

Corporate Governance, Earnings Management and Financial Performance: A Case of Nigerian Manufacturing Firms

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Abstract

Accountants and financial economists have for long identified that corporate governance affects both financial performance and the opportunistic behaviour of managers. Studies on the influence of corporate governance mechanisms on firm performance often overlook the possibility that reported earnings can be misrepresented by managers in order to achieve a variety of objectives. This paper examines the relationship between corporate governance on corporate financial performance when performance is stripped of the discretionary component of accruals. Secondary data were extracted from annual reports of the sample firms for the period between 2008 to 2010 and univariate OLS multiple regression was used as a tool for data analysis. The study documents that corporate governance significantly impact on both the adjusted and unadjusted firm performance in different magnitudes and directions. Specifically, it is empirically established that board composition is inversely related with true performance while a positive interaction emerges between executive compensation and firm performance regardless of the performance specification.

Introduction

Global corporate scandals that took its toll with the collapse of once prestigious companies such as Enron and Worldcom reiterated the need for an investigation into the quality of financial reports and increased the clamouring for a better governance mechanism worldwide. It has been observed by accountants and financial economists that central to these corporate failures is that “there are systematic deficiencies in accounting standards and governance systems that generate financial information” (Bowen, Rajgopal and Venkatachalam, 2003, p.1). In a bid to prevent such future failure of companies, most nations across the globe introduced new codes of best governance practices to align managers interest with the wealth maximization objective of the shareholders. An effective governance mechanism should therefore be capable of converging managers’ decisions (both operating and investment) with that of the shareholders. But, despite the introduction of the codes of best governance practices in Nigeria in 2003 and its continuous modifications, the results that it has achieved can be said to be minimal as there are fresh cases of governance malpractices that threaten the survival of quite a number of firms in different sectors of the economy.

Corporate governance is a mechanism that is employed to reduce the agency cost that arises as a result of the conflict of interest that exists between managers and shareholders. The conflict emanates, almost naturally, because the separation of ownership from control of the modern day business places the managers at a privileged position that gives them the latitude to take decisions that could either converge with or entrench the value maximization objective of the firm. Thus, managers can use their control over the firm to achieve personal objectives at the expense of stakeholders. In this regard, Kang and Kim (2011) note that management could influence reported earnings by making accounting choices or by making operating decisions discretionally. One of such discretionary decisions to manipulate reported earnings is imbedded in the accrual-based accounting.

Accruals are a particularly important tool for manipulative accounting 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” (Bergstresser and Phillippon 2006, p511). Financial reports serve as a mirror through which a firm’s performance is viewed by all its stakeholders. The quality of these reports is contingent upon its reliability in making investment decisions by investors and other interested parties to the firm. Since financial statements reflect performance as well as managerial competence, it is not unlikely that managers will engage in manipulating earnings within the regulatory framework to insinuate that they are good managers. This aggressive accounting practice becomes even more prominent when managerial compensation, such as option and stocks, is tied to firm performance (Bergstresser and Phillippon, 2006; Cornett, McNutt and Tehranian, 2008). Earnings management affects firm performance and can even temper with shareholders’ wealth. The motivation for misrepresentation of firm performance arises because of the conflict of interest between managers and shareholders.

Studies that explored the relationship between corporate governance and firm performance, both in the developed and developing countries, are quite impressive. Also, the interaction between governance mechanisms and financial reporting quality or opportunistic accounting have been considerably discussed. Quite a number of these studies conclude that good governance mechanisms can impact on the discretionary behaviour of managers (Warfield, Wild and Wild, 1995; Klein, 2002). Moreso, previous studies document that boards with more independent outside directors engage less frequently in earnings management through abnormal accruals (Klein, 2002; Xie, Davidson III and DaDalt, 2003). On the contrary, Shehu (2011) find that independent directors are associated with high opportunistic accounting.

Audit committee has also been discussed in relation to earnings management, but it has yielded inconclusive results. Dabo and Adeyemi (2009) find that audit committee is positively related with discretionary accruals in Nigerian manufacturing firms. Institutional investors is another important variable that is often examined by researchers in the corporate governance literature. It is argued that firms with large institutional shareholders are more likely to act in the interest of the investors, because large institutions have more resources and ability to monitor, discipline and influence managers (Hartzel and Stark, 2003). The predominant issue regarding executive compensation seem to suggest that stock-based incentive leads to higher earnings manipulation and insider trading. This argument was empirically supported by Cheng and Warfield (2005).

Although, the magnitude and direction of these relationships vary a great deal according to researchers and the study domains, most of these findings document strong evidences that corporate governance impacts separately on both corporate performance and earnings management. However, taking these two phenomena together, presents a rather complex situation that needs further investigation. In this regard, Cornett et al. (2008) observe that if corporate governance mechanisms impact on both earnings management and firm performance, then the influence of these governance mechanisms on reported performance can be said to be “at least in part merely cosmetic”. Thus, to establish the actual influence of corporate governance on firm performance requires stripping of these performance measures of the influence of discretionary accruals. This gives an insight into the true picture of the impact of governance variables on both the pre-managed (true) and managed (adjusted) performance as it allows the comparison between the two.

To date, little effort has been put by researchers to examine the influence of governance structures on corporate performance when performance is adjusted to take into account the effect of earnings management. Closest to this work are that of Cornett et al. (2008) and Zhu and Tian (2009). Cornett et al. (2008) find that adjusting for impact of earnings management substantially improves the relevance (importance) of governance variables and significantly declines the importance of incentive-based compensation for firm performance. However, Zhu and Tian (2009) find that the coefficient of CEO compensation significantly falls when firm performance is adjusted to exclude discretionary accruals. Their findings also reveal that board composition is more effective towards improving firm performance when actual performance is considered. The few studies that exist in this area of research are products of developed countries that have different regulatory frameworks and governance mechanisms with that of Nigeria. Also, these studies document inconclusive evidences, which calls for an investigation into the Nigerian scenario. This paper, therefore, examines the impact of corporate governance on firm performance, when performance is adjusted to take into account the opportunistic tendencies of managers in listed manufacturing firms in Nigeria.

Particularly, we focus on the importance of corporate governance variables of board composition, institutional ownership, audit committee and executive compensation because there are documented evidences that these variables impact both corporate performance and earnings management. The choice of manufacturing firms is informed by the role that these firms play towards the economic development of Nigeria and the diversity of firm in the sector allows the latitude to study the different firms that are into different lines of businesses within the sample. To achieve this objective, it is therefore hypothesized that corporate governance does not significantly impact on pre-managed firm performance in Nigerian manufacturing firms. The contributions of this work is two-folds. Firstly, it adds to the sparse literature that investigates the relationship between executive compensation and corporate governance, on the one hand, and corporate performance when performance is stripped of the discretionary component of accruals, on the other. Secondly, it extends similar studies that were carried out in the developed countries to the emerging economies such as Nigeria.

The remaining of this work is organized as follows. Section two reviews extant literature related to this study and presents the theoretical framework. In section three, methodological issues are raised and discussed, and the model of the study specified. Section four presents and discusses results. Finally, section five concludes the work and proffers recommendations in the light of major findings.

2.1. Literature Review And Theoretical Framework

Earnings management is the deliberate altering of financial information to either mislead investors on the underlying economic status of a firm or to gain some contractual benefits that depend largely on accounting numbers (Watts and Zimmerman, 1986; Healy and Wahlen, 1999). Accruals are the most important earnings management instruments that are used by managers to either increases 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” (Bergstresser and Phillippon 2003, p511).

The incentives for earnings manipulation have been documented in the literature in a wide variety of contexts. Bhat (1996), linked it to the attempt to enhance shareholders’ value and to maximize executive compensation through income smoothing and earnings management respectively. Healy and Wahlen (1999) note that the incentives to “window dress financial statements” encompass the motivation to increase managers compensation and job security, to avoid the violation of debt covenants, and to decrease regulatory costs or increase regulatory benefit. Income smoothing, occasional big bath, living for today and maximization of variability are identified by Koch and Wall (2000). Most recently, Chang, Shen and Fang (2008) note three incentives to manage earnings. Firstly, because of capital market motivation, which includes initial public offerings, seasoned equity offerings, management buoyant plans and plans for mergers to meet earnings forecast, to smooth earnings, etc. Secondly, contracts motivation such as management compensation, debt agreement or job security also constitute the incentive for earnings management. Thirdly, laws and regulations such as import regulation, industrial regulation, antitrust laws, e.t.c., also can serve as an incentive. Cornet et al. (2008) note that managers use discretionary accruals as a motivation for options (the incentive for bonus income by attaining some level of performance) and affecting stock prices to enhance managers’ wealth through restricted stock compensation. Other incentives for managers’ opportunistic behaviour that are established in the literature include bonus plans, meeting analyst’s expectations or raising funds on more favourable terms (Shah, Zafar and Durrani, 2009).

2.1.1 Board Composition

The composition of the board of directors is expected to play an important role in synchronizing the interest of the managers and that of the shareholders. Corporate governance structure in Nigeria requires that number outside directors on the board should be more than that of the executive directors. Also, the non-executive directors must comprise of independent directors appointed on the basis of experience and competence. Since the outside directors do not possess any interest regarding the shareholding of the firm, in order to maintain their reputation, they are expected to act in such a manner that maximizes the value of the firm. The basic argument is that if board composition, as represented by independent outside directors, affects firm performance positively, then it should be inversely related with earning management. Similarly if it negatively influences corporate performance, then it should be negatively positively with opportunistic behaviour of managers.

The relation between board composition and firm performance have been explored in the literature. Most of these studies are the extension of Weisbach (1988) who investigated the efficiency of CEO monitoring mechanism between inside and outside directors. The work documents that outside directors play a significant role in monitoring CEO. This means that boards that are dominated by outside directors can significantly constrain the opportunistic tendencies of managers and act in a manner that is consistent with the value maximization objective of the firm. In another context, Cornet et al. (2007), examine the impact of corporate governance and pay-for-performance on earnings management. Using 100 largest firms in the U.S. as ranked by S&P between 1994-2003, they find that the presence of independent outside directors reduce earnings management. Similarly, Cornet et al. (2009), investigate how corporate governance mechanism affects earnings and earnings management at large publicly traded U.S. companies for the period between 1994-2002. The study finds that largely independent boards constrain managers' discretionary behaviour. Also, the research conducted by Roodposhti and Chashmi (2010) for the period between 2004-2008 in Iran, using 196 firms listed on Tehran Stock Exchange, revealed a negative association between board independence and earnings management.

On the contrary, Hashim and Devi (2008) examine the relationship between board independence, CEO duality and accrual management in Malaysia. Using 200 top non-financial companies listed on Malaysian Stock Exchange, they find that large proportion of independent executive directors are associated with higher income-increasing earnings management. Moreso, Shah et al. (2009), investigate the relationship between board composition and earnings management in Pakistani listed companies for the period between 2003 and 2007. They find no significant relationship between board composition and earnings management. All the above studies relate to countries that have different regulatory frameworks and different levels of sophistication of corporate governance structure with that of Nigeria.

Overall, it is expected that if board independence can constrain managers to play along the line of shareholders' wealth maximization objective, then it should be positively related to firm performance when the true financial performance is considered rather the reported earnings which could be marred by the impact of earnings management.

2.1.2 Audit Committee

Audit committee plays an important role in monitoring management to protect shareholders' interest. The code of best governance practice in Nigeria requires that the committee should be largely independent, highly competent and possess high level of integrity. It is responsible for the review of the integrity of financial reporting and oversee the independence and objectivity of the external auditors. Audit committee has been explored in prior literature and how it relates to earnings management using various constructs of audit committee effectiveness such as size of the board (Yermack, 1996; Xie et al., 2001), composition and independence (Klein, 2002), audit committee meetings (Beasley et al., 2000), financial expertise of committee members (Kalbers and Fogarty, 1993), and financial motivation of independent directors (Chtourou, Bedard and Corteau., 2001). In the existing literature, (Hassan, 2011) observed that more attention has been given to financial expertise as a construct of board competence. This, he observed, could be misleading as accounting expertise is much more relevant to the board members in the discharge of their duties as a monitoring mechanism.

The results of studies on the relationship between audit committee and opportunistic accounting are inconclusive. Xie et al (2001) investigated the roles of the board and audit committee on earnings management. Using a sample of 282 firm-year observations from the S&P 500 index of each year of 1992, 1994 and 1996, they find that active committee of experienced members, that is members with some financial expertise and/or corporate background is associated with reduced level of discretionary accruals. The disparity in governance structures and regulatory frameworks call for an investigation of similar phenomenon in the Nigerian context. Also, Chtourou et al. (2001) investigate the impact of corporate governance on earnings management in U.S. firms. Using a sample drawn from the population of U.S. firms that appear on Compustat 1996, they find that financial expertise, independent directors and active committee (proxied by board meetings) are inversely related with discretionary accruals. The study uses chi-square as a tool for data analysis, which is a less effective tool for establishing cause and effect relationship.

Finally, if audit committee serves as an effective mechanism in monitoring managers and enhances the quality of financial reports as noted by Klein (2002), it is therefore predicted that it should be inversely related with earnings manipulation and positively related to pre-managed financial performance.

2.1.3 Institutional Shareholding

Institutional shareholders have both the incentive and power to compel managers to act in consonant with value maximization objective of the firm. Shehu (2011) note that institutional ownership has emerged as an important tool for protecting minority interest. This is because large institutions have the opportunity, resources and ability to constrain managers behaviour (Roodposhti and Chashmi 2011) and they also represent ownership concentration in some cases because of their ability to make bulk purchases of the firms equity shares. If this argument can be relied on then institutional shareholding should be positively related with firm performance while it should be inversely related with earnings management. "However, at least in principle, it is possible that managers might feel more compelled to meet earnings goals of these investors and, thus engage in more earnings manipulations" (Cornett, Marcus, Saunders and Tehranian, 2005, p5)

The interaction between institutional shareholding and earnings management has been explored in the literature. Cornet et al. (2008), investigate how governance structure and incentive-based compensation influence firm performance when measured performance is adjusted for earnings management. The study used top 100 firms rated by S&P in U.S., they find that earnings management is significantly reduced by institutional shareholders whether institutional shareholders is measured based on the proportion of shares owned by all institutional shareholders or by institutional involvement in the firm. This finding is an extension of Klein (2002) and the finding of similar work by Cornett et al. (2005). The study might have revealed different result if carried out in the Nigerian context.

2.1.4 Executive Compensation

Agency theory aims at curbing the agency cost that arises as a result of the conflict of interest between owners (shareholders) and controllers (managers) of today's complex business setting. One of the means of reducing the agency cost is executive compensation, which is the settlement to the manager for the commitment towards the success of the firm. This settlement could be either by cash compensation or stock options (bonus plan) or the combination of both. Thus, Executive compensation is the essence agency theory (Dechow and Sloan, 1991). In order to achieve the objective of shareholders' wealth maximization by converging the interest of the managers with that of the shareholders, it only makes sense that executive compensation should be based on firm performance. However, this explicit and implicit executive compensation contracts also serve as an incentive for managers to use accounting judgement to increase earnings-bonus awards (Zhu and Tian, 2009). Thus CEO pay-for-performance can have a significant influence on the manipulation of reported earnings.

The interaction between executive compensation and the discretionary behaviour of managers is sparsely explored. Cornett et al. (2008) investigated the impact of CEO pay-for-performance and earnings management as it affects corporate performance. Using a sample of top100 firms listed on S&P for the period of 1993 to 2003, they find a strong and robust relationship between incentive-based compensation and conventionally reported measures of firm performance. However, the profitability measures that are adjusted for the influence of discretionary accruals reveals a far weaker relationship. In the same vein, Zhu and Tian (2009) examined the relationship between CEO pay-performance and firm performance, when performance is adjusted to consider the impact of earnings manipulation. With a sample consisting of 22 industrial firms, the study documents that the influence of CEO compensation declines drastically when performance is stripped of the effect of opportunistic accounting. In another context, Kang and Kim (2011) investigated whether earnings management amplifies the association between corporate governance and firm performance. Using 1,104 firm-year observation, excluding nonfinancial firms listed on Korean Stock Exchange between 2005 to 2007, the study finds that board of directors compensation, which includes salaries, bonus and stock option is positively associated with real-activity based earnings management. This suggests that the link between executive compensation and firm performance can be amplified by earnings manipulation that is engendered by genuine transaction. The truncation of the top and bottom 1% of the sample distribution to avoid outliers underscores the effect of firm size on both earnings manipulation and corporate performance.

Agency theory provides the natural backdrop upon which this study is based. The theory explains the relationship that exists between managers and shareholders as a result of the separation of ownership from control of the modern day business. Theoretically, the manager is supposed to act in such a manner that tallies with that of the shareholders. However, this is not always the case as the manager enjoys some privilege information that makes it possible to pursue his own interest at the expense of that of the shareholders. This may eventually temper with the value maximization objective of the firm. If corporate governance mechanisms are effective, the interest of both the owners and controllers of firms' resources are expected to converge. This means that governance variables should be positively related with financial performance and inversely related with opportunistic tendencies of managers.

3.1. Methodology, Model Specification and Robustness Test

This paper is a correlational research that links the corporate governance mechanisms of board composition, institutional shareholding, audit committee governance score and executive compensation to pre-managed firm performance. In order to achieve this objective, it is pertinent to link the explanatory variables to three dependent variables, i.e., earnings management (discretionary accruals), reported financial performance (earnings before interest and tax) and true financial performance (reported financial performance less discretionary accruals). The sample consists of 25 non-financial firms listed on the Nigerian Stock Exchange (NSE) for the period between 2008 to 2010, making 60 firm-year observations. The choice of sample firms was motivated by data availability from the sample firms for all the variables included in the model.

3.1.1 Earnings Management

Consistent with prior studies (such as Dechow, Sloan and Sweeney 1995 and Jaggi and Leung, 2007), a cross-sectional regression of the modified Jones Model (1991) to obtain the discretionary component of accruals. The choice of the modified Jones model (1991) was informed by the argument of Dechow et al. (1995) who note that the model is more powerful in detecting earnings management among the existing models. Total accruals (*TACC*) is defined as the difference between net income (*NI*), which is the earnings before taxation and extraordinary item and cash flow from operating activities (*OCF*).

$$TACC_i = NI_i - OCF_i \dots \dots \dots (i)$$

$$TACC_{it}/A_{it-1} = \alpha_t[1/A_{it-1}] + \alpha_{1i}[(\Delta REV - \Delta REC)/A_{it-1}] + \alpha_{2i}[PPE_{it}/A_{it-1}] + \varepsilon_{it} \dots (ii)$$

Where *TACC* is the total accruals (*NI - OCF*), *ΔREV* is change in revenue, *ΔREC* is change in receivables, *PPE* is property, plant and equipment and *ε* is the residual. To control for heteroskedasticity, all variables are scaled by previous years total assets. Al-Fayoumi, Abuzayed and Alexander (2010) note that change in revenue is included to control for economic circumstances of each firm in the sample, while gross plant, property and equipment are included to control for the total proportion of accruals relating to non-discretionary expenses.

Earnings management is measured by the discretionary accruals, which is obtained by making the error term from equation (ii) the subject of the formula. Consistent with Cornett et al. (2008), the study uses absolute abnormal accruals to proxy for earnings management. The positive or negative value is irrelevant because earnings management eventually has to be reversed thus the best measure for discretionary accruals is the absolute value of it (Klein, 2002; Bergstresser and Philippon, 2006). Therefore, discretionary accruals (*DA*) is estimated as:

$$DA_{it} = TACC_{it}/A_{it-1} - \alpha_t[1/A_{it-1}] + \alpha_{1i}[(\Delta REV - \Delta REC)/A_{it-1}] + \alpha_{2i}[PPE_{it}/A_{it-1}] \dots (iii)$$

The larger the value of the discretionary accruals, the higher the presence of earnings manipulation and vice-versa.

3.1.2 Financial Performance

The study uses earnings before interest and tax (EBIT), which is the ratio of profitability to capital employed, to measure for firm performance. This proxy is often used by researchers to represent corporate performance. Cornett et al. (2008) observed that EBIT is capable of being manipulated by managers through accruals involving sales and account receivable and the treatment of depreciation and amortization.

3.1.3 True Financial Performance

In recognition of the possibility of managers to misrepresent financial performance through the use of discretionary accruals, the study estimates true financial performance by the residual of EBIT over discretionary accruals. This is consistent with Cornett et al. (2008) who note that because the discretionary component of accruals is eliminated, changes in this measure should reflect true performance rather than mere cosmetic influence of on reported performance. True financial performance, therefore equals EBIT less discretionary accruals.

3.1.4 Independent Variables

Next, the corporate governance variables (board composition, institutional shareholding, audit committee and executive compensation) and their proxies are presented. All variables, except audit governance score, which is obtained as a dummy variable, are expressed as a percentage which is consistent with prior studies such as Shehu (2011). Moreso, Zhu and Tian (2009) expressed discretionary accruals as a percentage.

Board Composition (X_1) is the ratio of independent outside directors to total board size (Hassan 2011).

Institutional Shareholding (X_2) is the ratio of equity shares of the firm held by institutional investors to the total shares outstanding.

Audit Committee (X_3) is measured by the audit governance score, which sums the effect of the most used governance characteristics of audit committee size, audit committee independence and board meetings. The study adopts the governance score as used by Shehu (2011) to measure for the overall strength of the board. It is therefore measured as follows:

Audit committee size: Zhou and Chan (2004) observe that a larger audit committee with increased organizational status and power delegated by the board of directors is more likely to be recognized as an authoritative body by the management and the external and internal auditors. Therefore, 1 is coded for sample firms that have more than three directors on the committee and 0 otherwise.

Audit committee independence: substantial evidence exists in the literature that established that audit independence has a positive relationship with the contents of financial reporting (Klein, 2002). The use of discretion to manage earnings can be directly linked to the audit independence depending on their choice of a course of action. Thus, the value 1 is coded for sample firms that compose of all independent directors during the year and 0 otherwise.

Audit committee meeting: The number of times the audit committee meets during the year represents the effectiveness of the monitoring role of the board. Audit committee effectiveness can be measured by the number of meetings (Menon and William, 1994). Therefore, we code 1 for sample firms that meet at least four times during the sample year and 0 otherwise.

To obtain the audit committee governance score, the three dichotomous variables are summed up. Then 1 is coded for a sample firm whose ACS is greater than 1 or equal to 2 (indicating strong audit governance) and 0 otherwise.

Executive Compensation (X_4) is the natural log of cash compensation. The study concentrates on cash compensation rather than stock and stock options because few of the sample firms disclose that report. Therefore, consistent with Zhu and Tian (2009), we focus on total cash compensation, which is the aggregate of cash and bonus salaries. The natural log, $\ln(\text{excom})$, is used to control for heteroskedasticity.

Firm Size (D_1) is used in this study to control for the likely impact of firm size on the discretionary accruals of the sample firms. It is defined as the natural log (\ln) of total asset. It is argued that the larger the firm size the higher the expected agency problem that the firm is likely to experience. Also, given the fact that large firms have more resources and earn higher profit, Grey and Clarke (2004) note that they are more likely to avoid managing earnings through discretionary accruals. Quite a number of studies control for firm size including Zhu and Tian (2009) and Shehu (2011).

The univariate multiple regression equation model is:

$$Y_{1-3} = \alpha_0 + \alpha_1 X_{1it} + \alpha_2 X_{2it} + \alpha_3 X_{3it} + \alpha_4 X_{4it} + D_1 + \varepsilon_{it} \dots \dots \dots (iv)$$

Where Y_{1-3} are the dependent variables of absolute discretionary accruals, earnings before interest and tax and earnings before interest and tax less discretionary accruals. α_0 is the intercept, α_{1-4} is the coefficient of the independent variables, $X_1, X_2, X_3,$ and X_4 are the independent variables of board composition, institutional shareholding, audit committee strength and executive compensation respectively, D_1 is the control variable (firm size) and ε is the regression residual.

4.1. Result and Discussions

In this section, the study’s results are presented and discussed. The descriptive statistics are first presented, then followed by the regression results.

Table 1: Descriptive Statistics (Dependent Variables)

Variables	DA	ADA	EBIT	TEBIT
Mean	-11.06797	19.49007	.2130406	.3210006
Std. Dev.	23.87505	17.55828	.2596906	.3506488
Min.	-61.66185	.0303349	-.1588726	-.7745985
Max	69.23753	69.23753	1.560356	1.652156
Observ.	60	60	60	60

Source: Result Output Using STATA

Table 1 above is the summary statistics of dependent variables- absolute discretionary accruals (ADA), reported financial performance (EBIT) and true financial performance (TEBIT). The inclusion of signed discretionary accruals is just compare its values with that of absolute discretionary accruals in the light of previous studies of similar nature. The result reveals that the average signed discretionary accruals is -11.06797. This implies that on the average the sample firms manage accruals downward (income-decreasing accruals). Cornett et al. (2006) argue that because discretionary accruals must eventually be reversed, their average value over a long period should be near zero. Therefore, the possible reason for the wide deviation of the average from zero in our case could be attributable to the fact that the sample year consist of 3 years which is not a period long enough to make the value hover around zero. The average value of the absolute discretionary accruals is 19.49 which is wide disparity from that of the signed discretionary accruals.

Further, the average value of the reported financial performance is 0.21, ranging from -0.16 to 1.6. This is a lower value when compared with the average of true financial performance, which is 0.32 and lying between 0.77 to 1.7. Overall, except for the signed discretionary accruals there is no large difference between the means and the standard deviations. This is an indication that the data is normally distributed and is fit to produce a reliable result.

Table 2: Descriptive Statistics: (Independent Variables)

Variables	BC	IS	AC	EXCOM	FSIZ
Mean	16.2599	20.3727	.483333	2.039939	15.55328
Std. Dev.	9.954195	20.74949	.503939	2.522199	2.077973
Min.	0	1.2	0	3.068000	11.08903
Max.	33..3333	79.2	1	9.890003	17.98697
Observation	60	60	60	60	60

Source: Result Output Using STATA

Table 2 is the summary statistics of the explanatory variables. The average of board composition (independent outside directors) is 16.3% with the minimum of zero and a maximum of 33.33%. The result indicates that there is weak presence of independent outside directors on the board of directors of our sample firms. Institutional shareholding averages 20.4%, ranging from the extreme values of 1.2% and 79.2% of total equity ownership. This implies that while some firms are substantially owned by institutional investors, others are almost wholly owned by individual investors.

The average of the audit governance score of the sample firms is as high as 0.49, which is quite impressive. Ranging from 3.07 to 9.9 million Naira, executive cash compensation averages 2.04 million per annum. Finally, the average firm size, which is the nature log of total assets is 1.6 billion Naira, ranging between 1.1 to 1.8 billion. Here also, the disparity of all the means from their standard deviations is minimal, indicating that the data are not positively skewed and are fit to produce result that is reliable.

Table 3: Correlation Matrix

	BC	IS	AC	EXCOM	FSIZ
BC	1.0000				
IS	-0.2146	1.0000			
AC	-0.3051	0.3196	1.0000		
EXCOM	-0.2727	0.2797	0.2939	1.0000	
FSIZ	-0.3350	0.2133	0.1651	0.4515	1.0000

Source: Result Output Using STATA

The correlation matrix table above shows the relationship between all pairs of independent variables in the study model. The result reveals that board composition (BC) is inversely correlated with all other independent variables. While the other independent variables appear to have positive correlation with each other. This calls for an investigation of the possibility of multicollinearity. The multicollinearity test using the variance inflation factor (VIF) indicates absence of excessive correlation as all factors are above 1.0 and tolerance values are below 10. The mean of the VIF is 1.27. Further, the diagnostic statistics obtained from White's heteroskedasticity test indicate that the regression model performs properly. The results are not shown for brevity.

Summary of Regression Results

Next, the summary of three set of regression output are presented. Each of the dependent variables of absolute discretionary accruals (earnings management), earnings before interest and tax (firm performance) and earnings before interest and tax less discretionary accruals (true financial performance) are regressed against the explanatory variables of board composition (BC), institutional shareholding (IS), audit governance score (AC) and executive compensation (EXCOM). Nature log of total asset is used to control for the likely impact of firm size on both discretionary accruals and firm performance.

Table 4: Regression Results: absolute discretionary accruals (ADA) is the dependent variable

Variable	Coefficient	Std. Err.	T. Test	Prob.
Intercept	64.18416	20.89285	3.07	0.003***
BC	-.6503493	.2363201	-2.75	0.008***
IS	-.239257	.1110623	-2.15	0.036**
AC	1.937509	4.674368	0.41	0.680
EXCOM	-1.74414	1.121401	-1.56	0.126
FSIZ	-.259116	1.184727	-0.22	0.828
Adj. R-square	13.82			
F-Statistic	2.89			
Prob. of F	0.0219**			

Source: Result Output Using STATA. (***) and ** indicate 1% and 5% significant levels respectively).

Table 4 above is the summary of regression result where absolute discretionary accruals is the dependent variable. The result indicates that board composition is inversely related with opportunistic accounting and is significant at 1%. The relationship between institutional shareholding and the discretionary behaviour of managers has also been revealed to be negative and significant at 5%. A positive association between audit governance score and absolute discretionary accruals has emerged, but the interaction is not statistically significant. It is also perceived that executive compensation is inversely related with earnings management but this relationship is not economically significant. The impact of firm size on earnings management is also negative but not robust. The negative association that emerges between board composition and earnings manipulation extends the finding of Weisbach (1988) who documents that outside directors play a significant role in monitoring the CEOs and influence them towards the realization of the wealth maximization objective of the firm.

It also conforms with the finding of Cornett et al (2008) who used 100 largest US firms to establish that outside directors reduce earnings management. Roodposhti and Chashmi (2010) also find the same results using 196 Iranian firms listed on the Tehran Stock Exchange. However, it contradicts that of Hashim and Devi (2008) who used Malaysian sample to reveal that outside directors reduces the opportunistic tendencies of managers. This revelation is hardly surprising because the independent outside director does not possess any interest with the firm and he is appointed based on expertise and integrity. It is only natural to assume that such a director will act in such a manner that does not temper with his integrity. The study therefore concludes that in the Nigerian case and within the sample firms, boards dominated with independent outside directors constrain managers in their use of discretion to alter reported earnings, thereby converging the managers' interest with that of the shareholders.

Regarding institutional shareholding, the study documents an inverse relationship between it and discretionary accruals. This seems to support the view that institutions have more resources to monitor and discipline managers to act in such a manner that is in tandem with minority shareholders' interest (Hassan, 2011; Roodposhti and Chashmi, 2011) and they also have financial expertise that enables them to detect the opportunistic behaviour of managers (Grey and Clarke, 2004). Interestingly, our finding extends that of Shehu (2011) who used a sample of quoted Nigerian banks to establish a positive relationship between institutional investors and financial reporting quality. It also conforms with the findings of Cornett et al. (2005 and 2008) who used US samples to document the same results. This study therefore concludes that institutional investors can go a long way in curbing the opportunistic tendencies of managers and reduce agency cost. The large ownership of the total equity shares some of the firms explains the ability of the firms to make bulk purchases. Since they hold a substantial amount of equity ownership it is not unlikely that institutions will employ resources to protect their huge investments. Overall, the adjusted R-square is approximately 14%, indicating that corporate governance explains the opportunistic tendencies of managers to the extent of 14%, while 86% is explained by other factors not captured in the model. The F-statistic value is 2.9 and is significant at 5%. This result indicate that the model is fit and is the study findings can be reliable.

Table 5: Regression Result (EBIT is the dependent Variable)

Variable	Coefficient	Std. Err.	T. Test	Prob.
Intercept	-57.58487	22.22886	-2.59	0.012**
BC	-.2340434	.2514318	-0.93	0.356
IS	-.6073599	.1181643	5.14	0.000***
AC	6.083922	4.973275	1.22	0.227
EXCOM	3.938637	1.19311	3.30	0.002***
FSIZ	.5352426	1.260486	0.42	0.673
Adj. R-square	0.5540			
F-Statistic	15.66			
Prob. of F	0.0000***			

Source: Result Output Using STATA. (***) and ** indicate 1% and 5% significant levels respectively).

Table 6: Regression result (EBIT-DA is the dependent variable)

Variable	Coefficient	Std. Err.	T. Test	Prob.
Intercept	-86.3234	31.48868	-2.74	0.008***
BC	-.9889952	.35617	-2.78	0.123
IS	.2619498	.1673877	1.56	0.101
AC	13.52916	7.044979	1.92	0.033**
EXCOM	3.69626	1.69012	2.19	0.19
FSIZ	4.321109	1.785563	2.42	0.008***
Adj. R-square	0.5092			
F-Statistic	13.24			
Prob. of F	0.0000**			

Source: Result Output Using STATA. (***) and ** indicate 1% and 5% significant levels respectively).

Tables 5 and 6 are summaries of regression results where the impact of corporate governance on firm reported performance and unmanaged (true) financial performance are respectively examined.

The true performance is stripped of the influence of opportunistic managerial behaviour, which is expected to reflect the true influence of the corporate governance variables on performance rather than investigating the impact of the variables on reported performance, which could be merely cosmetic.

The coefficients of board composition are negative in both cases, but it is not statistically significant when reported firm performance is considered. This implication of this is that high proportion of outside directors actually tempers negatively with the firm performance and the influence is much when actual performance is considered. This explains the dramatic increase of the coefficients from 0.23 to 0.98 which is consistent Cornett et al. (2008) and Zhu and Tian (2009). The finding supports the argument that the independent outside directors may be more inclined to please those that appoint them on the board rather than discharging their fundamental monitoring role with utmost sense of integrity. It can therefore, be concluded, contrary to expectation that outside directors have a colliding interest with managers which leads to the expropriation of shareholders' wealth.

The association between institutional shareholding and firm performance in both cases are positive. However, it is not significant when true performance is the explained variable. The implication of this is that, although it is positive in both measures of performance, the importance of institutional investors may have been exaggerated when reported performance is marred by the effect of discretionary accruals. This fact could be explained by the sharp decline in the coefficient from 0.6 in the case of reported performance to 0.2 in true performance. The finding contradicts Klein (2002) and Cornett et al. (2008) who both concluded that institutional investors serve to constrain firm discretion regarding accruals. Our earlier finding of the inverse relationship between institutional shareholding and earnings management could be attributed to the use of absolute discretionary accruals to proxy for opportunistic accounting. Perhaps a different result could have been obtained when signed discretionary accruals was used.

An interesting finding is documented regarding the impact of executive compensation on firm performance. Executive compensation appears to have a positive and significant influence on both the two performance measures. However, the coefficient declines from 3.9 when reported performance is taken into consideration to 2.6 when performance is adjusted for the impact of discretionary accruals. Thus it is perceived that management influence on reported performance is a bit exaggerated. But regardless of the specification, the higher the compensation value (cash compensation in this case) the higher the financial performance of the firm. The study outcome conforms with the finding of Kang and Kim (2011) who find that the link between executive compensation, which includes salaries, bonus and option, and firm performance can be amplified by earnings manipulation that is engendered by genuine transaction. It is also partly consistent with the Cornett et al. (2005) who used U.S sample to document that option compensation has a dramatic impact on pre-managed firm performance. However it contradicts the same work in the conclusion that its impact disappears in the face of true financial performance. The study also contradicts Zhu and Tian (2009) who used Chinese sample to document a result that is largely an extension of Cornett et al. (2005 and 2008). It is therefore concluded that although the coefficient significantly declines, it can not be ascertained that the influence of executive compensation on performance in the Nigerian manufacturing firms is not merely cosmetic, but it can be said to exaggerated.

Looking at the relationship between audit committee strength and firm performance, the study documents positive but insignificant relationship between the two in both regressions. Thus there is no statistical evidence to establish the influence of audit committee and performance regardless of the performance measure. This finding is also consistent with Cornett et al. (2008) and Zhu and Tian (2009).

The control variable reveals a positive interaction with performance in both cases. However, the impact is robust only when true performance is the explained variable. This result also extends the findings of Cornett et al. (2008). It is therefore concluded that because large firms have more investment opportunities, among other reasons, it is capable of making profits higher than that of its smaller counterparts.

Overall, in both cases R-square adjusted hovers around 50% meaning that corporate governance variables explains both measures of firms performance to a large extent. The F-values are both above 10 and significant at 1%. This is an indication that the model is fitted and the study findings can be relied upon. It is therefore glaring that corporate governance has a significant impact on firm performance regardless of whether reported performance is merely cosmetic or it depicts the true economic realities of the firm.

Conclusion and Recommendation

The interaction between corporate governance and earnings management, on one hand, and corporate governance and firm performance, on the other, have been documented in the literature. But when these two strands of literature are taken together, a rather complex situation emerges that need further investigation. The actual influence of governance variables on performance requires stripping the performance measure of the influence of discretionary accruals. In this paper, it has been documented that corporate governance impacts on financial performance when performance is considered to take into account the opportunistic tendencies of managers. Based on the study findings, it is recommended that the appointment of independent directors on the board should be based on the previous records of those directors rather than emphasizing on the proportion to total number of directors on the board. Also, recommended that executive compensation should be less aggressively linked to performance to the extent that it does not induce managers to manipulate reported earnings to improve their compensation as its influence on corporate performance is perceived to have been exaggerated.

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