



**FIRM'S CHARACTERISTICS AND EARNINGS MANAGEMENT: EVIDENCE FROM LISTED PHARMACEUTICAL COMPANIES IN Nigeria**

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**Abstract**

*The global financial crises that have shaken the global financial industry between 2007-2008 have given birth to several problems and worries about the quality of financial reporting worldwide. The manipulation of earnings has the effect of reducing the quality of reported financial data, which distorts the relationship between reported earnings and stock returns and makes it more difficult to allocate resources effectively. Thus, the purpose of this study is to examine how firm characteristics affect earnings management in the listed pharmaceutical sector of Nigeria. Using an ex-post facto study design, data was collected from yearly reports of specific pharmaceutical sectors in Nigeria from 2012 to 2021. The population of this study consists of all listed pharmaceutical companies on the floor of the Nigeria Stock Exchange as at 31<sup>st</sup> December, 2021. There are eleven (11) listed pharmaceutical companies in Nigeria. Due to unavailability of data five (5) companies are used for the sample size of this study. Multiple regression analysis was used to assess the data, and the findings at showed 5% level of significant that, board independence and audit quality have a major influence on the earnings management of the pharmaceutical industry in Nigeria. The results show that firm characteristics in Nigeria's listed pharmaceutical sectors significantly influence earnings management. This study concluded that characteristics of the firms had a major impact on the management of earnings for the listed pharmaceutical industries in Nigeria. The study recommends that investors in listed pharmaceutical companies in Nigeria should always be on the lookout for the potential for more real activity earnings management before arriving at their investment decisions.*

**Keywords:** Firms' characteristics, earnings management, manufacturing industries, Nigeria

**INTRODUCTION**

Studies on earnings manipulation are crucial for stakeholders and shareholders alike because they influence management and investment choices. The practices are increasing the information asymmetry between shareholders and management and have a direct impact on the quality of financial reporting. But the surge of financial scandals that shook the global financial community in recent years has brought up a lot of issues and worries about the caliber of financial reporting worldwide. This was brought about by multiple high-profile instances of major corporate organizations collapsing as a result of financial crises that were documented on almost every continent in the world (Kelvin, 2020). Due to the pervasive failure of the financial information



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quality, it is now necessary to tighten manager control and enhance the quality of the financial information by establishing sound business structures.

Since financial statements are crucial tools used by investors to make decisions, they must be trustworthy (Liu, 2012; Altarawneh, Shafie, & Ishak, 2020). Investor confidence in the accuracy of the information supplied by listed corporations has been damaged, nevertheless, by financial scandals. As a result, consumers of financial reports are now less likely to believe what they read, especially in light of questions about the accuracy of these reports raised by instances of irregular reporting and the discovery of unethical accounting practices, even in well-known businesses (Al-Sraheen & Alkhatib, 2016).

The issue of corporate financial reporting has gained international attention after the 2007 global financial crisis, primarily as a result of documented instances of business failures stemming from inaccurate, deceptive, and improper financial reporting in companies that had previously enjoyed a positive reputation due to their impressive performance histories in their respective industries (Agrawal & Chadha, 2005). A financial statement is considered deceptive if it is written with the goal to mislead and/or confuse the users, or if it lacks the attributes of relevancy, correctness, comparability, dependability, compatibility, and it contains fundamental flaws. Falsifying accounting records, omitting transactions, or applying accounting principles incorrectly are a few methods that can be used to commit this kind of fraud (Higgs, 2003). There are several possible explanations for the preparation of such misleading financial statements. As can be seen from the various convergence considerations. There is a perception that shareholders prepare false financial statements because they demand higher returns on their investments.

When compared to many advanced economies, Nigeria's financial information quality is not up to standard. As a result, the development of effective equity markets was hampered. Investors in Nigeria frequently lament the lack of availability or unreliability of financial data on business performance (Shehu, 2011). Therefore, the purpose of this paper is to examine how firm characteristics affect the management of earnings in the Nigerian pharmaceutical industry that is listed.

### **Statement of the Problem**

Earnings management practice and choice of policies resulting from many judgments at the same time are capable of manipulation which produce less reliable accounting earnings that do not reflect a firm's financial performance because it is likely to reduce the quality of reported earnings and their usefulness for investors' decisions, thus reducing investors' confidence in the financial reports (Egolum, & Onodi, 2021). Accordingly, it is argued that managers and controlling owners have incentives to manage reported earnings to mask the true firm's performance and to conceal their private control benefits from outsiders. There are many reports of price manipulation, profit overstatement, and accounts falsification by some dubious stewards which rendered the financial reporting ineffective. This problem is more pronounced in firms whose corporate structure is shaky, concerning dwindling profitability, risky leverage, and low corporate insolvency. Challenges such as these force managers to engage in earnings management or what they colorfully call window-dressing (Egolum & Onodi, 2021). More so, this situation is often seen among firms



with high profitability and then wishing to pay lower tax returns. In any case, whether the corporate characteristics of the firms are attractive or not, earnings manipulation does not tell well of the quality of a firm's financial reporting.

Many studies (Kim, Jeong, Kang, Lee, 2017; An, Li, & Yu, 2016; Mohammad, Wasiuzzaman & Salleh, 2016) have concentrated on a variety of earnings management issues, particularly with regard to the extent of earnings management practices and the firm-specific factors that may influence it. The effect of firm-specific features on EM has been the subject of numerous earlier studies (e.g., Waweru & Riro, 2013; Anagnostopoulou & Tsekrekos, 2016). The majority of these studies have been carried out in developed nations where there is a high degree of transparency and strong legal protections for investors and other users of financial statements. These studies have demonstrated improvements in the quality of earnings as a result of the adoption of corporate governance and a legislative framework.

Much less is known about the relationship between earning management and firm-specific characteristics in developing nations, especially Nigeria. This relationship has been the subject of extensive testing in developed nations. More intriguingly, the outcomes of various studies on this relationship in developing nations vary based on a number of variables, including industry, sample size, data year, and economic climate. Furthermore, the public believes that managers in the pharmaceutical industry in Nigeria are more likely to use opportunistic earning management in order to maximize their personal gains rather than the gains of the stakeholders. Therefore, this research investigates whether the pharmaceutical industries in Nigeria that are listed use earning management as a means of disguising their poor performance and misleading the users of financial statements.

Sequel to the problem statement, the following hypotheses are formulated to achieve the research objectives

**H<sub>01</sub>:** Board independent has no significant effect on earnings management of listed pharmaceutical companies in Nigeria.

**H<sub>02</sub>:** Audit committee has no significant effect on earnings management of listed pharmaceutical companies in Nigeria.

## LITERATURE REVIEW

### Earnings Management

Abolo (2022) defined earnings management as an action taken by management of companies in generating profit. This practice reflects the interests of executive directors rather than the advantage to the shareholders. This definition indicates the reality of earnings management that can reveal false information about the performance of a firm. Alzoubi (2019) asserted that earnings management is of two categories. First, managers look at it as an opportunistic behavior for maximizing utility in handling debt contracts, compensation contracts and political cost. This is



known as opportunistic earnings management. Secondly, earnings management is considered as the perception of efficient contract process, whereby managers are provided with the flexibility of protecting themselves and the firm to anticipate the unforeseen events to gain the partners involved in the contract (Umobung & Ibanichuka, 2017).

Al-Shaer, Salama, and Toms (2017), noted that earnings management is more liable to occur where a firm is usually unable to fulfill investors' expectations or in the periods of unstable earnings. They further added that the latest accounting scandals documented indicate that managers occasionally mislead stakeholders concerning the firms' financial performance by trying to present financial statement that do not offer a time and true representation of the firm's value. According to Amin, Lukviarman, Suhardjanto, and Setiany (2018), earnings management may happen as a result of the problem of agency. Firms' managers could manage earnings to present false financial statements aimed at enhancing their status, hiding facts that stakeholders should know or manipulating contractual outcomes that is based on detailed accounting figures. The fundamental managerial instances to manage earnings are numerous. These comprise instances when a company reported a loss in the prior year, manipulating the prices of short-term stock and fulfilling capital market requirements amongst others (Akeju & Babatunde, 2017).

### **Board Independent**

Board independence refers to the extent a board is composed of independent non-executive directors who have no relationship with the firm beyond the role of director. The appointment of outside directors is an effective corporate governance mechanism which reduces agency problem and increase earnings quality (Klein, Shapiro, & Young, 2005). Such independent directors offer shareholders greater protection in monitoring management. Independent non-executive directors curtail managers' discretionary decisions and limit the opportunity of the board to become 'an instrument of top management' (Beasley & Petroni, 2001). Analysis of board independence influenced on the relationship between tax planning and firm value has been investigated by Khaoula & Moez (2019) shows the negative influence of board independence on the relationship between tax planning and firm value. While similar research states there is a no effect of board independence on corporate tax planning (Khaoula & Ali, 2012), so this research is expected to provide the latest results to reassert the effect of board independence on the relationship between tax planning and firm value.

### **Audit Committee Size**

One important committee within board is the audit committee. The audit committee is an important part of the board responsible for the supervision of the firm's internal control (Zhang *et al.*, 2019). Therefore, as a corollary to board diligence; is the effect of audit committee presence and activity on corporate tax avoidance. Prior studies, such as Hossain *et al.* (2011) found that accrual-based earnings management is negatively related to board and audit committee meeting frequency; whereas, Abbott *et al.* (2004) found that the probability of restatements is lower in firms with more audit committee meetings. Shareholders' interests are protected through the activities of audit committee because management may not always act in the interest of corporation's owners.

Further studies in favour of larger audit committee posited that when more people are involved in checking the activities of managers, wrongdoings will be reduced and performance will be enhanced.

### **Nexus between Board Independence and Earnings Management**

The main purpose of a company's board of directors is to protect the interests of its investors. Since the CEO typically has a significant influence over who is chosen for the board and most directors are people the company's senior management knows, the issue of board independence is critical (Abdullah & Nasir, 2004). Ngamchom asserts that there is a negative correlation between earnings management and board independence (Ngamchom, 2015). The study supports the findings of Susanto (2013) and Xie, Davidson, and Dadalt (2003), who discovered that a corporation's earnings management practices decrease with the number of independent directors and improves management oversight. Conversely, Abdullah and Nasir (2004) used data from the Kuala Lumpur Stock Exchange (KLSE) and did not find any significant correlation between board independence and earnings management.

### **Nexus between Internal Auditing Quality and Earning Management**

Putra and FitoMela (2019) posit that superior audit quality results in less opportunistic earnings management and more informative earnings management. The results of Jordan et al. (2010) suggest that management's attempts to round up earnings per share are constrained by audit quality. Oyebamiji (2020) asserts that among Nigerian listed companies, audit quality had a negative and substantial influence on earnings management strategies. According to Inayah and Prasetyo's study from 2021, earnings management is significantly impacted negatively by the auditor's experience, although this effect is mitigated by the audit board. Tajudeen (2020) asserts that audit quality significantly affects how Nigerian listed manufacturing companies manage their earnings. According to Rahmawati (2020), the results of this study showed that audit quality has a positive and significant impact on earnings management in Indonesia. Elghuweel et al. (2017) state that there is a strong positive correlation between internal audits and sound business governance. The study's conclusions, as presented by Alareeni (2018), paint a clear picture of the various earning management techniques used in GCC nations. The results of the study by Flayyih et al. (2018) showed that the audit has an effect on the five parameters taken into account by the corporate governance findings in earnings management. Yasser and Soliman (2018) assert that earnings management is significantly impacted by the audit's quality. As per Widagdo, Rahmawati, Murni, Wulandari, and Agustiningsih (2021), the behavior of earnings management is significantly influenced by the audit quality.

### **Theoretical Framework**

Signaling theory was originally introduced by Michael Spence in 1973. The current view of signaling theory was developed by Spencer in 1983. This theory encompasses the response of investors to the positive and negative signals that greatly affect market conditions. Signal theory in this study is used to draw the relationship between the influence of firm attributes on the earnings management of firms. Managers of firms would always want their financial records to look



attractive even when it is not, in reality. Signaling theory is of the view that changes in corporate financial indicators primarily affect investors who often react in different ways in response to such signals as buying stocks or observing the development of the stock in the market. Under this theory, financial reporting is said to stem from management's desire to disclose its superior performance where good performance – indicated by the corporate financial ratios of the firm – will enhance the management's reputation and position in the market for management services, and good reporting is considered as one aspect of good performance.

This signal can be any information related to management's efforts to realize what was required of investors or other information that can show their company is better than other companies (Fajaria & Isnalita, 2018). This signal is given to reduce information asymmetry where the internal party better understand the condition of the company (Yimenu & Surur, 2019).

### **Empirical Review**

Alhassan, Gololo, and Anwarul-Islam (2019) looked into how the audit committee affected the way listed manufacturing companies in Nigeria managed their earnings. Ten (10) sampled manufacturing firms that were listed on the Nigerian Stock Exchange (NSE) between 2010 and 2019 provided secondary data for the study. The Random Effects Model (REM) was employed in the study to analyze the data. The findings demonstrated that while the audit committee's tenure had a negligible negative impact on earnings management, its financial expertise had a significant negative impact. Moreover, the audit committee's share ownership has a detrimental effect on managing earnings. Thus, the study comes to the conclusion that the audit committee's ownership and experience both improve the caliber of financial reporting for Nigerian manufacturing companies. The study suggests that the board should make sure that an adequate number of financial experts are appointed to the audit committee, among other recommendations, based on the influence of having financial experts on the committee. In a similar vein, the study suggests expanding the audit committee's membership to include more people who own significant shares. This can lessen earnings management by increasing their willingness to safeguard their investment and assisting with appropriate monitoring and supervision.

Mustapha, Rashid, Ado, and Ademola (2019) looked into how audit quality might affect how much Nigerian listed companies manage their earnings. From 2012 until 2017, the study's population consisted of all publicly traded companies that are part of the Nigerian Stock Exchange's (NSE) main market. A sample of sixty-three companies was chosen in accordance with the study's filtration criteria. The corporate governance data came from the companies' annual reports and accounts, while the financial data came from the Thompson Reuters DataStream. The study variable was compared to the accrual model using the audit quality as the test variable. Multiple regression analysis was used in the study to test the model. The regression analysis showed that accrual earnings management and audit quality have a negative significant relationship. The results show that any rise in the audit fee unit will result in a decline in the chosen firms' earnings management. Consequently, the result goes against the premise of creative accounting theory and supports agency theory.



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Real earnings management (REM) practices in Jordan were examined in relation to the personal characteristics of CEOs by Alhmood, Shaari, and Al-dhamari (2020). To accomplish the goals of this study, data from 58 companies that were listed for six years, from 2013 to 2018, on the Amman Stock Exchange, were used. The study's findings showed a statistically significant positive correlation between CEO experience and REM. The length of CEOs' tenure, however, had no bearing on REM in Jordanian businesses. Furthermore, the findings demonstrated that there is a strong inverse relationship between CEO duality and REM. Lastly, REM was found to have a significantly positive association with the political connections of CEOs. This study provides empirical evidence regarding the impact of CEO characteristics on REM and the potential for exploitation resulting from these characteristics, which in turn affects the quality of financial reporting.

Kelvin (2020) investigated the connection between quoted manufacturing firms in Nigeria's earnings quality and firm characteristics. The research employed yearly data from six manufacturing companies (May and Baker PLC, Nigeria Bottling Company, AG Leventis PLC, Livestock PLC, and Champions Brewery) from 2011 to 2018. The Hausman Test was utilized in conjunction with panel data analysis to ascertain the most suitable method for the analysis. The study discovered a strong and positive correlation between persistence—a measure of earnings quality—and firm characteristics, which were determined by return on asset and current ratio. According to the study, manufacturing companies should consider taking on more debt, particularly when interest rates are very low. They should also increase their liquidity assets and turnover, as this has been shown to improve the reported earnings quality of the company.

The relationship between the standard of internal auditing and earnings management in Omani businesses was established by Alyaarubi, Alkindi, and Ahmed (2021). For the study, a total of eighty individuals were selected from the Muscat Securities Market (MSM) in the Sultanate of Oman, two sectors: industrial and service. The secondary data that was gathered is analyzed using Smart PLS 3.0. The study's conclusions show that, in both the industrial and service sectors, internal audit quality and earnings management have a positive relationship. According to this research, Omani listed companies' earnings management will be improved and enhanced by higher-quality audits.

### Methodology

Because the study is based on a quantitative approach and positivism paradigm, it uses an ex-post facto research design. The population of the study consists of eleven (11) pharmaceutical companies listed firm on the floor of the Nigerian Exchange Group (NGX) as at 31st December, 2021. The study sample of five (5) pharmaceutical companies that published their financial statements for ten (10) consecutive years without missing any year were drawn from the population. Fidson Healthcare PLC, GlaxoSmithline Consumer (Nig) PLC, May & Baker Nigeria PLC, Neimeth International Pharmaceutical PLC, and Pharma-Deko PLC, were purposively selected due to access to their published financial statement for the period of 2012-2021. Multiple regression technique is used to analyze the panel data gathered for firms' characteristics and its effect on earnings management of pharmaceutical companies in Nigeria by means of STATA 13.

### Model Specification

The model specification for the study is mathematical presented as;

$$Y = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + \mu_0 \dots \dots \dots (1)$$

Hence;

$$EM = \beta_0 + \beta_1 BI + \beta_2 AQ + \mu_0 \dots \dots \dots (2)$$

Where: EM = Earnings Management

BI= Board Independent

AQ= Audit Quality

$\mu_0$  = error term

$\beta_0$  = constant

Y = dependent variable

**Decision rule:** null hypothesis should be rejected if the p-value is < 5% significance level, otherwise it should be accepted.

### RESULTS AND DISCUSSIONS

This aspect of the study indicates the descriptive and inferential output obtained from the study and findings from the results are discussed on the basis of the literature

#### Descriptive Statistics

Table 1

Variables	EM	BI	AQ
Mean	0.022640	0.674727	0.149264
Median	0.018993	0.673994	0.147628
Maximum	0.139626	0.810572	0.341472
Minimum	-0.098652	0.475031	0.046548
Std Dev	0.026158	0.076011	0.062967
Skewness	-0.047654	-0.350222	0.654673
Kurtosis	15.19221	2.536313	3.597816
Jarque-Bera	371.6478	1.764069	5.179425
Probability	0.000000	0.413940	0.075042
Sum	1.358403	40.48365	8.955850
Sum Sq. Dev.	0.040369	0.340883	0.233923
Observations	50	50	50

Source: Author's computation. 2023

As shown in Table 1 the test result of the data mean, median, standard deviation, skewness and kurtosis. The population or sample of the study is normally distributed when the mean variables is similar to the value of median, skewness value is zero while kurtosis value is greater than, equal to or less than 3 (Tabachnick & Fidell 2007). Findings shows that the variables are normally distributed.

Consequently, the mean value for earnings management is 0.022640%. This means the earnings management yield 2.26% during the period under review. Similarly, the mean value for board independent and audit quality have an average value of 67.47%, and 14.93% respectively. The minimum value for earnings management is 2.26% and the maximum value of 13.96%. The result of the descriptive statistics test shows that the board independent has a minimum number of 67.47% and a maximum number of 81.06%. Audit quality has minimum number of 14.93% and the maximum number of 34.15% respectively.

**Table 2:** Coefficients (Standardized) Relation between Variables

Variables	Coefficient	P-Value	t-value	C. Alpha
Earning Magt	4.864		9.564	0.743
Board Indep.	.436	.003	6.434	0.754
Audit Quality	.348	.000	9.635	0.876
R <sup>2</sup>	.568			
Adjusted R <sup>2</sup>	.560			
F-Stat	92.765			

**Source:** Stata Output, 2023

Table 2 demonstrates that board independence has a substantial impact on earnings management at 1% significance level. According to the coefficient of 0.436, there will be a 43.6% increase in earnings management for every unit increase in board independence. Therefore, H01, which claims that board independence has no appreciable impact on the listed pharmaceutical industries' ability to manage earnings, is hereby rejected. The findings run counter to those of Ngamchom (2015) and Susanto (2013), who found a negative correlation between board independence and earnings management.

Table 2 also demonstrates that, at the 1% level of significance, audit quality has a positive and significant impact on earnings management (coefficient of 0.348). This suggested that earnings management will rise by 34.8% for every unit increase in audit quality. Thus, H02, which claims that audit quality has no appreciable impact on the listed pharmaceutical industries in Nigeria's earnings management, is likewise rejected. This outcome is in line with the findings of Widagdo, Rahmawati, Murni, Wulandari, and Agustiniingsih (2021) and Yasser and Solman (2018), who discovered that the audit quality significantly affected the earnings management behavior. With an adjusted R<sup>2</sup> of 0.560, board independence and audit quality are responsible for 56% of the variation in earnings management. The remaining 44% were explained by other factors that this study did not include.

## CONCLUSION AND RECOMMENDATIONS

The study investigates the effect of firm characteristics and earnings management in Nigeria by employing samples from listed pharmaceutical companies on the floor of the Nigerian Exchange Group from 2012 to 2021. In this study, the explanatory variable of firm characteristics is measured in terms of board independent (BI) and Audit Quality (AQ). The dependent variable is earnings management. Board independent and audit quality has a statistically significant effect on earnings



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management as of the pharmaceutical companies in Nigeria at a 5% significant level. It is thus concluded that corporate management has a strong incentive of engaging in earnings management through some firm characteristics.

Based on the analysis carried out, the study recommends that investors in listed pharmaceutical companies in Nigeria should always be on the lookout for the potential for more real activity earnings management before arriving at their investment decisions. It is also recommended that the board of directors of pharmaceutical companies should consistently engage the services of audit committee members with expertise. This is because such committee member will be able to choose and implement audit process capable of prompting the management in performing their duty with accuracy and integrity. This will also assist in checkmating the operations of the executive directors and limit the instance of earnings management.

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