure discretionary accrual with error, when discretion is exercise over revenues, in this model, non discretionary accrual (NDA) where estimated during occurrence period and subsequently subtracted from total accrual to arrived at discretionary accrual (DA), however total accrual is considered as the discrepancy between earning and cash flow from operation, thus:
TA=E-CFO
Where
TA = Total accrual
E = Earnings
CFO = Cash flow from operation
In other words, in line with previous studies total accrual were decomposed or partitioned into Discretionary accrual (DACC) and non discretionary accrual (NDAC), thus:
$TACC_i = NDAC_i + DAC_i$……………………………………………………………………. (1)
Where TACC Firm$_i$ is calculated as the disparity between income before tax and extraordinary item (EARN) and operating cash flows (OCF), therefore:
$TACC_i = EARN - OCF_i$………………………………………………………………………… (2)
Furthermore, to determine DAC the study consider Jones (1991) model which is the most popular model adopted by prior studies in detecting accrual management (Saleh et al. 2007). The model was:

$$DAC = \frac{TACC_i}{A_{i-1}} - \left\{a\,\frac{(1)}{A_{i-1}} + b\,\frac{(\Delta REV)}{A_{i-1}} + c\,\frac{(PPE)}{A_{i-1}}\right\} \text{............................ (3)}$$

Where:
TACC = Total accrual.
ΔREV=Changes in receivable.
PPE = Gross property, plant and equipment.
A=Total asset.
However, the following multiple regression analysis were used to examine the relationship between (board the size, audit committee the size) and earnings management but control variables were included hence earnings management were detected through DACC, which is found to be associated with leverage, profitability, firms the size (Young 1998) (as cited by Saleh et al. 2007).
$DAC=\beta_0+ \beta_1 BS+ \beta_2 ACS+ \beta_3 LEV + \beta_4 PR + \beta_5 FS+ \varepsilon$
Where:
DAC= Discretionary accrual
BS= Board the size

ACS=Audit committee the size
LEV=Leverage
PR= Profitability
FS=Firms the size

3. Research Methodology

Data is collected from printed annual reports and account downloaded from the internet, the linkage for the published statements is accessible at Nigerian stock exchange web site and invest in Africa. The study was focus on the 29 companies listed on the consumer sector of the Nigerian stock exchange, for the years 2010 to 2013, given 116 observations. Data on Dependent Variable was extracted from the statements of financial position, cash flow and comprehensive income,

while data for Independent and control variables were gathered from corporate governance report, statement of financial position as well as a comprehensive income statement.

4. Result and Discussion

4.1. Descriptive Statistics

Table 1 below provides a descriptive analysis for the study variables. From this table, on the side of independent variables, the board the size of the total 116 firms year observation involved in this study has a minimum of 5 directors with a maximum of 10 directors, this implies that none of the companies has less than 5 board members, additionally, none of the companies' directors goes beyond ten (10). Therefore, Nigerian listed companies in the consumer sector have different the sizes of the board of directors, perhaps due the differences in the companies' the size (Zahra & Pearce, 1989). However, the board sizes across the said companies have 8.5862 as mean value with a standard deviation of 1.4924. However, the mean value and standard deviation of audit committee the size of Nigerian Consumer Securities Market Companies are 5.0345 and 1.1339 respectively, with a minimum of 2 directors and a maximum of 6 directors. This indicates that none of these companies have less than 2 members serving the audit committee, at the same time, none of these companies have more than six (6) director/members included in the audit committee. The Code of Corporate Governance requires all listed companies in NSE to have at least three (3) members serving the audit committee (CAMA, 1990; SEC-CCG, 2003). This suggests that all Nigerian listed companies studied have complied with such governance requirement, with exception of one company who failed to do so.

Overall, this study concludes that the studied Nigerian consumer industries, companies comply with the requirement of the Code of Corporate governance issued by Capital Market authorities with exception of one company that fails to establish the audit committee with a minimum requirement.

For control variables, it appears that the mean value of leverage, as measured by the proportion of long term debt to the debt and equity for Nigerian consumer industries, companies is 0.3276 with a standard deviation of 0.2752, but it has a minimum and maximum of 0.00 and 0.87 respectively. These figures reveal that, there is a tendency for Nigerian consumer industries

Companies to manage earnings, going by the positive accounting theory and debt covenant hypothesis which states that more leverage more accrual. Therefore, there is high tendency for the management to manipulate its accounting figures. The more companies are geared the more possibilities for managing earnings are open, and then revise as the case. Regarding the companies' profitability, it appears that the mean value of the profitability for the Nigerian consumer Securities Market Companies is 0.2359 ranging from 0.00 to 0.81 profits. This suggests that Nigerian consumer industries, companies are highly profitable. Furthermore, for the firm the size, as measured by the natural log of total assets, it has a mean value of 22.3531 with a standard deviation of 2.7568. The result shows a minimum and maximum the size of 14.75 and 26.26 respectively.

For the dependent variable, the mean tendency for managers of consumer industries, companies to manage or manipulate earnings is less with the minimum of -10 and maximum of 5.00.

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness		Kurtosis	
BS	116	5.00	10.00	8.5862	1.4924	-0.665	0.225	-0.679	0.446
ACS	116	2.00	6.00	5.0345	1.1339	-0.651	0.225	-0.588	0.446
LEV	116	0.00	0.87	0.3276	0.2752	0.587	0.225	-0.971	0.446
PR	116	0.00	0.81	0.2359	0.2227	1.063	0.225	0.262	0.446
FS	116	14.75	26.26	22.353	2.7568	-0.916	0.225	0.613	0.446
DACC	116	-10.00	5.00	-0.4138	2.8347	-1.033	0.225	3.356	0.446

Table 1: Descriptive Analysis

4.2. Pearson Correlation

Table 2 shows that, there is a significant correlation between board the size and audit committee the size with earnings management, at 0.230 and 0.212 respectively at 5%.

It can also be seen that, there is a correlation between the size of the audit committee and board the size at 0.296 and significant at 1%. However, the correlation between independent and control variables occur between board the size and profitability as well firm the size at 0.183 and 0.201 significant at 1%.

	DACC	BS	ACS	L	P	F
DACC	1	-.230*	-.212*	-0.115	-.414**	-.220*
BS		1	.296**	0.127	.183*	.201*
ACS			1	0.035	0.02	0.009
LE.				1	.414**	.250**
PR.					1	.372**
FS.						1
*. Correlation is significant at the 0.05 level (2-tailed).						
**. Correlation is significant at the 0.01 level (2-tailed).						

Table 2: Correlation analysis

However, to ascertain the validity of the said result, the study runs post estimation test as presented below.

4.3. Regression Analysis

By using a multiple regression, analysis of the relationship between board and audit committee the sizes on earnings management. It also discusses its relationship with control variables that is leverage, profitability and firm the size. The result of linear regression using earnings management as dependent variable and (board the size and audit committee the size) as the test variables is presented in Table 3. The audit committee the size of consumer industries, companies in the Nigerian stock exchange is found to be negatively and significantly associated with earnings management, which is consistent with study hypothesis, this implies that more members of the audit committee reduces the tendency of managing earnings practices. This finding is lined with other studies of (Chandrasegaram, et al., 2013; Visvanathan, 2008; Alves, 2011; Soliman & Regab, 2012)

However, the size of the board appears to be insignificantly negative, which is contrary to the study hypothesis. This suggests that Nigerian consumer companies with lower board the size are less related with the earnings management practices. This finding is in line with other studies of Ali, et al., 2010; Emna, et al, 2011; Aygun, IC & Arvan, 2010; and Nor Haron, et al., 2011 that found a positive relationship between the two variables. This implies that the smaller board focuses their attention in resolving issues that may arise, whereby larger boards may be difficult to control, hence conflict of interest may arise among the directors, which might have hampered the monitoring and evaluation process of managers' actions (Fama & Jensen, 1983).

However, for the control variables, the study report only one variable (profitability) has significant impact on earnings management at 1% percent, which is negatively and significantly associated with earnings management. This implies that the lower the companies' profit the higher the level of earnings management.

	Expected sign	B	t-value
(Constant)		5.984	2.505
BS	+	-0.192	1.121
ACS	-	-0.441	-2.014**
LEV	+	0.913	0.958
PR	+/-	-5.119	-4.153***
FS	+/-	-0.730	-0.770

Table 3: Regression analysis

*Note: *. Correlation is significant at the 10%, **. Correlation is significant at the 5%*

**** Correlation is significant at the 1%*

5. Conclusion

The main aim of this study is to investigate the relationship between board characteristics and earnings management in Nigeria. This study uses board the size and audit committee the size as determinant of board characteristics. The analysis of sample study shows that Nigerian consumer companies take an average of -0.4138 to manipulate accounting earnings with a minimum of -10 to the maximum of 5. With regards to regression analysis the result shows that only one independent variable (audit committee the size) is negatively and significantly related to earnings management. The finding supports the argument that audit committee the size is an important determinant of earnings management. More so, the findings show that one of the control variables (profitability) is negatively and significantly related to earnings management, which is in line with previous studies, however leverage found to be positively and insignificantly related to earnings management, but firm the size is found be negatively and insignificantly related to earnings management which are all consistent with prior studies. Overall the results support H1, while H2 is not supported.

6. Recommendations for Future Research

Based on the study limitation and findings, this study suggests future research to overcome the limitations of this study and provide more insight into the determinant of earnings management. The current study uses board the size and audit committee as determinant of earnings management, as such future study is suggested to incorporate other important variables of corporate governance or board characteristics, such as audit committee meetings, board of directors meetings, gender of board and audit committee members, etc. (BRC, 1999) to provide more insight into understanding how board characteristics are influencing earnings management.

It is recommended that, board the size of the sampled companies should be decreased to minimize possibility of managing earnings, while audit committee the size should be increased to reduce the tendency of earnings management practices.

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