



EARNINGS MANAGEMENT AND ANALYSIS OF OPPORTUNISTIC BEHAVIOUR, MONITORING MECHANISM AND FINANCIAL DISTRESS

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ABSTRACT

This paper explores the dynamic between proactive approaches to earnings management (free cash flow and profitability), passive mechanisms of observation (leverage), and proactive responses to pressure (financial crisis). Several variables may provide incentives for management to control costs and maximise profits. This research operates on the premise that management has a propensity to tinker with reported results in order to conceal losses or declines in profitability. This study used a sample of Nigerian publicly listed firms from 2010–2012 and found that earnings management was most common when companies were profitable and in good financial condition. This research's findings would help clarify the interplay between various factors, allowing regulators to make more informed decisions on how to strengthen laws and regulations and bolster public trust in financial reports.

INTRODUCTION

The technique of managers manipulating financial reports via transaction structuring and financial reporting at their discretion is known as earnings management. The goal of this manipulation may be to sway the results of contracts that depend on reported accounting data, or it may be to mislead certain stakeholders about the company's real economic performance (Healy & Wahlen, 1999). Managers have the ability to use earnings data to convey to debt holders and shareholders important information about the operation of the organisation. If this is the case, then there may not be any detrimental effects on the public and shareholders from profit management. The Enron and WorldCom financial crises changed the way people thought about profit management, making it more opportunistic. The perception is that when it comes to managing profits, managers put their own interests ahead of those of the investors (Arya et al., 2003; Hao, 2010; Jiraporn et al., 2008).

Unlike fraudulent operations, earnings management entails the use of accounting procedures and estimations that comply with generally accepted accounting standards (GAAP). Within the confines of recognised accounting practices, companies that engage in earnings management would influence their results (Rahman & Ali, 2006). Supervisors may not inflate profits if monitoring systems are in place. The monitoring theory acknowledges the impact of outside observation, such as creditor scrutiny, on the application of earnings management. Shih and Yueh (2002) suggest that ongoing surveillance may be a useful tool for identifying and mitigating the effects of management practices that lead to inflated profits over time.

Economic hardship may have detrimental effects on the economy and result in possible losses for creditors and investors. In the case of financial difficulties, managers may anticipate having their bonuses cut, perhaps losing their jobs, and having their reputation and career negatively impacted (Liberty & Zimmerman, 1986; Gilson, 1989). By using accounting techniques that falsely increase revenue and conceal losses, managers may turn to conservative management techniques in an effort to hide diminishing performance (Habib, Bhuiyan, & Islam, 2013). In spite of not exhibiting any prior indications of financial crisis, companies that participate in income-increasing profit manipulation practices are more likely to go bankrupt, according to Rosner (2003).

This research aims to investigate the relationship between pressure behaviours (financial hardship), leverage as a monitoring device, and opportunistic behaviours (free cash flow and profitability) in connection to earnings



management. The aim of this study is to explain the link among the variables. Regulators may find the results useful in tightening guidelines and standards to boost public trust in the accuracy of reporting financial activities. The goal of this research is to provide investors and regulatory bodies with useful information about how well companies disclose their financial information.

LITERATURE REVIEW

The measurement and distribution of economic data to users of financial data is known as accounting. Accounting is separated into two distinct groups based on who the information is intended. Businesses use internal accounting to make decisions, particularly when assessing projects and profitability. Conversely, external accounting functions to support stakeholders in decision-making about their affiliation with the company. The many stakeholders that external accounting affects, including creditors, investors, regulators, consumers, suppliers, and staff, should get useful information from it. Making educated judgements about future investments, tax planning, company partnerships, and employment decisions requires knowledge of this information (Watts & Zimmerman, 1986; Spohr, 2005).

The management of the company is in charge of gathering and disseminating external accounting data. Managers leverage their familiarity with the business as insiders to provide information that appropriately depicts the company's performance and financial situation. Accounting data must be both reliable and relevant in order for decision-makers to find it valuable (Spohr, 2005). Managers have discretion in generating and submitting financial data for their own gain when there is an informational imbalance among them and outside data consumers. The term "earnings management" describes the use of judgement in the compilation and presentation of accounting data.

There is a lack of precision and clarity in the definitions of earnings management. The idea of earnings management has been well defined by earlier studies. One of the pioneers in the subject of earnings management definitions is Schipper (1989). Schipper (1989) supplied the following definition of dishonestly tampering with the external financial reporting system to get a personal advantage:

Healy and Wahlen (1999) provide an extensive explanation of earnings management. The technique of managers manipulating financial reports via transaction structuring and financial reporting at their discretion is known as earnings management. The goal of this exploitation is to either sway the results of contracts that depend on reported accounting figures or deceive some stakeholders regarding the business's true financial results.

Earnings management is defined by Leuz, Nanda, and Wysocki (2003) as insider manipulation of a company's reported financial performance with the goal of misleading particular stakeholders or affecting contractual outcomes. Although the concept of profit management usually recognises the significance of managerial intention, it is unclear whether this aim should be opportunistic in character. In certain presentations, the phrase "earnings management" refers to managerial judgement rather than self-serving activity (Dechow & Skinner, 2000; Scott, 2003). Financial reporting that is dishonest may result from illicit profit management, which may lead to users misinterpreting financial figures. The Enron case serves as an example of how fraudulent financial reporting may lead to serious regulatory penalties and a company's demise. It is best to refer to generally accepted accounting rules (GAAP) when assessing the validity of earnings management. Recognised as genuine are earnings management practices that follow GAAP guidelines. Illegitimate profit management may result from a departure from GAAP (Al-Khabash et al, 2009).

Yaping (2005) found that the practice of earnings management entails using managerial discretion to modify accounting estimates and employment-related regulations. Dechow and Skinner (2000) assert that managers have the power to use their judgement and discretion in accounting, which allows them to choose appropriate accounting procedures and make estimates within those procedures. One technique for managing profits is the use of accruals. Although there is a connection between total accruals and managing earnings, it's crucial to understand that not all of total accruals' components are. You may split the whole accrual into two halves. The first section talks about normal accruals, or non-discretionary accruals, which are based on management's assessments of the financial performance of a firm (Abd. Rahman & Mohamed Ali, 2006).

According to accounting rules, management is responsible for overseeing the quota of total accruals known as discretionary accruals (Amman et al., 2006). One way to evaluate if earnings management is present is through the



use of discretionary accruals. In their individual investigations, Becker et al. (1998), Abd. Rahman et al. (2006) have all used discretionary accruals as a metric for managing earnings. Apart from accruals, there are other methods for handling profits. Ratsula (2010) suggests four methods for controlling profits. The first technique is known as bathing. In periods of significant organisational stress or rearrangement, management may purposefully disclose bigger losses in an effort to boost the possibility of reporting future profits.

Furthermore, minimising revenue is another element to take into account. High-profit businesses are more likely to use this strategy to reduce income tax obligations and counteract political pressure. To lower reported income, this strategy entails raising costs. Maximising revenue is the main goal of the third strategy. It is managers who gain more from this strategy than stockholders. Income smoothing is the last method. The purpose of the strategy was to lessen the reported income's unpredictability. In order to control profits, management often uses earnings smoothing rather than reporting low results. The management's primary motivation influences the methods they use to manage revenues (Ratsula, 2010).

There are a number of reasons why managers may control profits. Duncan (2001) claims that businesses that either report unusually high profits or decide not to reveal a drop in revenue are examples of firms that engage in earnings management. According to Aman et al. (2006), variables linked to profit manipulation include stock ownership, internal finance, political costs, and debt covenants. This research makes the assumption that management often manipulates results in order to avoid disclosing deficits or drops in reported profitability. The goal of window dressing is to provide a front that shows a company's capacity for competition and sustained excellence in the marketplace (Shuto, 2007). To hide subpar performance and give the impression that the business is doing well, opportunistic managers may falsify accounting data.

This research looks at managers' opportunistic actions in connection to the profitability and free cash flow of the business. An agency issue may arise as a result of managers manipulating profitability by taking advantage of large amounts of free cashflow. The surplus cash flow that may be used to fund initiatives with a positive net present value is referred to as free cash flow (Jensen, 1986). When a business misallocates its free cash flow or spends it without considering the objective of increasing shareholder wealth, the agency issue occurs (Jensen, 1986). The management might choose to make a low-return or successful investment. A corporation may have slow growth if its investments are unprofitable or have minimal returns. Research to date indicates that when there is a large excess of free cash flow, managers are more inclined to seek personal gains (Gul, 2001).

Corporations with surplus free cash flow are usually linked to discretionary accruals in terms of earnings management. Evidence for the idea that excess free cash flow might encourage managers to take income-increasing actions and indicate financial flexibility was discovered by Bukit and Iskandar (2009). Businesses with strong free cash flow and little prospects for expansion are often linked to the agency dilemma. Under these circumstances, managers often take part in income-boosting activities to inflate reported profits (Chung et al., 2005). Stulz (1990) noted that when there is no cash flow imbalance, businesses are more possible to issue loan as external finance. Managers may invest in successful ventures rather than letting their free cash flow go to waste. Managers at companies with surplus capital and limited development possibilities may find it more difficult to make wasteful investments if they are subject to effective checking and corrective procedures from institutional shareholders, investors, boards of directors, audit committees, and other stakeholders (Gul, 2001).

To raise investor hopes for the business's potential for achievement, and its offer price, managers often falsify reported results (Rahman & Abdullah, 2005). Furthermore, managers of businesses that are losing money are inclined to participate in earnings smoothing (White, 1970). When there are large swings in revenue and diminishing profitability, managers are driven to stabilise a company's profits (Ashaari, et al., 1994). Dennis and Michel (1996) identified three primary objectives for profits management: lowering the firm's financial expenses, enhancing the wealth and well-being of managers, and minimising political costs. It is essential for managers to guarantee that earnings management fulfils a minimum of one of these goals.



METHODOLOGY

The study adopted an ex post facto design. The research used information from Nigerian publicly traded firms between 2019 and 2021. The research measured earnings management using Kothari's (2005) model. Several studies on earnings management, including those by Ahmad-Zaluki et al. (2011), Joubert & Fakhfakh (2012), have used this measurement. The ability of discretionary accruals, often referred to as anomalous accruals, to comprehensively and logically assess the dependability of accounting data makes them a widely used technique. This result is consistent with studies by Sun, Salama, Hussainey, and Habbash (2010).

As detailed by Mutchler et al. (1997), McKewon (2003), and others, there are a number of methods available to evaluate a company's financial health. Numerous research have used the Altman Z-Score to gauge financial hardship, and it is a popular tool for evaluating a business's financial standing (Maina & Sakwa, 2012). Demirhan and Platt (2009) divided the z-score-based classification of a company's financial health into three groups. Financially distressed companies are those with a z-score of less than 1.81; financially sound companies have a score of more than 2.67. Businesses in the "grey" category are those whose ratings lie between those of financially sound and financially troubled businesses.

Nonetheless, the research uses profit and free cash flow as markers of opportunistic conduct. We used the Lehn and Poulsen (1989) approach to calculate the free cash flow. Previous studies have shown a robust relationship between operational cash flow, return on assets (ROA), and the profitability of the organisation. Additionally, the study's use of return on assets (ROA) is based on current research projects. A good return on assets (ROA) might encourage management to inflate profits and provide a rosy picture of the company's potential profitability in the future (Demirhan & Platt, 2009). The research used return on assets (ROA) as a criterion to evaluate the performance of the firm, in line with Rahman and Ali's (2006) study. The computation of ROA included dividing the total assets by operational income, also known as earnings before interest and tax, or EBIT.

As a stand-in for leverage, the study uses the debt ratio (total debt/total asset), which is in line with Kim and Yoon's (2008) methodology. Research by Sukeecheep et al. (2013) has shown that the size and liquidity of a customer significantly affect discretionary accruals. As control variables, the research takes the company's size and liquidity into account.

ANALYSIS AND DISCUSSION

The research employs dependent, independent, and control variables, and Table 1 presents the descriptive data for each. The variables included in the research have a statistical explanation thanks to the descriptive analysis. Each variable in the research has its mean, standard deviation, lowest, and maximum values shown in the table. The results of the empirical study show that earnings management occurs between 0.000 and 0.160. According to reports, the average profit management value is 0.033. The study's result for earnings management is more than that of Abdul Rahman and Mohd. Ali (2006) (0.0132), but it is less than that of Mohd. Yusof (2010) (0.165). Based on available data, it seems that Nigerian public businesses generally use earnings management.

With an average financial distress rating of 0.734, the firm is not deemed healthy since it is below the 1.8 criterion (Demirhan & Platt, 2009). The results show that 73.4% of the tested enterprises fall into one of two categories: distressed or in the grey area.



Table 1. Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
EM	1166	0.000	0.160	0.034	0.032
FIN_DISTRESS	1166	-0.002	2.694	0.735	0.432
FCF	1166	-0.196	0.215	0.009	0.0581
PROFIT	1166	-0.199	0.343	0.062	0.072
LEVERAGE	1166	0.000	1.391	0.198	0.166
SIZE	1166	4.403	7.946	5.601	0.619
LIQUIDITY	1166	-0.935	0.974	0.224	0.234

Multiple linear regressions have been employed to test the hypothesis. Table 2 summarises the outcomes of the multiple regression analysis.

Table 2. Multiple Linear Regression (2019-2021)

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Tolerance	VIF
	B	Std. Error	Beta				
(Constant)	0.083	0.009		9.065	0.000		
FIN_DISTRESS	-0.007	0.002	-0.100	-3.238	0.001*	0.869	1.151
FCF	-0.022	0.022	-0.041	-0.996	0.320	0.488	2.050
LEVERAGE	0.032	0.007	0.171	4.550	0.000*	0.583	1.714
PROFIT	0.040	0.018	0.097	2.205	0.028*	0.427	2.340
SIZE	-0.010	0.002	-0.196	-6.166	0.000*	0.820	1.220
LIQUIDITY	0.005	0.005	0.040	1.034	0.301	0.554	1.804
R Square	0.044						
Adjusted R Square	0.039						
F Change	0.000						

a. Dependent Variable: EM

b. Predictors: (Constant), LIQUIDITY, FIN_DISTRESS, SIZE, FCF, LEVERAGE, PROFIT

The R-squared value is the proportion of the variance in the dependent variable that the independent factors can explain. It shows the percentage of the independent variable that the dependent variable accounts for or explains. According to this research, the factors FCF, LEVERAGE, PROFIT, SIZE, LIQUIDITY, FIN_DISTRESS, and SIZE together explained 4.4% of the variation in earnings management. Moreover, the results of this investigation corroborate the idea that the model used in this study is suitably specified. Regressals with accruals often exhibit low R2 values (Jenkins & Velury, 2008).

The table displays empirical results that establish whether hypotheses 1 (H1), 2 (H2), and 3 (H3) are supported or refuted. The hypothesis put forth in this research was that the occurrence of opportunistic behaviours, particularly profit and free cash flow (FCF), would be suggestive of earnings management (H1). H1 has some support based on the data shown in the table. In particular, the study shows a substantial correlation ($p = 0.028$, $p < 0.05$) between profit and the factors included. But there isn't a statistically significant correlation ($p = 0.320$, $p > 0.05$) between the factors and free cash flow. The presence of a positive connection between profit and a firm's present profit level implies that managers may be inclined to manipulate reported profits in order to benefit from favourable reported earnings. Bukit and Iskandar (2009) discovered a negative association among managing earnings and free cash flow. This implies that to preserve the business's existence and continuity during periods of low cash flow, managers may turn to earnings



management. The companies want to show the public that they are not running at a loss and that they can fulfil their commitments. The repercussions of disclosing losses might encourage management to falsify profits, which could provide users of reported income with inaccurate information.

Nonetheless, the outcomes furthermore bolster H2 ($p=0.000$, $p<0.005$). According to H2, there is a connection between earnings management practices and monitoring techniques. Contrary to expectations of a negative link between earnings management and monitoring measures, there is an apparent positive association between the two, as indicated by leverage. According to study by Ling et al. (2007), managers are less likely to manipulate profits when there is more external monitoring in place.

Financial hardship, which acts as a stand-in for pressure behaviour, has a substantial p-value of 0.001 ($p<0.05$), supporting the H3 theory. The existence of an inverse link among financial difficulty and earnings management implies that managers control earnings while the firm is not facing financial problems but do not do so when it is. This investigation supports the conclusions made by Demirkan and Platt (2009). Demirkan & Platt (2009) claim that since troubled enterprises have previously exhausted all other avenues for controlling and manipulating results prior to going through financial hardship, they do not participate in earnings management. Furthermore, they may not think that manipulating others in this way is beneficial.

CONCLUSION

For empirical research, this study used a sample of Nigerian publicly traded companies from 2019 to 2021. One hypothesis (H1) was proven false, but two others (H2 and H3) were validated. Managers manage profits when the business is prosperous and in good financial standing.

Earnings manipulation taints reported earnings information and makes it difficult to understand a company's operational success. Policymakers and regulators should be concerned about this since giving investors biased information might negatively impact their ability to make decisions, which would hinder the smooth functioning of the financial markets. Lawmakers and regulators have created rules and regulations to ensure the reliability and integrity of published information in response to these concerns. Protecting the interests of those who depend on this data to make financial choices is the goal.

In light of the above, the government should provide assistance to large Nigerian firms. In order to assure the survival of businesses, the credit-based business climate most depends on banks for corporate financing, especially during times of financial difficulty. This might be a unique feature that sets the Nigerian financial system on a sustainable path.

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