Corporate Governance Boards' Role in Accrual Manipulation: Evidence during Involuntary Acquisitions of Nigerian Banking Firms

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Abstract

Corporate governance can mitigate accrual manipulation. However, where accrual management can benefit shareholders, boards can relax control to permit creative accounting. Unfortunately, the avenues that can create such opportunities and the implications of such a pervasive role in firms' earnings quality have been understudied. In this study, we use a sample of 12 banks that merged involuntarily in Nigeria between 2007 and 2014to determine whether, prior to a forced acquisition, the boards of these firms manipulated accrual to mitigate liquidation threat and to obtain stock swap benefits. We found that banks did engage in accrual discretion prior to forced mergers. Involuntary acquisition incentivized firms' boards to exercise discretion over loan loss provisions in order to meet a required capital threshold (β=0.151; p-value <0.05). Firms being consolidated involuntarily relaxed their normally tight corporate governance mechanisms to permit loan loss and accrual management to obtain stock exchange benefits. Board size has a positive significant effect on loan loss provision manipulation (β=0.122; p-value>0.05), which results in earnings that are neither persistent nor highly predictive. Thus, involuntary consolidation encourages boards to engage in accrual management, leading to lower accrual persistence. Therefore, forced acquisition should be avoided, and where it seems inevitable, there should be more independent directors on boards prior to involuntary mergers to encourage higher transparency.

Keywords: Corporate Governance, Bank, Firms, Nigeria

Introduction

Corporate governance is an important control measure of any corporate organization (Ewert &Wagenhofer, 2015), which affects every facet of firms' accounting system. It ensures that firms report quality earnings (Asogwa, Ofoegbu, Nnam, & Chukwunwike, 2019; Egbunike, & Odum, 2018). In addition to ensuring quality reporting, several studies report that effective corporate governance can enhance firms' performance (Okafor, & Ibadan 2011; Sriram, 2018; Vij & Kaur, 2018). When corporate governance is very strong, it can mitigate managers' opportunistic behaviour that leads to accrual manipulation and poor earnings quality and adverse portfolio selection (Ewert & Wagenhofer, 2015; Ramzi, 2009).

However, the role of corporate governance board in mitigating accrual manipulation seems to be context-specific (Lehmann, 2016), which has raised a concern among researchers. Where corporate governance has been assumed to be very strong, several investors have lost their wealth **(Lemus, 2014;** Raymond, Jeons-Bon, & Agnes 2015) because it permitted managers to engage in creative accounting that made earnings transitory (Sloan, 1996; Lemus, 2014).

This corporate governance anomaly has raised worry among researchers, and in this regard, a study by Lehmann (2016) presented the idea that boards can relax corporate governance mechanisms to incentivize earnings management to the detriment of some potential stakeholders. Thus, contrary to what we may think, corporate governing boards are not totally free from creative accounting behaviour. Using a sample in the UK firms, Lehmann (2016) provided convincing evidence that the role of corporate governance in the effective containment of creative accounting is context-specific; that is, such a role is contingent on whether the earnings management will benefit the shareholders or not. For instance, he argues that when earnings management is to the benefit of current shareholders – such as by obtaining higher share swaps during strategic acquisitions – boards may encourage managers to manipulate accrual to achieve the purported share swap benefit. However, he noted that in a setting where earnings management is targeted towards enhancing managers' compensation packages, corporate governance plays its containment role where such manipulative action would benefit opportunistic managers at the expense of the current shareholders. A test of this argument showed that in the UK, firms with the strongest corporate governance manipulated earnings prior to their acquisition in order to obtain a share exchange advantage.

This evidence does not align with some extant literature on corporate governance conducted in some other countries (Davidson, Goodwin-Stewart, & Kent David, 2005; Klein, 2002). Fama (1980) and Beasley (1996) report that boards are always structured to ensure that their managers do not engage in opportunistic behaviour that leads to accrual management (Brown and Pinnelo 2007). Thus, Lehmann (2016) called for researchers to explore other avenues that can create an opportunity for boards to encourage accrual manipulation to protect potential shareholders and to confirm their findings.

Therefore, this study is a response to the clarion call of Lehmann (2016). We extended the contingent role by examining the scenario where banks merged involuntarily under the threat of liquidation in Nigeria. The ultimatum is always to either merge before a given deadline or to get ready for liquidation. The intentions of involuntary mergers are to meet a certain capital threshold and mitigate liquidation risk. Such an involuntary move to meet a mandatory capital threshold can incentivize the board to relax their governance mechanism, allowing managers to engage in accrual in order to meet the reviewed capital threshold and protect their principals' wealth. Our study focuses on the Nigerian banking sector because involuntary mergers and acquisitions have become an issue in the country within the past fifteen years. Thus, it is very important to examine how the corporate governance boards can incentivise managers to engage in accrual manipulation during involuntary bank acquisitions.

Literature Review

Conceptual Review

Corporate governance can be defined as the process in which corporate boards oversee and monitor the running of a company by the company's managers (Organization for Economic Cooperation and Development (OECD), 1999). It specifies the link and sharing of rights and roles among the shareholders, the boards, the agents and several other interest holders, including employees, consumers, suppliers, the community and the state.

Theoretical Review

There are various theories that explain the relationship between corporate governance and earnings quality such as agency theory, stewardship theory, hazard moral theory, resource dependency theory and stakeholder theory.

However, we anchor this study on the stakeholder theory as it embraces all other theories. Stakeholder theory emerged with increasing desire for firms to factor all their interests groups. The firms' interests groups are those that firms influence and are being influenced by the firms. The stakeholder theory argues that firms should pattern their behaviour, including their governance rules, to satisfy all parties that have stakes in them. In this context, stakeholder theory believes that presenting qualitative accounting information is a social responsibility of firms that ensures their earnings quality.

Empirical Review

Empirical evidence has proved that earnings management and corporate governance have a positive relationship in a merger setting. For instance, using samples from the UK, Lehmann (2016) confirms that the role of the board in preventing earnings management is contingent on the underlying incentives to engage in earnings management. In his construct, he noted that in a setting where earnings management is targeted towards enhancing managers' compensation packages, the containment role of corporate governance is likely to be inevitable compared to times when such actions will significantly benefit only the current shareholders. During acquisitions, for instance, managing earnings to gain an exchange advantage will help to protect the shareholders from earnings dilutions, and hence, they could encourage earnings management practices likely to save them from such dilution problems

(Erickson & Wang 1999). Board members could consider encouraging earnings management healthy for the shareholders and may even penalize the managers from responding negatively when such a situation arises (Anna et al., 2015).

Evidence has shown that several managers manipulated accrual in order to obtain shares for a share advantage as demonstrated in Erickson and Wang (1999), Botsari and Meek (2008), Aref and Nejat (2012), Louis (2004), and Yan-Jie et al. (2014). Managing earnings to obtain a share swap advantage may not have been possible without the backing of the boards. Hence, acquisitions provide a good setting for analyzing the role of corporate governance in shaping accrual manipulation.

In Nigeria, there are some studies that focused on related issue. For example, Asogwa, et al (2016) examined the effect of creative accounting around contemporaneous involuntary bank mergers and acquisitions, and non-routine board changes on creative accounting. They found that prior to acquisitions, banks manipulated accrual, particularly where there was an incoming new board chairman. Hassan, (2015) examined the effect of adoption of International Financial Reporting Standards on earnings quality on listed Deposit Money Banks in Nigeria and reported a relationship between earnings quality and IFRS adoption. Miko, and Amardin, (2015) examined how audit committee affects audit quality on preventing earnings management in the Pre- and Post- Nigerian 2011 Corporate Governance Code. They found that audit committee played key roles in ensuring audit quality and thus, prevented earnings manipulation. Nnadi, & Nwobu, (2016) focused on the impact of international financial reporting standards adoption and banking reforms on earnings management. They reported a significant negative link between IFRS adoption and earnings management. To examine the earnings management and board structure, Obigbemi, Omolehinwa, Mukoro, Ben-Caleb, & Adeola, (2016) took evidence from Nigeria and found that board structure affects boards' earnings management. In a comparative study, Ugbede, Lizam, & Kaseri, (2013) examined the effect of corporate governance on earnings management using evidence from Malaysian and Nigerian banks. Uwuigbe, Uwuigbe, & Bernard (2015) assessed the effects of firms characteristics on earnings management of listed firms in Nigeria. Finally, Uwuigbe, Uyoyoghene, Jafaru, Uwuigbe, & Jimoh (2017) examined the effect of IFRS adoption on earnings predictability using evidence from listed banks in Nigeria. Though the above literature address the issue of earnings management, corporate governance, and earnings quality, in none of the study was the effect of corporate governance on earnings quality around involuntary mergers and acquisitions examined, which has created literature gap.

Methodology

This study used secondary data obtained from the CBN Statistical Bulletin and financial statements of the banks sampled in the study. The population of this study is 158 listed firms in the floor of the Nigerian Stock Exchange as reported in Volume 2 of the Nigerian Capital Market Bulletin as well as in subsequent volumes which have involved in 145 mergers, acquisitions and/or corporate restructurings between 1983 and 2014. Using a judgmental sampling technique, we selected a sample of 12 banking firms for which we obtained data from between 2007 and 2014. All selected banks had experienced involuntary acquisitions within the period between 2007 and 2014. Therefore, our actual firm-level sample analysis consists of 84 firm years (12x7). We analysed our data using a multiple regression analysis with the aid of E-Views Statistical Software.

Earnings Management Model

Researchers have measured earnings management by determining the level of accrual manager reports (Healy, 1985; Jones, 1991; Dechow, 1995). For the purpose of this study, we determined discretionary accrual using a modified Jones model and clustering earnings model, following Yan-Jie et al. (2014).

Model of Loan Loss Provisions

Loan loss provision (LLP) has been found to be the target of bank managers that manipulate earnings (McNichols & Wilson, 1988; Chang., Shen, & Fang, 2008). Recent studies in Nigeria also used LLP to test commercial banks' desire to adjust earnings (Ali, 2015; Amidu, & Kuipo, 2015; Farouk, & Isa, 2018; Ozili, 2015). In addition to our previously adjusted model, we use this model to confirm the result of our unique model on DDEP. Following past researchers, we estimate discretionary LLP (DLLP) using some set of variables namely actual LLP, loan charge-offs, and beginning balance of allowance for bad debts. McNichols and Wilson (1988) and Chang, et al. (2008) use estimated residuals of bad debts regression model as a surrogate of discretionary accruals. In this case, LLP equals the sum of the ending balance of allowance for bad debts and loan charge-offs minus the beginning balance of allowance for bad debts (Cheng et al. 2008). As such, we use the following regression to determine normal LLP and following (Chang., Shen, & Fang, 2008; McNichols & Wilson, 1988) we use regression residuals as DLLP:

$$LLP_t = \alpha + \beta_1 LCHAOfs_t + \beta_2 BBADdbt_t + \varepsilon_t (10)$$

LLP_t equals LLP in year $_t$; ***LCHAOfs*** is a variable for loan charge-offs and ***BBADdbt*** is beginning balance for bad debt allowance; **εt** is a regression residual used as a proxy for ***DLLP.*** *t* denotes time dimension in terms of years.

To test the effect of corporate governance and involuntary acquisitions on ***DLLP***, we use the following model:

$$DLLP_{it} = \alpha + + \beta_1 bdsz_{it} + \beta_2 CEODual_{it} + \beta_3 Adcomfr + \beta_4 invmer_{it} + \beta_5 merstock_{it} + \beta_6 sz_{it} + \beta_7 roe_{it} + \beta_8 cfo_{it} + \beta_9 aq_{it} + \beta_{10} dbt_{it} + \beta_{11} os_{it} + \acute{\varepsilon} \quad (11)$$

Where α is a ***DLLP*** intercept. $\acute{\varepsilon}$ is the estimation error. β_1 through β_9 are the explanatory variables' coefficients. ***DLLP*** is the discretionary LLP at year ***t*** for firm ***i***, determined using McNichols and Wilson (1988)'s LLP discretion model, which has been found by Ali (2015), Amidu & Kuipo (2015), Farouk & Isa (2018) and Ozili (2015) to be very efficient in predicting normal LLP in Nigeria. $bdsz_{it}$ is the corporate governance variable that stands for board size transformed into natural logarithm. It measures the effect of board structure and composition on bank managers' discretionary LLP. ***CEODual*** is a measure of corporate governance in terms of power separation between CEOs and board chairperson. It takes value 1 if the CEO is different from the chairman of the board and 0 otherwise**.** ***Adcomfr*** is a corporate governance variable to test for the effect of audit committee frequency of meeting. The variable is transformed into natural logarithm. Other variables are as previously defined in equation 8.

Results and Analysis

We begin our analysis by using our analytic software to describe our data. We present the descriptive statistics in the table below.

Descriptive Statistics

Table 1: Descriptive Statistics for DLLP Multivariate Regression Analysis

Variables/Statistics	*Min.* *Statistic*	*Max.* *Statistic*	*Mean* *Statistic*	*Std. Dev.* *Statistic*	*Skew.* *Statistic*
Sz	1.22531	3.58782	2.8593158	0.47552728	-1.363
Os	0.00000	1.00000	0.4736842	0.50262469	0.108
Aq	0.00000	1.00000	0.7662338	0.42600049	-1.283
Invmer	0.00000	1.00000	0.7662338	0.42600049	-1.283
Ceodual	0.00000	1.00000	0.5454545	0.50119474	-0.186
Dbt	0.00000	11.00000	0.7272727	1.28387124	6.850
Cfo	1.03414	3.165660	1.89839716	0.434048284	0.291
Bdsz	0.00000	1.000000	0.46052632	0.501751319	0.162
Adcomfr	0.84510	1.51851	1.1778381	0.12404898	0.937

Dllp	0.30103	1.46240	1.0103775	0.26271418	-0.430
Roe	-1.52571	0.69098	-0.0721784	0.44756036	-1.431
Valid N (listwise)					

Source: Author

The standard deviations and skewness statistics show that the data is fit for analysis. The statistics are in the tolerant range of approximately 1 and 2, respectively.

Correlation matrix

DLLP negatively correlates insignificantly with involuntary mergers and acquisitions. It also negatively correlates with CEO duality variable. The correlation matrix also shows that there is no problem of autocorrelation since correlation coefficients are low for each other.

Table 2: Correlation Matrix

Variable	***Sz***	***os***	***Aq***	***invmer***	***ceodual***	***dbt***	***cfo***	***bdsz***	***adcomfr***	***dllp***
Sz	1	-.350**	.296**	-.268*	-.259*	-.072	.486**	-.279*	.316**	.101
		.002	**.009**	**.019**	**.023**	**.535**	**.000**	**.015**	**.005**	.384
Os	-.350**	1	.157	-.123	.083	-.145	-.094	.118	-.241*	-.202
	.002		.177	**.289**	.473	.212	.420	.315	.036	.081
Aq	.296**	.157	1	-.088	-.134	-.238*	.338**	.204	.120	.010
	.009	.177		.449	.244	.037	.003	.077	.300	.934
Invmer	-.268*	-.123	-.088	1	.235*	.050	-.110	-.074	.213	-.079
	.019	.289	.449		.039	.664	.341	.524	.063	.493
ceodual	-.259*	.083	-.134	.235*	1	.091	-.157	.088	-.027	-.248*
	.023	.473	.244	.039		.431	.172	.450	.817	.030
dbt	-.072	-.145	-.238*	.050	.091	1	-.246*	-.110	.077	-.180
	.535	.212	.037	.664	.431		.031	.346	.505	.118
cfo	.486**	-.094	.338**	-.110	-.157	-.246*	1	-.155	.352**	.198
	.000	.420	.003	.341	.172	.031		.182	.002	.085
bdsz	-.279*	.118	.204	-.074	.088	-.110	-.155	1	-.229*	-.237*
	.015	.315	.077	.524	.450	.346	.182		.047	.039
adcomfr	.316**	-.241*	.120	.213	-.027	.077	.352**	-.229*	1	.134
	0.005	0.036	0.300	0.063	.817	.505	.002	.047		.246
dllp	0.101	-0.202	0.010	-0.079	-.248*	-.180	.198	-.237*	.134	1
	0.384	0.081	0.934	0.493	.030	.118	.085	.039	.246	
	0.870	0.443	0.197	0.020	.423	.537	.158	.784	.884	.081

Source Author; roe variable was eliminated for space reasons.

Regression Results

Table 3: Multiple Regression Output

Model (DLLP)	Coefs.	Std. Error	T	Sig	Toleranec Collinearity	VIF Collinearity
(Constant)	1.289	0.360	3.576	0.001	-	-
Sz	-0.124	0.087	-1.424	0.160	0.476	2.100
Os	-0.114	0.069	-1.660	0.102	0.691	1.448
Aq	0.042	0.082	.514	0.609	0.647	1.545
Invmer	0.151	0.05	3.02	0.010	0.657	1.521
Ceodual	0.054	0.062	.871	0.387	0.851	1.174
Dbt	-0.035	0.024	-1.477	0.145	0.834	1.199
Cfo	0.063	0.090	.699	0.487	0.596	1.677
Bdsz	0.122	0.066	1.862	0.047	0.767	1.303
adcomfr	0.188	0.268	.704	0.484	0.714	1.401
Roe	-0.053	0.070	-.760	0.450	0.834	1.199
R	0.464[a]					
R-Squared	0.215					
Adjusted R-Squared	0.086					
F-value	1.67					
F-Sig. Value	0.018					
Durbin-Watson	2.00					

Source; Author

Discussion based on model of DLLP

We found that LLP provision is the target of bank managers in manipulating earnings in Nigeria. However, corporate governance mechanisms namely board size, CEO duality, audit committee frequency of meeting and ownership structures except board size have non-statistically significant effect on discretion over LLP in Nigeria. Board size plays restrictive effect given its negative influence on DLLP. Thus, during involuntary acquisition, corporate governing boards do not vary their composition in order to comprise the quantity of LLP as an earnings management tactics. Likewise, CEO duality plays a constraint role vis-à-vis discretion over LLP. Thus, during involuntary acquisition, separating the role of CEOs from those of the chairmen of the boards can help in mitigating accrual manipulation. Frequency of audit committee meeting does not negatively associate with DLLP, which means that during involuntary acquisitions such a meeting may constitute a forum to determine a way of escape from the trap of 'be merged or be liquidated mandate'. Therefore, increasing number of meeting had no effect on decreasing managers' discretion over LLP. The audit quality as well positively affects DLLP. This is quite strange because expectedly, banks audited by Big Four audit firms, should yield less discretion over LLP. This may be so under normal circumstances. In a situation of involuntary acquisitions, audit firms may relax their strictness in order to help in sustaining the existence of their clients and continue the client relationship. This is consistent with Lehmann (2016) that corporate governance mechanism can only act effectively if the action is to benefit of the shareholders. Thus, in this case audit control takes a shareholder dimension rather than a stakeholder dimension. Ownership structure suggests that banks that have institutional investors manage earnings through LLP during involuntary acquisitions. This is likely true because, they would not like to lose their investments. Our analysis also reveals that large sized banks do not play creative accounting game. We found that size constitutes a constraining factor to management of LLP among Nigerian banks during involuntary acquisition. This is consistent with the theory that big firms do not manage profit because they have resources to achieve their goals and compensate their managers. Thus, managers have no reason to be opportunistic. Their contractual benefits are sure unlike in small firms where the managers have to struggle to meet such target. Banks faced with merge or be liquidated mandate as well get limited by the debt covenant restriction. Evidence shows that firms can manipulate profit as soon as they are very close to debt repayment period. They do so in order to get a contract renewal. Debt covenant can also be tied to the reported profit. Thus, if a firm is about to report a loss, debt covenant can make such banks manipulate LLP or earnings to mislead the creditors. Therefore, the negative effect of debt covenant on DLLP plays a constraint factor. As banks face involuntary acquisition, they become aware that creditors can scrutinize their annual report very well for correct provision against their loan. Such awareness limits managers' choice of discretion over LLP.

Conclusion and Recommendations

Our analysis shows that, contrary to our postulation, firms consolidating involuntarily have earnings that have moderately high predictive power. However, we infer from the outcome that such predictability does not in itself suggest high earnings quality but is a mere trend portraying earnings inconsistency. CEO duality constrains discretion over LLP. However, increasing number audit committee meeting has no negative effect on DLLP. Likewise, we found that board composition encourage DLLP during involuntary acquisitions, which negatively impacts on the quality earnings of such banks. Overall, we can conclude that involuntary consolidation incentivizes the firms' boards to embark on significant accrual management practices that have drastic consequences on the firms' earnings quality. Forced consolidation denatures the power of the earnings to persist over a significant period of time and yields high predictability, which suggests the presence of inconsistencies rather than accrual quality. Corporate governance failures during involuntary acquisition appear to be a collaborative effort of opportunistic managers, board members, and shareholders fighting to avert potential liquidation. We recommend that potential shareholders of firms that have involuntarily consolidated should price their stocks based on the firms' earnings three to four years prior to the merger.

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