

-RESEARCH ARTICLE-

## EXECUTIVE COMPENSATION AND EARNINGS MANAGEMENT OF NIGERIAN LISTED NON-FINANCIAL FIRMS

### **Eghosa Godwin Inneh**

Department of Management and Accounting, Obafemi Awolowo University, Ile Ife, Nigeria

Email: eghinneh@oauife.edu.ng.

ORCID ID: 0000-0003-4636-9869

### **Lawrence Ogechukwu Obokoh**

Department of Cost and Management Accounting, Cape Peninsula University of Technology, Cape Town

Email: obokohl@cput.ac.za

ORCID ID: 0000-0002-7142-52431

### **Romoke Rafiat Busari**

Department of Management and Accounting, Obafemi Awolowo University, Ile Ife, Nigeria

Email: rbusari@oaucdl.edu.ng

ORCID 0000-0002-2595-0614

### ***Abstract***

*The study investigates the effect of executive compensation on earnings management of Nigerian listed non-financial institutions. A longitudinal research design was adopted for the study. A sample of 40 listed firms was selected using a purposive sampling technique. The study covers a period of 2010-2018, resulting in 360 firm-year observations. The data collected was analysed using the Ordinary Least Square Method (OLS). The results show that executive compensation and statutory audit have a significant negative association with earnings management. The results suggest that executives with lower compensation engage in opportunistic behaviour, which is consistent with the positive accounting theory, while highly compensated executives engage in*

**Citation(APA):** Inneh, E. G., Obokoh, L. O. & Busari R. R., (2020), Executive Compensation And Earnings Management Of Nigerian Listed Non-Financial Firms, International Journal of Economics and Finance Studies, 12 (2): 369-387. Doi: 10.34109/ijefs.202012208

*income-decreasing earnings consistent with the agency theory. Also, statutory audit plays a significant role in mitigating against the executive in engaging in income smoothing.*

**Keywords:** *Executive Compensation, Earnings Management, Positive Accounting Theory, Longitudinal Research Design, Agency, Statutory Audit*

**JEL classification:** M49

## 1. INTRODUCTION

Earnings management is not a new topical issue, following the global financial scandal that involved entities such as Enron, World.com and Sartyam. Nigeria has also witnessed several corporate failures such as Cadbury Plc, Ile-oluji, and Lever Brothers in the non-financial sector, despite the existence of corporate governance mechanisms. Okaro, Okafor and Ofoegbu (2018) posit that the Nigerian regulatory framework is weak. In reality, the non-financial sector is not as regulated as the banking sector despite evidence of earnings management practices and excessive total pay-package of the executives in the sector. Theoretically, executives are expected to furnish financial reports devoid of material misstatement and rewarded for their services through executive compensation. Irrespective of the adequacy of the executive compensation, the positive accounting theory proposes that executives will engage in opportunistic behaviour, by issuing misleading reports for their benefit (Watts & Zimmerman, 1986). Questions have been raised on the justification of the compensation and the financial report issued by the executives. There is a considerable number of empirical studies (e.g., Beasley, 1996; Balsam, 1998; Shuto, 2007; Cullinan, Du & wright, 2008; Pearson, 2012; Ye, 2014) on the subject matter outside Nigeria, and there is no consensus on the empirical findings. The divergent results are more attributable to the capital market development in various countries (see, Balsam, 1998; Joh, 1999; Shuto, 2007).

To the best of our knowledge, limited studies, if any, exist on executive compensation and earnings management in Nigerian listed non-financial firms despite investors' concern on the excessive total pay package of executives and the quality of financial reporting in Nigeria. Our assertion on the topical issue is also evident in the study of Yusuf and Abubakar (2017), who implicitly claim to be the first to examine the subject in Africa and second in developing countries, following the work of Chu and Song (2012) in Malaysia. We contribute to

knowledge by adding to the limited literature on the subject matter in Nigeria, especially in the non-financial sector. Also, we contribute to knowledge by adopting the real earnings management model developed by Roychowdhury (2006), which captures the accounting magic from all the activities in non-financial firms (production, cash flow, and expenses). The real earnings management model is rarely used in Nigeria to capture earnings management in the non-financial sector. The remainder of the paper is structured into the following sections: literature review and hypothesis development, research methods, discussion of the results, conclusions and recommendation.

## **2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT**

There is no consensus on the definition of earnings management, but researchers accept that it is the deliberate manipulation of a financial report or actual performance through the use of discretion, rather than accounting choices (Bajra & Cadez, 2018; Gao, Shen, Li, Mao, & Shi, 2019). For instance, the executives intentionally manipulate the actual performance or financial report to achieve the organisation's objective or the private executive gain (Healy & Wahlen, 1999; Schipper, 1989). This is harmful in the long run to the corporate image of the organisation (Merchant & Rockness, 1994; Putman et al., 2005; Clikeman, 2003). It is interesting to note that earnings management is an unethical practice (Healy & Wahlen, 1999; Krishnan & Parsons, 2008), but not an illegal activity (Xie, Davidson, & DaDalt, 2003; Enofe, Yafekhe & Eniola, 2017) and fraudulent practice (Dechow & Skinner, 2000). The executives employ flexibility in financial reporting to alter the firm's result (Ortega & Grant, 2003). Income smoothing can be achieved in the following ways: understatement of expense, overstatement of income, and misrepresentation of accruals. Earnings management has two perspectives: the information perspective in which managers try to reveal their expectations about the firm's future cash flows to investors through their discretion and the opportunistic perspective, which holds that management strives to mislead investors (Holthausen & Leftwich, 1983). Earnings management is usually measured using discretionary accruals.

The board of directors is saddled with the responsibility of directing and controlling the affairs of an organisation for a reward known as executive compensation. Executive Compensation comprises salary, share options, bonuses, benefits, and perquisites, preferably configured to accommodate the desires of the executive, organisation policy, government regulation, tax law, and rewards for performance (Clementi & Cooley, 2010). Compensation could be stock-based or

cash-based. In a well-developed capital market, executive compensation is majorly stock-based (Shuto, 2007; Cullinan et. al., 2008; Pearson, 2012). The board of directors, through the compensation committee comprising of independent directors, designs the reward policy of the executive team. Existing studies (e.g., Beasley, 1996; Balsam, 1998; Shuto, 2007; Cullinan et. al., 2008; Pearson, 2012) have shown that compensation is positively related to income smoothing, irrespective of the form of the compensation. The agency theory posits that managers should provide financial reports that depict the actual performance and financial position of the organisation. To achieve the corporate objective, the board must direct and monitor the activities of the managers at a contractual reward. The firm must establish a compensation plan in a manner that ensures managers' incentives align with shareholders' interest (Jensen & Meckling, 1976; Fama & Jensen, 1983). Contrary to the agency theory, the positive accounting theory and managerial power theory posit that the manager engages in opportunistic behaviour (Jensen, 1986; Scott, 2009) as a result of information asymmetry. Management may not act in the best interest of the investors (Bebchuck, Fried & Walker, 2002). Studies (e.g. Gao & Shrieves, 2002; Chu & Song, 2012; Cella, Ellul & Gupta; 2014) have shown that executive compensation is positively associated with earnings management. For this study, the researchers postulate that executive compensation is positively associated with earnings management.

**H<sub>1</sub>**: there is a positive association between executive compensation and earnings management.

**Table 1: Empirical Review**

<b>Author</b>	<b>Country/Population/(Sample)/ Period</b>	<b>Methodology</b>	<b>Conc lusio n</b>
Gao and Shrieves (2002)	United States/(1500)/1992-1999	OLS	+
Carter et al. (2005)	The U.S., (8,669) CEO years, (8,154) CFO years observation, 1996-2003	Tobit model	+
Bergstresser, and Philippon, (2006)	USA, 4671 firm-year observation, 1996-2001	OLS	+
Laux, and Laux, (2009)	U. S., (30), 2005	Industrial Average	<b>N/S</b>
Lierop (2011)	Netherland/148/(59)/2007-2009	OLS	<b>N/S</b>
Chen and Li (2011)	U. S., (18,203 firm-year observations of non-financial firms)/1995-2008	Quantile regression	-
Chu and Song (2012)	Malaysia, (196), 2009	2 SLS	+
Dong (2014)	U. S./(7,246), 2012	OLS	+
Cella, Ellul and Gupta (2014)	Indian/ (1023 firms), 7,941 firm-year observations/ 1992-2010	IV-Regression	+
Hassen (2014)	France/(120)/2007-2010	GLS	-
Rasheed et al. (2016)	Pakistan, three firms, 2008-2012	OLS	+
Yusuf, and Abubakar, (2017)	Nigeria, (9), 2006-2015	OLS	-

**Authors' Compilation (2019)**

*Where + signifies positive, - connotes negative and N/S insignificant*

### 3. METHODOLOGY

#### 3.1 Research Design and Model Specification

The study employs a longitudinal research design. The researchers use a secondary source of data collected from the audited financial reports of 40 non-financial firms purposively selected within the period 2010-2018, resulting in 360 firm-year observations. Longitudinal study makes use of panel data, with time series and cross-sectional unit properties. The research design is such that it increases the degree of precision of the estimate as a result of a large pool of data.

#### Earning Management Model

The study measures earnings management by adopting the real earnings management model developed by Roychowdhury (2006), which is suitable for non-financial /real sector as it measures the three activities which could be used to manipulate financial reporting. The activities are: (i) abnormal cashflow (AbCFO); (ii) abnormal production (AbPro), and (iii) abnormal expenses (AbExp). Each activity is measured using the three distinct models adopted from (Roychowdhury, 2006; Demerjian et al., 2017). The three distinct models are:

$$\frac{CFO_t}{A_{avg}} = \alpha_0 + \alpha_t \frac{1}{A_{avg}} \alpha_1 \frac{Sales_t}{A_{avg}} + \alpha_2 \frac{\Delta Sales_t}{A_{avg}} + \sum_{i=1}^n \phi_i FirmFixed_i + \sum_{i=1}^t \delta_i Year_i + \varepsilon_t \quad Eqn (1)$$

$$\frac{PRO_t}{A_{avg}} = \alpha_0 + \alpha_t \frac{1}{A_{avg}} \alpha_1 \frac{Sales_t}{A_{avg}} + \alpha_2 \frac{\Delta Sales_t}{A_{avg}} + \alpha_3 \frac{\Delta Sales_{t-1}}{A_{avg}} + \sum_{i=1}^n \phi_i FirmFixed_i + \sum_{i=1}^t \delta_i Year_i + \varepsilon_t \quad Eqn(2)$$

$$\frac{Exp_t}{A_{avg}} = \beta_0 + \beta_t \frac{1}{A_{avg}} \alpha_1 \frac{Sales_t}{A_{avg}} + \alpha_2 \frac{\Delta Sales_t}{A_{avg}} + \sum_{i=1}^n \phi_i FirmFixed_i + \sum_{i=1}^t \delta_i Year_i + \varepsilon_t \quad Eqn(3)$$

The study measures CFO as cash flow from the operation; PROD is the total cost of inventory produced. The EXP is the summation of research & development and general expenditure. Sales proxies the total turnover for the period and A connotes total assets. The researchers introduce both cross-sectional and time-invariant. The error term,  $\varepsilon_t$  is the residual terms in the Equation 1, 2 and 3. We control for heteroscedasticity by scaling down Equation 1, 2 and 3 by a total assets (see; Roychowdhury, 2006; Demerjian et al., 2017; Zalata, Ntim, Choudhry, Hassanein, & Elzahr, 2019). The real earning management is the sum of the residual in Equation 1, 2 and 3, that is, the sum of abnormal cash flows from operation (AbCFO), abnormal production (AbPro) and abnormal expenses (AbExp).

### Model Specification for Executive Compensation and Earnings Management

The study is premised on the agency and positivity accounting theory and in line with the studies of (Bergstresser & Philippon, 2006; Jiang et. al., 2010). The relationship between the two variables of study is functionally represented in Equation (4):

$$EM_{it} = \beta_0 + \beta_1 \ln(COMP_{it}) + \gamma Controls_{it} + \epsilon_{it} \quad Eqn(4)$$

We represent the earnings management (*EM*) with the summation of the residual in the Equation 1, 2 and 3. The executive compensation (*LN\_COMP*) measures the natural logarithms of the summation of equity and cash base compensation. The study introduces control variables such as firm size (*FIRM*), leverage (*LEV*), board size (*BDS*), industry, year, and implicit claims (*IMP*) (one minus ratio between *PPE* and total assets) to avoid spurious regression. Firm size is measured by the natural logarithm of the total assets; this is consistent with the study of (e.g., Ali, et. al., 2015; Demerjian et. al., 2017). Financial leverage is measured by the ratio of debt scaled down by total assets; this is consistent with similar studies (e.g., Haw, Hu, Hwang, & Wu; 2004; An, Li, & Yu, 2016) on earnings management. The study also introduces board size as a control variable to monitor the activities of the executive; larger board size will result in decreasing earnings management. We predict an inverse association between board size and earnings management, this being in line with the study of (Ye, Zhang & Rezaee, 2010; Gaviols, Segev & Yosef, 2012). Lastly, we also study introduce statutory audit as a control variable, measured by the Big Four. The Big Four consists of the four largest auditing professional practitioners in the world, namely: Deloitte, PricewaterhouseCoopers (PwC), Klynveld Peat Marwick Goerdele (KPMG) and Ernst & Young (EY). It is widely believed that engaging the Big Four in audit assurance service will mitigate against earnings management practices and foster financial reporting quality. This is because of the attributes of the Big Four such as;skilled personnel, technological innovation, experience, international coverage, and a global presence when compared with other audit firms. The Big Four have a higher likelihood of reducing earnings management practices as the managers are well-monitored and the top executives adequately advised on appropriate corporate mechanisms to mitigate against earnings management. Hence, we measure the statutory audit by a dichotomous variable, assigning a value of one if the statutory audit is carried out by Big Four and zero otherwise. The study predicts a negative relationship between the Big Four and earnings management, which is consistent with the study of (Ye, et al., 2010; Fan, et al. 2019). Equation 4 was expanded with the inclusion of specific control variables, resulting in:

$$EM_{it} = \beta_0 + \beta_1 \ln(COMP_{it}) + \beta_2 FIRM_{it} + \beta_3 LEV_{it} + \beta_4 BD_{it} + \beta_5 IMP_{it} + \beta_6 BIG4_{it} + \epsilon_{it} \text{ Eqn (5)}$$

**Apriori Expectation**

$$\beta_1, \beta_2, \beta_3, \beta_4, > 0$$

$$\beta_1, \beta_2, \beta_5 \& \beta_6 < 0$$

**Measurement of Variables**  
**Table 2: Relationship Between Executive Compensation and Earnings Management**

Variable code	Variable name	Measurement of variables
<i>EM</i>	Earnings Management	Summation of residual in Equation 1,2 and 3
$\ln(COMP_{it})$	Executive Compensation	The sum of the cash and equity-based compensation
FIRM_SIZE	Firm size	Natural log of the firm’s total assets.
LEV	Firm’s leverage	total liabilities divided by total assets
BD_SIZE	Board size	Number of persons in the board
IMP_CLAIMS	risk of increasing claims	One minus ratio between PPE and total assets
BIG_4_AUD	BIG four (Deloitte, PwC, KPMG and EY)	An indicator variable where one denotes if a firm has been audited by the big four and 0 if otherwise

**Source: Authors’ Compilation (2019)**

## 4. RESULTS AND INTERPRETATION

### Descriptive Statistics

Table 3 provides information about the descriptive statistics of the dependent and the independent variables of the 40 listed companies selected as sample repeatedly over 2010-2018. The Table displays information such as: the mean, median, skewness, and minimum value, standard deviation, and kurtosis

Table 3 shows that EM has a mean value of 0.00, which is expected as EM is derived from the summation of all the error terms. The sum of the residual in any model is expected to be zero. The variable LN\_COMP only has economic meaning after delogging the natural logarithm value using exponential power. Table 3 depicts that the firms' executive compensation of the selected firms has a maximum value of ₦ 1,386,551,000 and a minimum value of ₦ 300,000, an indication of a wide disparity in executive compensation in the sector. Also, FIRM\_SIZE delogged through exponential power has a mean and (median) value of ₦12, 913,321,000 and (₦16, 148,375,000), respectively, which also indicates that Nigerian non-financial firms are heterogeneous.

The variables EM, LEV and BD are positively skewed, while LN\_COMP, FIRM\_SIZE, IMP\_CLAIMS, and BIG\_4 are negatively skewed. The variables EM, LN\_COMP, FIRM\_SIZE, LEV, BD\_SIZE, are highly volatile because their standard deviations are greater than 1. Meanwhile, IMP and BIG\_4 are lowly volatile because the standard deviation is lower than 1.

**Table 3: Descriptive statistics**

	EM	LN_COMP	FIRM_	LEV	BD_	IMP_	BIG_4_
<b>Mean</b>	0.00	10.53	16.37	0.60	13.44	0.64	0.56
<b>Median</b>	-0.12	10.54	16.60	0.56	11.00	0.68	1.00
<b>Maximum</b>	5.97	14.14	20.76	0.94	48.00	1.00	1.00
<b>Minimum</b>	-4.04	5.70	10.62	0.00	3.00	-0.10	0.00
<b>Std. Dev.</b>	1.10	1.46	2.03	2.24	7.72	0.25	0.50
<b>Skewness</b>	1.11	-0.30	-0.71	6.36	1.47	-0.43	-0.24
<b>Kurtosis</b>	9.54	3.28	3.56	43.42	5.22	2.34	1.06
<b>Obs</b>	320	360	360	360	360	360	360

**Source: Authors’ Computation (2019)**

*Where EM denotes Earnings Management, LN\_comp represents executive compensation, FIRM\_SIZE represents natural logarithms of total assets, LEV represents leverage, BD\_SIZE connote board size, and BIG\_4\_AUD connote auditors type*

**Correlation Analysis**

The correlation matrix in Table 4 shows the degree of association between the variables of the study. There is a significant positive relationship between FIRM\_SIZE and LN\_COMP (Pc=0.52, Prob< 0.05). The result indicates that large firms pay high rewards to their executives, possibly as a deterrent from engaging in opportunistic earning behaviour or as a result of better actual performance results. Also, there is a negative relationship between LN\_COMP and IMP (Pc=-0.13, Prob< 0.05). The Table also shows a positive relationship between LN\_COMP and BIG\_4\_AUD (Pc=0.39, Prob< 0.05), which shows that firms with higher pay package incentives have a higher likelihood to engage the Big four to deter opportunistic executive behaviour. There is also a positive

relationship between FIRM\_SIZE and BIG 4 (Pc=0.275913, Prob< 0.05). The association between firm size and BIG 4 shows that larger firms employ the BIG 4 in their statutory audit; this may be due to complexity and the need to ensure credibility of the financial report. There is a negative relationship between BD\_SIZE and BIG\_4\_AUD (Pc =-0.20 Prob< 0.05). The result of the correlation analysis indicates that there is no evidence of multicollinearity as the Pearson correlation value of all pairwise associations are lower than 0,8.

**Table 4: Correlation Matrix**

	variable	1	2	3	4	5	6	7
1	EM	1.00 (0.00)						
2	LN_COMP_	0.10 (0.12)	1.00 (0.00)					
3	FIRM_SIZE	0.06 (0.35)	0.52 (0.00)	1.00 (0.00)				
4	LEV	-0.10 (0.12)	-0.01 (0.87)	0.03 (0.68)	1.00 (0.00)			
5	BD_SIZE	-0.01 (0.85)	0.03 (0.62)	0.12 (0.06)	-0.08 (0.20)	1.00 (0.00)		
6	IMP_CLAIMS	0.09 (0.17)	-0.13 (0.05)	-0.06 (0.39)	0.01 (0.82)	-0.01 (0.84)	1.00 (0.00)	
7	BIG_4_AUD	0.16 (0.01)	0.39 (0.00)	0.28 (0.00)	-0.02 (0.75)	-0.21 (0.00)	0.20 (0.00)	1.00 (0.00)

**Source: Authors’ Computation (2019)**

Where EM denotes Earnings Management, LN\_comp represents executive compensation, FIRM\_SIZE represents natural logarithms of total assets, LEV represents leverage, BD\_SIZE connote board size, and BIG\_4\_AUD connote auditors’ type. The figure not in parenthesis represents pairwise correlation using person moment correlation while figure in parenthesis represents the probability value

## 5. Interpretation and Discussion of Findings

This section reports the regression estimates of Equation 5 using both panel fixed and panel random effect methods. The study selects the appropriate method using the Hausman test. The fixed effect method, with Hausman's probability value ( $P < 0.05$ ), is the more appropriate model to discuss the relationship between executive compensation and earnings management. The results of the estimates are shown in Table 5. The explanatory power of the model shows that 38% of the variation in the dependent variable is captured by the explanatory variables, while 23% is captured by the variables after adjusting for the loss in degree of freedom. The F-statistic (2.55) with p-value (0.00) of the model shows that the model is different from zero, meaning that it is statistically significant.

There is a negative, but significant, relationship between executive compensation and earnings management with a statistics of ( $t = -2.12$ ,  $\text{Prob} < 0.05$ ). This implies that higher compensation motivates executives to properly discharge their agency duties by putting in place all necessary mechanisms that mitigate against earnings management and, hence, furnish financial reporting devoid of material misstatement. However, lower compensated executives smooth earnings possibly to meet the company target and increase their compensation linked to performance or for benefit, which is constituent with the positive accounting theory. This finding is consistent with the study of (Chen & Li, 2011; Hassen, 2014; Yusuf & Abubakar, 2017), but contrary to the study of, for example, Chu & Song, 2012; Hassen, 2014; Rasheed, Kaynat & Nawaz, 2016). The level of disparity in the pay-package and employment opportunities of the corporate executives could be the rationale for the divergent results of various studies in different environmental settings as environmental and macro-economic factors influence results. For example, in Nigeria, there is a high level of disparity in the compensation plan of companies and there are limited huge pay-package positions for executives. Consequently, executives in highly compensated companies have a higher likelihood of aligning with the shareholders' interests to retain their appointment, rather than engaging in opportunistic behaviour. Also, statutory audit plays a significant role in ensuring that executives engage in income-decreasing earnings management. This is evident in the inverse relationship between statutory audit and earnings management ( $t = -1.19$ ,  $\text{Prob} < 0.01$ ) and consistent with the study of Ye, et al. (2010) and Fan, et al. (2019).

**Table 5: Regression Estimate**

Variable	Fixed Effect			Random Effect		
	Cof	T- Stat	Prob	Cof	T- Stat	Prob
LN_COMP	-0.29	-2.12	0.04**	-0.01	-0.14	0.89
FIRM_SIZE	0.09	0.37	0.71	0.02	0.37	0.71
LEV	-0.65	-1.49	0.14	-0.68	-2.04	0.04**
BD_SIZE	0.01	-0.25	0.80	0.00	0.16	0.87
IMP_CLAIMS	-1.25	-1.91	0.06*	0.07	0.19	0.85
BIG_4_AUD	-1.19	-2.63	0.01***	0.22	1.09	0.28
C	3.46	0.88	0.38	-0.06	-0.07	0.95
R-squared	0.38			0.02		
Adjusted squared	R-	0.23		0.00		
F-statistic	2.55		0.00	0.96		0.45
Hausman	26.50		0.00			

**Source: Authors’ Computation (2019)**

*The Table showed the coefficient, T-statistic, and Prob of Regression from Equation 5, using a Fixed and Random effect. Hausman Test was conducted to choose the Fixed effect method as the most appropriate method. Where \*\*\*, \*\* & \* indicated level of significance at 1%, 5% & 10% respectively.*

## 6 Conclusion

The study investigated the effect of executive compensation on earnings management in the non-financial sector using 40 Nigerian-listed firms from 2010-2018. A longitudinal research design was employed and the data collected was analysed using an OLS. The results indicate that executives with lower compensation engage in opportunistic behaviour, which is consistent with the positive accounting theory, while highly compensated executives engage in income-decreasing earnings consistent with the agency theory. It can be deduced that management with lower compensation, in the Nigerian non-financial sector, engages in opportunistic behaviour to meet or beat the company’s target or for their benefit.

Also, the statutory audit plays a significant role in mitigating against the executives in engaging in opportunistic behaviour. The findings suggest that the

Nigerian non-financial executive compensation plays a significant role in reducing earnings management, which is consistent with the agency theory. The study further shows that earnings manipulation is mostly undertaken by poorly paid managers. The mandatory statutory audit plays a significant role in ensuring that the executives engage in income-decreasing earning management. It is, therefore, necessary to strengthen regulations and impose stricter sanctions on executives who engage sharp practices or manipulate financial statements for their personal gains.

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