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Earnings Management and Corporate Failures: Information System Perspective

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Abstract: *The study examined creative accounting and corporate failures. The objective of the study examined why corporate organizations, practice earnings management in Nigeria and investigate whether earnings management practice has a significant effect on corporate failures in Nigeria. This study adopts a survey method of research design and the population of the study is the staff of commercial banks in Nigeria. The study adopts a quota sampling technique and the sampled members consist of failed banks in Maiduguri, giving a total sample size of 42. The questionnaire was used as the main instrument for data collection. The questionnaire was designed in five response Likert-scale options and administered to Accountants and branch Managers of the sampled banks for the study. The data generated were presented in a tabular form and analyzed using mean scores and the hypotheses were statistically tested with Z-test. This study found a strong positive relationship between earnings management practices and corporate risk which ultimately results in corporate failure. The result is based on an analysis of a 5 –point - Linker scaled questionnaire responses from some major corporate firms in Nigeria. It shows that the higher the level of earnings management practice, the higher the corporate risk. The established effect of earnings management combined with the recent wave of accounting scandals that swept across Nigeria and the rest of the world leading to public outcry of culpable negligence, the study recommended that corporations should ensure that they obtain sufficient evidence, exercise due diligence and professional skill to properly evaluate financial statements which may have been 'doctored' by management in exercise of creative accounting.*

Keywords: *Earnings management, corporate failure, corporate governance..*

1.0 INTRODUCTION

According to Osazevbaru (2012), accounting is generally referred to as the language of business just as finance is branded the lifeblood of organizations. Accounting aims at communicating information and facts about the business activities of organizations that can be quantified in monetary terms to varied interest groups. To satisfy this important role, it requires that the practice of accounting be done in uniform language and style. This is the basis for accounting concepts and conventions, complemented by accounting standards and company laws. Many users of accounting information had suffered disappointment in their experiences of relying on accounting information that eventually turns out unreliable due to earnings management practices. Several companies for instance; Cadbury, Enron, WorldCom, and others liquidated after providing positive results of their operations to users. This liquidation is mostly attributed to earnings management practices. As reported by Accounting-Degree Organization (2012) in a work titled "the 10 worst corporate

accounting scandals of all time", scandals such as that of Enron, Waste Management, WorldCom, Tyco, Health South, Freddie Mac, American International Gron-AIG, Lehman Brothers, Berni Madoff and Satyam which are mostly American based organizations liquidated due to one type of earnings management practices or the others. Several companies including banks liquidated the same way in Nigeria. This has negatively affected the credibility of financial reporting in Nigeria and the world as a whole. Earnings management according to Fizza and Qaisar (2015) is otherwise known as aggressive accounting, income smoothing, earnings management, and others are the financial gimmicks used to moderate a company's financial reports to encourage investors to buy the company's stocks to increase the firm's market value. Earnings management in financial reporting is termed an act of taking the statement of financial position for granted (Mulford and Comiskey, 2016).

Subhajit (2010) remarks that earnings management is at the root of a number of accounting scandals and corporate collapses as many companies manipulate accounting figures in order to facilitate the financial reporting goals established by management, (Emma, Steve & Uche, 2019). It may be difficult to exonerate practicing accountants from corporate failures as many have argued that financial misconduct being perpetuated by banks by overstating financial statements could not be possible without the active coalition of external auditors.

Earnings management refers to accounting practices that follow the letter or rules of accounting standard practices but certainly deviate from the spirit of those rules, (Bankole, Ukolobi and McDubu,2018). Earnings management differs from fraudulent practices thus not illegal but immoral and unethical in terms of misguiding investors and stakeholders.

Corporate failure is perceived as when a company becomes insolvent or goes out of business as witnessed, "failure and distress" associated with fraudulent accounting and window dressing of financial statements such as in Enron,2013, WorldCom scandal 2012, Olympus,2016, Lehman brothers 2008 and recently; Thomas Cook, 2019 in UK and USA. In the case of Nigeria; banks PHB, Spring bank, and Diamond are examples of corporate failures, and Akintola William and Deloitte were indicted for facilitating the falsification of accounts of Afribank plc (Main stream bank plc) and for deliberately overstating the profits of Cadbury Plc. It is reported that between 1990 and 1994 Nigeria lost more than ₦6b ($42.9m) within the banking sector, This-Day (2006) and Oluwagbuyi, (2013) cited in (Bankole,2018).

The systemic failures of the above corporations were attributed to unethical practices and financial mismanagement by the directors which the non-discovery of by external auditors (professional accountants) requires satisfactory explanations and not assisting them in accomplishing their selfish interests.

The failed banks in Nigeria were being audited and given clean bill of health immediately by auditors before they collapse which raised the pertinent question as to who gave the clean bill. The question that immediately comes to mind has the management of the failed banks falsely portray accounting figures and breaches the accounting system and control through the conniver of professional accountants or auditors?

Earnings management gives a "true and fair view" of financial statement as manipulation of the financial numbers were made within the preview of relevant laws and established accounting standards, (Bhasin,2016); it has become a controversial issue as whether it legal or illegal; some literatures are in support and others against. In order to perverse and present robust and attractive business image to the yearning investors has been observed as primary reason for manipulating or window-dressing financial statements. The objective of this study is to examine if earnings

management causes corporate failures in Nigeria or if there is any relationship between earnings management and corporate failure. The previous literature and empirical examined, no specific empirical on earnings management and corporate failure in Nigeria but they discussed types and causes, examining earnings management and corporate failures specifically will be a contribution to the literature.

1.2 Statement of the Problem

The several corporate scandals all over the world since the year 2000 to date have brought to bear the fact that many companies‟ earnings are the aftermath of accounting gimmicks and shenanigans. According to Osazevbaru (2012), this discovery has not only cast doubt on the integrity of preparers of accounting reports, but has also led to the loss of confidence in those who are supposed to check business namely; auditors, analysts, and government regulators. The loss of public confidence in financial reporting has affected negatively the investment interest of potential investors, thereby affecting the performance of securities markets.

According to Munene (2014), there are companies that engage in creative accounting, over-reporting their financial performance to meet targets and please ever-demanding shareholders. Manipulation in financial reports benefits only in the short-run hence susceptibility to future corporate collapse and scandals. The managers pursue personal interests at the expense of shareholders. They propose huge perks, make defective decisions of investment or participate in earnings management and fraud. This takes no notice of the fact that shareholders may be willing to examine the behavior of management (Lekaram, 2014).

Earnings management practice in Nigeria appears to be increasing as many corporate bodies are being investigated. The case of Cadbury Nigeria Plc was due to the doctoring of accounts to cover up certain inadequacies or some bad deals perpetrated by management. The corporate failures of most Nigerian companies today and especially the arrest of some banks' Chief Executive Officers by the Economic and Financial Crimes Commission (EFCC), were blamed on fraudulent financial reporting, which has affected the reputation of the accounting profession and the stability of the financial system. Earnings management practices have been increasing in recent years in Nigerian firms for the sake of attracting unsuspecting investors or obtaining undeserved accounting-based rewards by presenting an exaggerated misleading or deceptive state of financial affairs. It is evident that the extent of window-dressing of organizations‟ financial statements in Nigeria has greatly violated all known ethical standards of the accounting and auditing profession which needs to be investigated.

Several studies abound on earnings management (Akenbor, 2012; Osazevbaru, 2014) have focused mainly on the impact of earnings management on firm value and investors‟ investment decisions with a little highlight on the reasons for such practices and a few considerations for corporate failures. Moreover, most of the studies are foreign-based whose findings may not be suitable for the Nigerian situation putting environmental differences into consideration. The few available studies in Nigeria such as Osisioma and Enahoro (2016), Aremu and Bello (2014), and others as mentioned above, pay little attention to corporate failure, especially in the banking industry. Based on the above, our study will be among the few studies to look at earnings management and corporate failures in Nigerian financial reporting, focusing on commercial banks based in Maiduguri.

1.3 Objectives of the Study

The main objective of this study is to examine creative accounting and corporate failures. Specific objectives include;

i. To investigate the extent to which corporate governance enhances efficiency.
ii. To examine why corporate organizations, practice earnings management in Nigeria.
iii. To investigate whether creative accounting practice has a significant effect on corporate failures in Nigeria.

2.0 CONCEPTUAL FRAMEWORK

2.1 Corporate Governance

Governance could be conceptualized as the manner in which power is exercised in the management of economic and social resources for sustainable human development. It addresses the leadership role in the institutional framework. According to kwakwa and Nzekwu (2013), governance is a 'vital ingredient in the maintenance of the dynamic balance between the need for order and equality in society;

promoting the efficient production and delivery of goods and services, ensuring accountability in the house of power and the protection of human rights and freedom." Governance is therefore, a system, practices, and procedures that govern institutions, the manner in which these rules and regulations are applied and followed, the relationships created by these rules, and the nature of the relationships.

Corporate Governance, on the other hand, refers to the manner in which the power of a corporation is exercised in accountings for the corporate total portfolio of assets and resources with the objectives of maintaining and increasing shareholders' value and the satisfaction of other stakeholders while attaining the corporate mission (kawakawa and Nzekwu 2013). In other words, Corporate Governance refers to the establishment of an appropriate legal, economic, and institutional environment that allows companies to thrive as institutions for advancing long-term shareholder value and maximum human-centered development.

Thus, Corporate Governance is also concerned with the creation of a balance between economic and social goals and between individual and communal goals.

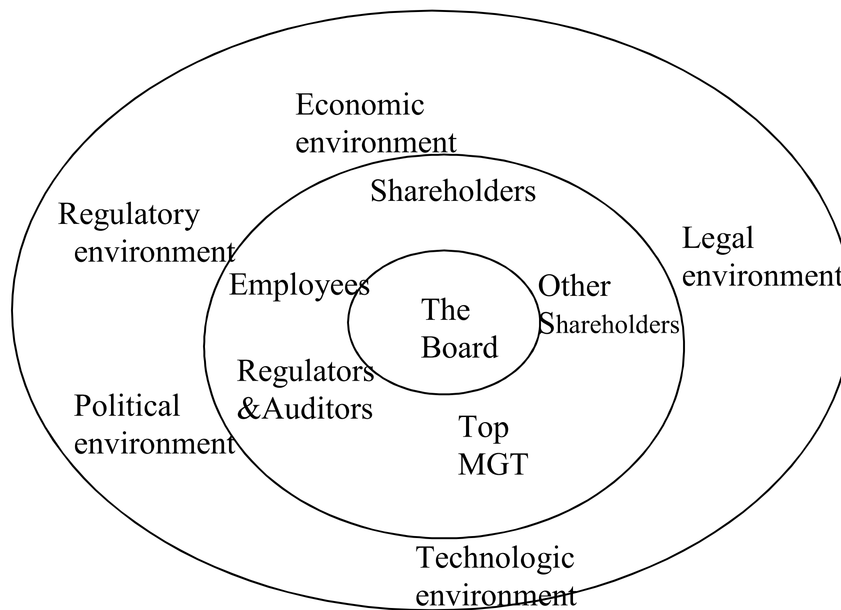
David Smith (2015), president and CEO of the Canadian Institute of Chartered Accountants sees Corporate Governance as a 'culture that has a common understanding of the roles of management and the board'. To him, "Corporate Governance is a culture of mutual respect that both parties have for each other's role". It is a culture of continuous open dialogue and communication. In rounding up his views on corporate governance, smith noted that it is about people "people doing not just what the rules say but about doing what is right".

In a keynote address presented by chief (Dr) J.O Sanusi said that corporate governance is about accountability as well as maintaining an effective channel of information disclosure that would foster good corporate performance" he against understood that it is also about how to build trust and sustain confidence among the various interest groups that make up an organization.

Toyin Phillips (Ph.D.), in "Issues in corporate governance in the banking sector"(2010) said that corporate governance is an internal system encompassing politics, processes and people which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy objectivity and integrity. Corporate governance (According to the Cadbury committee of UK) "Is a set of rules that define the relationship

between shareholders, managers, creditors, the government, employees and other internal and external stakeholders in respect to their rights and responsibilities , or the system by which companies are directed and controlled". Corporate governance according to chief Ikechi Emenike, "The role of the media in promoting good corporate governance" (2010) deals with the way corporate bodies utilize their funds to generate financial wealth for shareholders, and social wealth for the community in which they are located. Corporate governance according to (O.I Mala) is the system of Internal controls and procedures by which individual's companies are managed.
Corporate governance in Nigeria is concerned with the processes by which corporate entities particularly public liability companies are directed and controlled. (Alhaji G.A Yakasai Corporate Governance in a Third world country with particular Reference to Nigeria".

CORPORATE GOVERNANCE AND ITS ENVIRONMENT



2.1.2 Creative Accounting

The word creative entails innovation, unique ideas, skills and dynamism in one's endeavor. On the other hand, the American Institution of certified public accountants defined accounting as "the art of recording, classifying, and summarizing in terms of money, transportations and events which are, in part at least of a financial character, and interpreting the results thereof (Okafor 2013). According to Okoye and James (2020), the term creative accounting is considered as deceptive accounting, Akenbor and Ibanichuka (2012) affirm that it is widely employed to describe the accounting techniques which allow companies to report inaccurate financial results of their business activities. Creative accounting means using accounting knowledge to influence the reported figures, while at the same time remaining within the jurisdiction of accounting rules and laws. The intention is that instead of showing the actual performance or position of the company, the figures would reflect what the management wants to tell the stakeholders (Yadav, 2014).

Creative accounting has also been defined by Bankole, Ukolobi and McDubus (2018) as accounting the practices which follow the letter or rules of standard accounting practices but certainly deviate from the spirit of those rules. Even though creative accounting practices are immoral in terms of misguiding investors, they are different from fraudulent practices and thus are not illegal (Okoye and James,2020). Indicate that while according to Michael (2015) the wider US definition sees creative accounting as including fraud, the UK definition perceives creative accounting as using the flexibility within the accounting system, but which excludes fraud.
Creative accounting, as a matter of approach, is not objectionable per se. However, when unethical elements make intrusion, the resultant accounting details become anything but true and fair.

2.1.3 Bank Failures/Distress in Nigeria

Bank failures and distresses are age-long problems that have always played depository institutions. Each bank failure comes with a liquidation problem, where the depositors and creditors to the bank suffer huge losses. As problems of bank failures increased, government regulations came to be handy, to protect unwary depositors and the economy at large, thereby preventing systemic abuse of the early bankers. The history of financial distress in Nigeria's Banking System dates back to 1930 when about 21 banks failure were recorded, prior to the establishment of the Central Bank of Nigeria in 1958, bank distress in Nigeria could be traced to the free banking era. Historically, before the indigenous banking crises of the 1950's there were only three bank failures- the industrial and commercial bank (1930), the Nigerian mercantile bank (1936) and the Nigeria Penny Bank in (1946). Between the ordinance years of 1952 to 1954, eighteen banks went to their early and untimely graves fall due to undercapitalization and unsound banking practices perpetrated by their operators. With each failure, the depositors usually bore the brunt of distress, suffering untold hardship and losing a reasonable or entire deposit. It was against this background that nationalists agitated for a Central Bank for Nigeria as a regulatory and supervisory body that could salvage the poorly staffed and poorly capitalized indigenous bank threatened by the regulation not necessarily for liquidation activities. More damaging to these indigenous banks were sections 5(2) and 6(2) of the ordinances, which gave the existing banks three years within which to comply with the provisions of the ordinance or discontinue banking business. Therefore, there was peace and stability in the banking sector until 1986, when under the pressure from the International Monetary Fund (IMF) and the World Bank, a structural adjustment program (SAP) was launched as the official policy for Nigeria. The deregulation of the economy created risk and opportunities for the banks and there was increased competition among banks and also finance houses, which were a creation of government deregulation (Uche, 2013).
The identification of bank distress signals with eight banks occasioned by the liberalization and deregulation policies of the mid-1980s, coupled with the demands of the 1988 Basle Accord of Capital Adequacy for banks, culminated in triggering off the establishment of the Nigeria Deposit Insurance Corporation (NDIC) Decree of 1988.

2.2 THEORETICAL FRAMEWORK

Legitimacy Theory

This theory was defined by Dowling and Pfeffer in 1981 as a study of how the external resources of organizations affect the behavior of the organizations. The procurement of external resources is an important tenet of both strategic and tactical management of any company. It highlights the extent to which corporate social and environmental disclosures are influenced by the boundaries

established by the society in order to be appreciated and avoid being penalized by the society in which the company operates. (Not patronizing effectively)

Ethical Theory

Velayutham, (2013) opined that companies generally prefer to report a steady trend of growth in profit rather than to show volatile profits with a series of dramatic rises and falls. This is achieved by making unnecessary high provisions for liabilities and against assets values in good years improving reported profits, these provisions would be reduced later in bad years. Advocates of this approach argue that it is a measure against the 'short-termism' of judging an investment on the basis of the yield achieved in the immediately following years. It also avoids raising expectations so high in good years that the company is unable to deliver what is required subsequently. Against this it was argued that if the trading conditions of a business are in fact volatile then investors have a right to know this and that income smoothing may conceal long-term changes in the profit trend.

Information Theory

The information perspective or theory according to Ball, (2013) is a key element underpinning the study of the creative accounting phenomenon. There exists an information asymmetry in corporate structures between a privileged management and a more remote body of stakeholders. Managers may choose to misuse their privileged position to exploit shareholders by managing financial reporting disclosures to their advantage (Schipper, 2018). It may be quite difficult for individual stakeholders to detect accounting manipulation practices by management due to their insufficient personal skill and indifference or unwillingness to engage in a detailed financial analysis, (Effiok & Eton,2012).

Wittenberg-Moerman (2018) suggests that conservative reporting decreases information asymmetry regarding a borrower and increases the efficiency of the secondary trading of debt securities.

2.3 EMPIRICAL REVIEW

Ijeoma (2014) carried out a study on creative accounting on Nigeria's banking sector and the result revealed that the major reason for creative accounting practices in the Nigerian banking industry is to inflate the operating costs to reduce exposure to taxes. Karim (2016) conducted a survey on the existence of a gap between accounting and auditing perceptions of creative accounting, and possible solutions to regulate such practices in Bangladesh. The survey has shown that there is no reason to punish either auditors or accountants for applying creative accounting. Accountants are only company employees that follow management instructions. Therefore, if management demands that financial statements are prepared in a certain way, accountants will primarily be concerned about keeping their jobs, and will follow the instructions accordingly. The recent study by Charles (2015), on the practices influencing creative accounting among corporations listed in Nairobi Securities Exchange their findings concluded that management compensation, contractual obligations, tax management and insider dealings are practices that significantly influence creative accounting among companies listed on the NSE in Kenya. Charles G. K, Agnes N. M, & Dorothy M.N, (2012) established that tax avoidance and evasion is a major motivation that drives practice of creative accounting

Fagbemi, T. O, &Olaoye, Joshua A (2014) conducted research on "Cosmetic Accounting: A Review of Literature and Perception of Accountants' in Nigeria" and their findings from the study

show that respondents are aware of cosmetic accounting and that it is unethical. The results also indicate that the investors suffer as a result of decisions made using a doctored financial statement. Furthermore, Alzoubi (2016) analyses the connection between company management and earnings management in Jordan. He arrived to the conclusion that ownership structure has a significant influence on earnings management
Also, Conner (2017) notes that creative accounting amounts to fraudulent reporting, as it creates an illusion that the entity is healthier and more prosperous than it actually is. Sen and Inanga (2015) found evidence of creative accounting by firms in Bangladesh which they traced to conflict of interest amongst different groups that the accountant wants to serve. Accounts are therefore prepared to serve the particular group the accountant so wishes. Schiff (2013) states that investors should beware of taking a company's financial report on the face of it as it could be a recipe for disaster. He re-emphasized that the earnings per share (EPS) which is what investors actually pay for in the course of investment can be easily goosed and manipulated. Such manipulation could be done through consolidating own subsidiary's income and net worth; capitalizing expenses instead of writing them off and hiding pension liabilities.

Moreover, Leung and Cooper (2015), in Australia conducted a survey of 1,500 accountants and found that creative accounting as an ethical issue ranks above tax evasion. Merchant and Rockness (2014) in their study investigated the motives for creative accounting and found that explicit self-interest motivated creative accounting got higher disapproval than where the motive is to promote the company. Also found is that accountants are more critical of the abuse of accounting rules than of manipulation of transaction. Fisher and Rosenzweig (2015) proffer explanations of the findings for accountants" attitudes. Evidence of the practice of creative accounting has been found to be global (Sen and Inanga, 2015). Here in Nigeria, Izeze (2018) found proof of the practice of creative accounting concerning oil multinationals. He emphasized that figures of oil transactions submitted to the Nigerian National Petroleum Corporation (NNPC) and Department of Petroleum Resources (DPR) are largely cooked up and that for a long time, the oil multinationals in Nigeria have practiced creative accounting accidentally fleecing the country of its enormous fortunes. Also, the management of African Petroleum Plc had used creative accounting to hide a debt of N23 billion during the privatization of the company (Proshare, 2019). This act is the antecedent of its share scandal.

In addition, Osazevbaru (2012) in a study "creative accounting and firms market value in Nigeria", looked at the impact creative accounting could have on a firm's value. Statistical evidence revealed that it can positively affect a firm's value. This implies that most investors are not able to see through the financial illusion of creative accounting. Therefore, they act according to the prospect theory of Kahneman and Tversky (1986) which posits that individuals often tend to use cognitive heuristics when faced with the complex task of assigning probabilities to uncertain outcomes. This has some important implications for the enforceability of standards whether international or local. That business is not exempt from morality suggests that activities of account preparers as moral agents can be questioned. That created financial statement suits the purpose of the preparers, which makes it unfair to users and tend to undermine the authority of regulators. Akembor (2012) in their study revealed that the major reason for creative accounting practices in Nigerian banks is to boost the market value of shares and that users of accounting information are adversely affected by the practice of creative accounting.

3.0 Research Methodology

This study adopts a survey method of research design and the population of the study is the staff of commercial banks in Nigeria. The study adopts quota sampling technique and the sampled members consist of failed banks in Maiduguri, giving a total sample size of 42. The questionnaire was used as the main instrument for data collection. The questionnaire was designed in five response Likert-scale options and administered to Accountants and branch Managers of the sampled banks for the study. The data generated were presented in a tabular form and analyzed using mean scores and the hypotheses were statistically tested with Z-test. This is in line with the methods used by Osazevbaru (2012) and Munene (2014). The formula for calculating *Z* is as given below:

$$Z = \frac{\bar{X}_1 - \bar{X}_2}{\sqrt{\frac{(n_1-1)(S_1^2) + (n_2-1)(S_2^2)}{n_1 + n_2 - 2}\left(\frac{1}{n_1} + \frac{1}{n_2}\right)}}$$

Where:

Z = **Z test**
$\bar{X}$ = Mean of the sample of Managers
$\bar{X}$ = Mean of the sample of Accountants
S_2^1 = Variance of the sample of Managers
S_2^2 = Variance of the sample of Accountants
n_1 = Sample size of the Managers
n_2 = Sample size of the Accountants

4.0`RESULTS AND DISCUSSION

The responses to the questionnaires administered were presented and hypotheses were tested using Z test.

$H_0$1: There is no significant extent to which corporate governance enhances efficiency. We used the data generated to test this hypothesis. The computed Z is **4.11**

Decision: We **r**eject H_0 since Z-computed (**4.11**) is greater than Z-critical value (**1.96**). This implies that corporate governance enhances efficiency and thereby adversely affect the stakeholders of accounting information.

$H_0$2: There is no significant way in which corporate organization practice earnings management in Nigeria. This hypothesis was tested using the data generated and the result of the computed **Z** is **2.96**

Decision: We reject H_0 since Z-computed (**2.96**) is greater than Z-critical value (**1.96**). This implies that there is a significant way in which corporate organization practice creative accounting.

5.1 CONCLUSIONS

This study found a strong positive relationship between earnings management practices and corporate risk which ultimately result to corporate failure. The result is based on analysis of a 5 – point - Linker scaled questionnaire responses from some major corporate firms in Nigeria. It shows that the higher the level of earnings management practice, the higher the corporate risk. Management influenced by various reasons manipulates the information content of financial statements to beat the scrutiny of not only the 'uniformed' interest groups in and outside the

company but also the well informed professionally - trained external corporations. Earnings management is negative and antithetical to integrity. The established effect of earnings management combines with the recent wave of accounting scandals that swept across Nigeria and the rest of the world leading to public outcry of culpable negligence, recommended that corporations should ensure that they obtain sufficient evidence, exercise due diligence and professional skill to properly evaluate financial statements which may have been 'doctored' by management in exercise of creative accounting.

5.2 RECOMMENDATIONS

Accountants must increase or work on their moral values by putting into the highest practice their ethical code of conduct. This is because the value of all accountants is a function of the reputation of the profession. So, stopping earnings management must be the duty of accountants and corporations by religiously following the generally accepted accounting and corporatizing principles and practices.

The practice of forensic accounting which integrates accounting, corporatizing, and investigative skills should be embraced to discourage creative accounting.

Earnings management practices should be considered as a criminal offense and therefore accounting bodies, law courts, and other regulatory authorities need to adopt strict measures to stop the practice and punish offenders.

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