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Influence of Board Political Connection on Earnings Management among Quoted Manufacturing Companies in Nigeria

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Abstract

Purpose- *This study examined the influence board political connection on earnings management among quoted manufacturing companies in Nigeria.*

Method-*This study was an expost-facto type of research and covered time frame of 5 years from 2015 to 2019. A total of 47 manufacturing companies constituted the sample size. Data used were obtained from financial statements of the sampled manufacturing companies. Statistical tool used include descriptive statistic, correlation and regression. In calculating earnings management, Jones model was applied for nondiscretionary accruals in the event year.*

Findings-*The study revealed that board political connection has significant influence and positive relationship with earnings management among quoted firms in Nigeria.*

Contribution-*The study contributed to knowledge by applying Jones model in calculating nondiscretionary accruals in the event year and establish that companies whose board members are politically connected should not downplay accounting practices and reporting standards that are applicable and eschew from any form of deceptive activities that will be detrimental to the going concern of their organizations.*

Keywords: Earnings Management, Discretionary accrual and Board Political Connection

Introduction

Over the years earning management has been common practices among organizations around the world (Umobong & Ironkwe, 2017). Earnings management is a means used by executive directors of companies to manipulate earnings by employing particular accounting techniques capable to increase expenditure or income transaction, or employing some means structured out to enhance earnings (Isenmila & Afensimi, 2012). Earnings management are carried out by directors of companies in order to attract investors, to avoid payment of correct tax to government, managerial compensation, loan covenanting, dividend income and future capital appreciation, insider dealings etc. Earnings Management is deceptive, but does not go against generally accepted accounting principles (GAAPs) (Haryudanto & Yuyetta, 2011). Calibers of persons that constituted the board of directors of companies are crucial in promoting earnings management activities.

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Companies that are political in mode of operation are generally alleged to exhibit poor corporate governance practices and it is believed to be dangerous by stakeholders such as auditors and lenders (Bliss & Gul, 2012a) Directors with political connection are believed in encouraging earnings management in companies (Hemdan, Hasnan & Rehman, 2021). A board of company with high percentage of politically connected members could bring about issues of manipulating of financial statement (Watts & Zimmerman, 1990; Huang et al., 2012). Political board member can easily obstruct information that firms bring to the notice of the market (Boubakri et al., 2012; Chaney et al., 2011).

Earnings management can bring about information asymmetry which further increases the agency problem (Mamo & Aliaj, 2014). Hemdan, et al., (2021) noted that political connection aids mechanism that can increase agency problems indicating that companies that are more politically connected could have more agency conflicts compare to others that are not.The practice of earnings management may distort the truthfulness and fairness of the reported statement of income and financial position, and this could form a basis for severe corporate collapse (Mahmia, 2017). Financial distress experienced by some firms in the past like Enron in 2001, WorldCom in 2002, Cadbury PLC 2006 and by some deposit money banks in 2008 in Nigeria have shown the unpleasant side of earnings management practices and deficiency of the board (Hauwa, Ocheni, & Muktar, 2017).

Most studies on board political connection as could relate to earnings management were conducted mostly in some developed and in Asia countries (Alhadab, Abdullatif, Ahmed, Tahat. and Mansour, 2020; Anggraini & Widarjo, 2020). The closely related studies from Nigeria were by Osazuwa, Che-Ahmad and Che-Adams (2018) who investigated political connection, board characteristics and firm performance in Nigeria and found that board politically connected companies have negative relationship with performance; Osamwonyi and Tafamel (2013) examined firm performance and board political connection and found no association with board political connection and firm performance. The extant studies were divergent in their outcomes. Again to the best of the researchers' knowledge, studies from Nigeria have not specifically examined the effect and show the nexus between board political connection and earnings management in Nigeria which this study desires to bridge the gap in knowledge. The specific objectives are to examine the influence board political connection on earnings management activities of listed manufacturing firms in Nigeria. The remaining parts include literature review, methodology, results and discussion, and conclusion.

Literature Review

Concepts of Earnings Management

Earnings management is called different names like earnings manipulation, window dressing, cooking the book and income smoothening. Amat and Gowthorpe (2004) observe that earnings management is commonly used in the United States of America (USA), whereas creative accounting is a more preferred term in Europe countries. Healy and Wahlen (1999), posit that earnings management arises as a result of ways executive directors employ high level strategic judgment in financial reporting and manner of organizing dealings in such a way to deceive owners or dispersed stakeholders of the firm financials or to manipulate predetermined outcomes that relied on the reported accounting numbers.

Earnings management addresses issues that are concerned with manipulations of methods, techniques and principles of accounting and reporting to achieve directors' desired goals. It is an unethical means of achieving a preferred required earnings by employing different accounting methods (Bello, 2011). Omoye and Eriki (2014), state that earnings management entails the use of discretion in changing the regular operational activities of the company in order to achieve certain desired goals. Incentives for earnings management are the manipulations of bonus plans and debt covenants, capital markets, the political and regulatory processes which could influence earnings positively or negatively. Earnings management is employed using five common strategies and techniques such as Big Bath, Cookie Jar Reserves, Operating activities, Materiality and revenue Recognition methods. Similarly, there are two basic types of earnings management which include accrual earnings management (AEM) and real earnings management (REM).

Board Political Connection and Earnings Management Relationship

Some board members of a company have affiliation or politically connected with government in one way or the other and this can give opportunity for them to engage in some kinds of activities that will benefit their organisations. According to Faccio (2006), a politically connected firm is a situation thereby a very few among the investors or majority interest or top management is a minister or a parliamentarian or is otherwise related to a politician or affiliated to a political party. The issue of board political connection is more prominence or common in developing countries with Nigeria inclusive (Poon, Yap & Lee, 2013; Osazuwa, et al., 2016). Board political connection companies exhibit some members in the board that have received political title like Ex-President, Ex-Governor, Ex-Commissioner or have received State or National merit awards like Justice of Peace (JP), Grand Commander of the Order of the Niger (GCON), Order of the Federal Republic (OFR), Member of the Order of the Niger (MON), Member of the Federal Republic(MFR),Officer of the Order of the Niger (OON), Commander of the Order of the Niger (CON) as the case may be.

Nurul, Nor, Fazrul and Zuraidah (2020) noted that board politically connected companies can easily redirect the management towards reducing expenses in the firm. In Indonesia, Habib et al. (2017b) claimed that companies which are politically connected use associated parties in tunneling resources, and on the other hand managing earnings to disguise their tunneling activities. In the USA, Xu et al. (2019) posited that companies situated in corruption countries or areas involve more in earnings management by way of accrual-based earnings management (AEM) and real earnings management (REM). Hemdan, et al., (2021) argued that directors of firms with political connections can easily engage in earnings management activities because the political influence and connections enable them to push for things that favours the organization and personal interests in the place. Khwaja and Mian (2005) showed that political connection of a company can affect transparency, credibility, integrity, accountability and could give rise corruption level, particularly in developing countries of the world. Braam et al. (2015) revealed that firms which are politically connected always give support to real earnings management (REM) practices owing to its likely possibility of attracting political favors. Sani,. Abdul Latif, and Al-Dhamari, (2020), examined CEO choice on the real earnings management by using generalized method of movement and Driscoll–Kraay panel data regression as the statistical tools for analyzing and found that directors with political connections and power significantly influence earnings management practices an organisation. Alhadab, et al., (2020) investigated political connections and government ownership on accrual and real earnings management among Jordanian listed companies. A total of 310 companies constituted the sample observations and revealed that political connections companies increase the level of real earnings management when evaluated with companies without political connections in Jordan. Also, the study showed that government-connected companies have influence in reducing accrual and real earnings management when assessed with non-government connections companies. Armaya, Rohaida and Redhwan (2021) carried out a study to examine the influence of corporate board monitoring on real earnings management practice in Nigeria by employing 385 observations of listed companies from 2012 to 2016. It employed Driscoll-Kraay standard error regression and found that directors with political connections have significant influence and positive relationship with real earnings manipulations. Following the outcome of extant studies, the study hypothesized that: H0: Board political connection has no significant influence on earnings management among listed manufacturing companies in Nigeria.

Theoretical Framework

Agency theory anchors this study. Jensen and Meckling propounded the theory in1976 and was structured out to resolve agency problem that existed between shareholders and management Jensen and Meckling (1976) noted that agency is seen as an agreement that exist between the principal (owner) and the agent (management), such that the agent is delegated some power to undertake certain activities on behalf of the principal. This theory sets out that the principal (shareholders) are the owners of the companies, while the agent is management or appointed executive directors mandated with the authorities and responsibilities to carry out tasks of the company (Clarke, 2004). The agency theory claims that agents (managers) would want to act on their selfish interest, rather than that of the shareholders' due to those that run the firm are different from the owners (Jensen & Meckling, 1976). But a well constituted board structure which could act as corporate governance mechanism are essential in addressing agency problem.

On this basis, the theory stipulates that management or board of directors may not want to make decisions in the best interests of owner rather for personal gains (Padilla, 2002). The separation between shareholders and directors could end up in conflict (Aguilera, Filatotchev, Gospel & Jackson, 2008). The dichotomy between shareholders and directors of companies create moral hazard and adverse selection challenges. As ways of showing efficiency in performance to the owners' resources management or directors could be involved in earnings management activities. In effect, the managers of the firm may pursue personal objectives at the expense of the owners (Hart, 1995), but corporate governance information which are issues of the board of directors in firm's annual reports can assist to reduce the notion. Agency problems are common issues with political connected companies, which could bring about poor earnings quality (Al-Dhamari & Ismail, 2015). In the angle of agency theory, earnings management is a deceptive and opportunistic behavior employed by management to achieve personal agenda.

Methodology

It is expost facto type of research covering time periods of 2015 to 2019. A total of 47 sampled manufacturing firms are selected through purposive sampling method. Data used are obtained from financial statements and accounts of the sampled companies

In calculating earnings management, Jones model was applied. The Jones (1991) model for nondiscretionary accruals in the particular year of event is given below as:

$NDA_t = \alpha_1 \left(\frac{t}{At-1} \right) + \alpha_2 \left(\frac{\Delta REVt}{At-1}\right) + \alpha_3 \left(\frac{PPEt}{At-1}\right)$ .... (1)

Where;

NDA_t = Non-Discretionary Accruals (NDA) for year *t* divided by total assets for the year as t-1

ΔREV_t =Change in revenue is measured as revenue in year *t* less revenue for the year as *t - 1*;

PPE_t = Gross total of the property plant and equipment as of the end of year *t*;

A_{t-1} is total assets at the end of year *t - 1*; and α_1, α_2, α_3 are company-specific factors.

Estimations of the company-specific factors which are also known as parameter, α_1, α_2, and α_3, are achieved by employing the model below:

$TA_t / A_{t-1} = a_1 \left(\frac{1}{At-1} \right) + \alpha_2\left(\frac{\Delta REVt}{At-1}\right) + \alpha_3\left(\frac{PPEt}{At-1}\right) + \varepsilon_t$ .... (2)

Where,

a_1, a_2, and a_3 symbolize the ordinary least square estimations of α_1, α_2, and α_3, and TA_t is total accruals in year *t*. ε_t is the residual, stands for the company-specific discretionary portion of total accruals".

The model for this study is specified as:

$DA=\alpha_0+ \beta_1 BPC_{it}+e$...(3)

Where:

DA= Discretionary accrual as proxy for earning management

α_0 =Constant

β_1=Coefficient

BPC_{it}= Board political connection of firm "I" at time "t". [Board political connection is operationally measured as "1" if a board member has political title, otherwise is "0" (Osamwonyi & Tafamel, 2013; Osazuwa, *et al*., 2016)]

e = error term

Data Analysis

Results of data analyzed are presented in various Tables and interpreted accordingly.

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
DA	235	-20.91173	60.13092	-79.47	13.64
BPC	235	.7115385	.4541399	0	1

Table 1 describes the profile of the variables. It is observed that discretionary accrual (DA) used as a proxy for earnings management indicated minimum and maximum values of -79.47 and 13.64, while the mean indicated negative value of-20.912 about -21% and standard deviation of 60.13units respectively implying that there is high effect of earnings management among the sampled manufacturing companies. Board political connection (PBC) showed minimum and maximum values of 0 (meaning that some companies are not politically connected) and 1 (indicating that some companies are politically affiliated). The mean value of 0.712 which is greater than the standard deviation of 0.454 suggested that greater numbers of the sampled companies were politically connected compared to those that were not.

Table 2: Correlations

Variable	DA	BPC
DA	1.0000	
BPC	0.0689	1.0000

Table 2 shows association between the variables. Discretionary accrual (DA) is at unit value, board political connection is at positive association value of PBC, r=0.069(7%). The outcome indicates that board political connection has low effect with earnings management. The low result also indicates absent of multi-collinearity problem in the result since the correlation value is less than 0.90 (90%).

Table 3 which indicates coefficient of determination value of 0.6047 with earnings management proxied by discretionary accrual (DA), implied that over 60% of the systematic variation was accounted by board political connection. On adjusting the degree of freedom, the adjusted coefficient of determination (Ṙ2) of 0.6007 showed that about 60% of the change in the dependent variable (earnings management) was explained by board political connection while about 40% was unexplained. The goodness of fit measure which is the F-statistic indicated 14.98 at probability value of 0.000 suggested that entire result is significant and direct linear relation.

Table 3: Regression Estimation (Observation =235)

DA	Coef.	Std. Err.	t	P<|t|
BPC	9.119063	2.20327	4.14	0.000
_cons	-14.42317	6.76321	-2.13	0.035

R-squared (R2)=0.6047 Adj R-squared (Ṙ2) = 0.6001
F(1, 233)=14.98 Prob. value=0.0000

Board political connection (BPC) which indicated t-value of 4.14 at probability value of 0.000 is statistically significant. The result showed that board political connection has significant influence and a strong factor influencing on earnings management. Board political connection with positive coefficient value of 9.12 units with earnings management, implied that a unit in board political connection can bring about increase in earnings management. The result is in tandem with Hemdan, et al., (2021) indicated that a politically connected directors encourages earning management. Sani, Abdul Latif, and Al-Dhamari, (2020) revealed that t politically connected directors have significant influence in increasing earnings management. Also, Alhadab, et al., (2020) showed that politically-connected companies increase the level of real earnings management when evaluated with non-politically-connected companies. Finally, Armaya, et al., (2021) found that politically connected directors have significant influence and positive relationship with real earnings manipulation.

Conclusions and Recommendations

This study centres on impact of board political connection on earnings management practices of manufacturing companies in Nigeria. Agency theoretical framework has demonstrated that management employs different approaches such as earnings management for personal gains and problem arises because of separation of ownership from control. Having analysed the results, it is observed that politically connected board members havs significant positive relationship with earnings management practices in manufacturing firms in Nigeria. The implication is that companies that are politically connected have tendency of enhancing earnings management. In nutshell, politically connected board member can capitalize on their politically affiliation to party or the government in power to deplore activities that can influence earnings management among listed manufacturing firms in Nigeria.

It recommends that firms whose board members are politically connected should not downplay accounting practices and reporting standards that are applicable and eschew any form of deceptive activities that will be detrimental to the going concern of their organizations. Government regulatory authorities such Security and Exchange Commission, Federal Inland Revenue Services, Nigerian Exchange Group PLC, Financial Reporting Council of Nigeria (FRCN) etc should ensure that companies that are politically connected are closely monitored and give quality reporting instead of disclosing manipulated accounts and reports to stakeholders.

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