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The Impact of Earnings Management as for The Nigerian Listed Firms Financial Reporting Quality on Information Asymmetry

Saheed A. Lateef[1], Norfadzilah Nik Mohd Rashid[2], Umar Aliyu Mustapha[3], Abdallah Bala Ado[4]

[1 2 3,4]Universiti Sultan Zainal Abidin Malaysia
[1]*latsad4real@yahoo.com*
[2]*nikmfadzilah@unisza.edu.my*
[3]*umaraliyu 2011@gmail.com*
[4]*abdallahkmata@gmail.com*

ARTICLEDETAILS

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ABSTRACTS

Earnings management is one of the critical issues related to financial reporting quality, particularly after the Enron and WorldCom scandals. Earnings management behaviors are related to the low level of corporate social responsibilities (CSR) and improvement in both areas would be expected to result to Improvements in the quality of financial reporting (FR). Hence, the aims and objective of this study is to examine the impact of earnings management as financial reporting quality on information asymmetry for the listed firms, Nigeria. The study is a conceptual paper on the relationship between earnings management of financial report and information asymmetry of Nigerian listed firms. Based on constructing the underlying theoretical framework of earnings management, the relationship between earnings management and information asymmetry is studied. The study revealed that both real earnings quality and accruals earning quality models are relevant to understanding the financial reports, that is, lower information asymmetry challenge. Therefore, uninformed users of financial reports are encouraged to rely on financial analysts in order to make efficient portfolio decisions. Also, if there is any need for the management of listed companies to use earnings manipulation, real earnings manipulation is recommended for them rather than the accrual-based approach. Finally, the study suggests that other researcher(s) can go beyond this to put retail and institutional on one side, and foreign investors on the other side, then focus on each group in separate studies.

INTRODUCTION

Information asymmetry is concerned with the level of understanding of information between the managers of the firms and the users of financial reports (Almasarwah, 2015). Higher information asymmetry means that the management which prepares the financial reports are at a better position to manipulate the activities of the business and the financial reports they prepare to their advantages (Zhang, 2018; Li, 2017). That may lead owners at a loss as to the actual state of affairs of the business at the end of financial year since they do not have adequate information. It needs to be mentioned that the value of information in the reports is determined by the quality of decision made by the investors who used the information.

*Corresponding Author Email Address: latsad4real@yahoo.com

A high-quality financial report will bring about a reduction in information asymmetry and hence reflects on investments in the stated firm. It is essential to note that investment decisions makers are classified into two: professional or informed; and non-professional or uninformed. Informed decision makers are those investors whose investment decisions emanate from sound and well analysed financial information while uninformed investors make their investment decision by being influenced by more of other factors other than financial information (Habib Jouber, Hamadi & Fakhfakh, 2011).

Fundamentally, investments in companies and other organisations are made by retail investors, institutional investors, and foreign investors. Whereas institutional investment groups usually have financial professionals in their organisations hence are informed, retail investors, and sometimes foreign investors may not necessarily be professionals themselves or may not have much of financial knowledge (Almasarwah, 2015). The peculiarity of many sectors most especially the manufacturing sector as considered by this study, is to the effect that Nigerian government is seriously concerned about its contribution to the Gross Domestic Product (GDP) especially as the government is desirous of diversification of the economy. Activities in the many sectors of the economy have slowed down considerably, though the growing demand for services under normal development theory should have been fulfilled by manufacturing which should have grown alongside the services.

Several studies on the relationship between financial reporting quality and information asymmetry focused on general relationships, that is, without demarcations between the proxies of earning quality to check their effects (Nnadi, Omoteso, & Yu, 2015). Some others that attempted demarcations either focused on one of the most common measures of earnings management, Accrual Earnings Management (AEM) quality or Real Earnings Management (REM) quality only; or focused only on the earning quality as it affects investment decision, investment efficiency among other (Ranjitha & Madhumathi, 2015). To the best of the researcher knowledge, none of these studies especially in Nigerian environment has tested the effect of earnings management measures of financial reports on information asymmetry, using both real and accrual earnings quality measures. Therefore, this sector needs to have a single study that will examine both the accrual and real earnings quality of the financial reports prepared by firms towards the information asymmetry in the sector.

RESEARCH OBJECTIVES

The main focus of this study is to examine the impact of earnings management as a financial reporting quality on investors' information asymmetry of Nigerian Listed Firm with focus on the area of both real and accrual earnings quality measures. The specific objectives are as follows:

a. To examine the impact of real earnings management for financial reports on information asymmetry of Nigerian listed firms.

b. To ascertain the effect of accrual earnings management for financial reports on information asymmetry of Nigerian listed firms.

LITERATURE REVIEW

Information Asymmetry Concept

Information asymmetry can be explained as a situation in which preparers of financial reports have more information compared to the users of the financial reports. Academic literature, for instance, Verrechia (2006), suggests that better disclosure policies

by firms reduce information asymmetry between insiders and outsiders by bringing private information into the public domain. Usually, information asymmetry is studied in the context of principal-agent problems. It is in contrast to comprehensive information that is a critical assumption in neo-classical economics. The concept, as reported by Auronen (2003) was first introduced by Akerlof (1970) in his paper titled 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism'. Subsequently, Spence (1973), Stiglitz (1975), and Rothschild and Stiglitz (1976) expanded the concept to develop the concepts of signalling and signalling equilibrium, screening, and externalities respectively.
In a more recent period, information asymmetry is becoming a subject of significant interest among academics. Beginning with Kyle (1985), for instance, it was argued that an increase in information asymmetry adversely affects the cost of capital as liquidity providers increase bid-ask spread to guard against adverse selection risk. In agreement with this position, Bhattacharya and Spiegel (1991) suggest that information asymmetry causes unwillingness to trade and increase the cost of capital as investor protect themselves against potential losses. This study agrees with the positions of Kyle (1985) and Bhattacharya and Spiegel (1991). The question we asked, concerning the case of listed firms in Nigeria is that 'can the low trading in the shares of these firms on the Nigerian Stock Exchange be attributed to the problem of information asymmetry?

As a challenge, information asymmetry has a negative effect on the cost of capital. For example, the theoretical work of Verecchia (2006) showed that the information environment; precisely the extent of private information and differences in information across investors affects a firm's cost of capital. In another report, Lambert, Leuz, and Verrechia (2007), it was claimed that the relationship between information and cost of capital arises due to the precision of information about the distribution of the firm's future payoffs.

Thus, earnings quality can affect the uncertainty about the future distribution of the firm's payoffs and thereby also affect the information asymmetry between informed and uninformed investors. It needs been mentioned equally that researchers, such as Hirschleifer, Hou, Teoh, and Zhang (2004); Desai and Venkataram (2007); among others have theorized that "a subset of sophisticated investors (short sellers) are able to discern that persistence of earnings reported by firms with high accruals are not sustainable and assume positions accordingly to arbitrage on the overpricing". In line with these issues and especially considering the position of Bhattacharya and Spiegel (1991), one possible answer to the questions of low trading in the shares of listed firm including manufacturing firms in Nigeria, as opposed to the shares of banks, is to posit that there is information asymmetry which has invariably caused unwillingness to trade in their shares. This hypothetical position is premised on the fact that in the same market, some sectors shares enjoy patronage why some not enjoy the patronage including manufacturing sectors.

Financial Reporting Quality Concept

The term, qualitative characteristics of financial reports, as defined by the International Accounting Standards Committee (IASC, 1989) as "attributes that make the information provided in financial statements useful to users". These characteristics were divided mainly into Fundamental qualitative characteristics and enhancing qualitative characteristics. The Fundamentals are Relevance and Faithful representation while the enhancing characteristics are: comparability, verifiability, timeliness and understandability. These characteristics are to enhance the usefulness of information that is relevant and faithfully represented IASB (2010).

The main aims and objectives of financial reporting is to provide high-quality financial reporting information concerning economic entities, primarily financial useful for economic decision making (Elkalla, 2017; Dimkpah; 2013; Beest, Braam, & Boelens, 2009). In the same vein, FR provides information about the financial position of reporting entities, (i.e., the information about the entity's economic resources and claim against the reporting system. They, as made available by the management of enterprises are not prepared to 'fulfil all righteousness'. They are meant to serve some purposes hence their preparations.

Financial reports are the product of financial transactions and activities of the firm usually prepared periodically especially as they may be required. The goal is to provide information that is adjudged useful for decision making by the users. The duty of preparation of the reports is placed on the shoulders of the management, who, as required by the Agency theory, run the day-to-day affairs of the firm, for and on behalf of the shareholders. As put by Jonas and Blanchet (2000), financial reporting is not only a final output because its quality depends on each of its parts including information about the selection, the disclosure of the company's transactions, and application of accounting policies and knowledge of the judgments made.

Furthermore, Quality of financial reports is seen in the benefits derived from the reports by the users. High-quality financial report reduces information risk. It minimises asymmetric information problems that arise from conflicting agency' (Rajgopal & Venkatachalam, 2011). Also, it prevents managers from using discretionary power for their benefit in addition to helping them make efficient investment decisions (Zarowin, 2015; Leonie, 2013; Chen, Hope, Li, & Wang, 2011). In the light of this assumption, Martinez-Ferrero (2014) stated that high-quality information facilitates greater transparency thereby reducing information asymmetry and satisfying the needs of investors and other stakeholders. This study aligns with these positions as stated in respect of these benefits that depict the quality financial reports.

Although general purpose financial reports do not provide all the information that is needed by the potential investors, lenders and other creditors, they are expected to provide a basic set of information that should be able to help the existing, potential investors, lenders and other creditors to estimate the value of the reporting entity for a reasonable extent (Zhang, 2014; IASB, 2010). It is when this is seen and attested to by the users of these financial reports that one can reasonably conclude that they are of the required quality.

Where the qualitative factors of financial reports are present, the expectation is that there will be a reduction in information asymmetry, which invariably should affect investment decisions positively. This study aligns itself with the definitions and positions of authors and researchers cited in this section. Based on the prior study mention above, the main aims and objectives is on the earnings quality of financial reporting as they affect information asymmetry in the manufacturing firms in Nigeria.

According to Martinez-Ferrero (2014), the most employed proxies to assess FRQ in literature are classified into three as earnings quality; accounting conservatism; and accruals quality. This position of Martinez-Ferrero (2014) was premised on the illustration of Dechow, Ge, and Schrand (2010), who defined categories of earnings quality proxies, on the grounds that "higher earnings quality (EQ) indicates the features of the organization's earnings process that are essential to a specific decision used by specific decision- makers" . Hence, the proxies put as: properties of earnings, earnings response coefficients and external indicators of FRQ. On this premise, Dechow, Ge, and Schrand considered the determinants of earnings quality to be firm attribute, governance and controls, financial reporting practices, auditors, external factors, capital market incentives, and the institutional factors in the country of the company.

Concerning the position of Ball, Kothari, and Robins (2000), degree of accounting conservatism, which implies more timely incorporation of economic loss into accounting earnings management than of economic gains, is the second classification of FRQ proxies in the argument of Martinez-Ferrero (2014). The third classification is on the study of Garrett, Hoitash, and Prawitt (2012) that accruals quality is based on mapping previous, current and future cash flow operations with accruals.

For the fact that earnings quality measures are the most popular proxies for financial reporting quality in literature, primarily because the measure covers much information as captured in the financial reports, Authors, such as Jeanjean and Stolowy (2006); Garcia-Meca and Sanchez-Balesta (2009); Ahmed, Chalmers and Khif (2013); Lin, Chu, and Cang (2014); Sellami (2016); among others have proposed and used different proxies for earnings management, the most popularly used among these proxies are the REM and Accrual-based. It is on this note that we chose to review empirical studies primarily on their relationships with information asymmetry.

Following from above, these most common measures: accrual-based activities and real activities manipulation, need to be understood in line with how they are employed on a general level and more specifically in line with this study on the listed manufacturing firms in Nigeria. Whereas accrual earnings management implies discretionary accrual choices allowed within accounting standards with no direct cash flow consequences, real earnings management, on the other hand, involves deviations from standard operational practices to manipulate earnings numbers and thus have direct magnitudes on current and future firm cash flows. This study aligns with that classification in the measurement of earnings management of financial reports of listed firms in Nigeria.

Agency Theory

The separation or divorce of ownership of an organization from management gives rise to the theory, agency. Agency theory, propounded by Ross in 1972, specifies that in the recent corporation, managerial actions depart from those required to increase shareholder returns (Berle & Means, 1932; Pratt & Zeckhauser, 1985). As put by Jensen and Meckling (1976), agency theory terms stipulate that the owners are principals, and the managers are an agent, and there is agency loss in which return to the residual claimant, the owners are below what they would be if the principals and owners exercised direct control of firms.

In a similar vein, while the agency theorists suggest a clear separation of interests between owners and managers at the physical level (Dimkpah, 2013; Jensen & Meckling, 1976), this may be debatable and organizational sociologist will point out that what motivates individual calculative action by managers is their perception (1970). To the extent that executive feels their future fortunes are bound to their current firm's employers through an expectation of future pension rights. Then, the executive may perceive their interest as aligned with that of the firm and owners of the firms, even in the absence of any shareholding by that executive.

The theoretical considerations argue a view of managerial motivation alternative to agency theory. It may be termed as stewardship theory (Barney, 1990; Donaldson, 1990). Under this theory, the executive manager far from being an opportunistic shirker, mostly wants to do a reasonable job, to be a good steward of the companies assets. Therefore, stewardship theory holds that there is no general issue of executive motivation. Given the absence of an emotional, motivational problem among executives, there is the question of how far executives can achieve excellent corporate performance to which they aspire.

Stewardship theory, an immediate fall out from Agency, was propounded by Mitnick in 1973. It holds that performance variations arise from whether the structural situation in which the executive is located facilitates effective action by the executive. In the contributions of Donaldson (1985), the issue becomes whether or not the structure of the organization assists the executive to formulate and introduce a plan for high company performance. To what extent are Nigerian firms able to mitigate the negative influences of these theories, especially as is seen in the areas of information asymmetry and other relevant issues? This will be determined and answered in the fourth chapter of the study.

Research Framework and Hypotheses Development

The model adapted for this study, which combined both measures (Accrual and REM) qualities as independent variables with information asymmetry as the dependent variable was from the work of Abad *et al.* (2017). It needs to be mentioned that the model as putting in the study of Abad *et al.*, evolved from the works of Roychowdhury (2006), Barth, Landsman and Lang (2008), Cohen, Dey, and Lys (2008), Cohen and Zarowin (2010), Ahmed, Neel, and Wang (2013), Kim and Sohn (2013), Doukakis (2014), and Ge and Kim (2014). Based on the information revealed from the existing literature above, the study came out with the framework that shows the relationship between earnings management and information asymmetry.

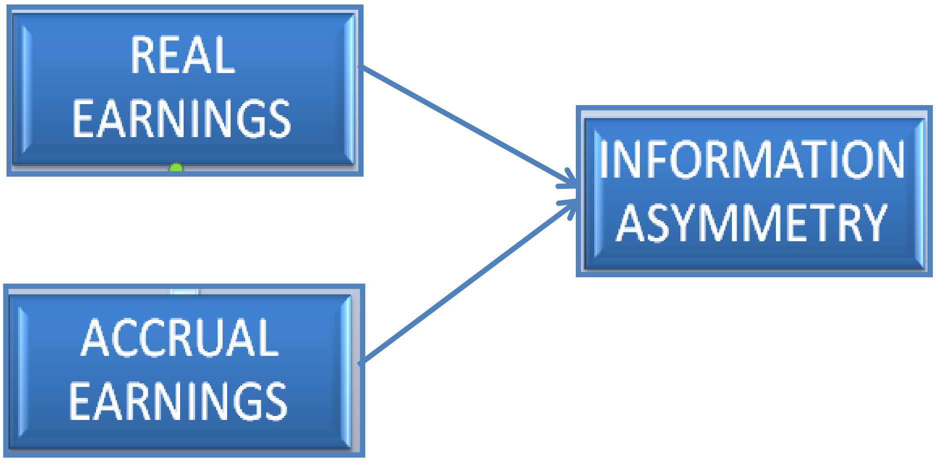

Figure 1: Theoretical Framework of Earnings Management of Financial Reporting Quality and Information Asymmetry of Nigerian Listed Firms.

Methodology and Hypotheses Development

This examines the relationship between earnings management of financial reporting quality and information asymmetry of Nigerian listed firm. The study is a conceptual paper in nature. The empirical evidence from the previous studies revealed that accrual earnings reported by the firms are noisier if managers intentionally smooth earnings (Elkalla, 2017; Zarowin, 2015; Zhang, 2018; Ranjitha & Madhumathi, 2015). Managers use discretion in financial reporting to reveal more about the firm's future earnings and cash flows. Income smoothing helps to reduce the cost of borrowing, and it favourably affects the term of trade with suppliers and customers. Hence, firms smooth earnings to reduce the cost of debt (Zhang, 2018; Li, 2017; Trueman & Titman, 1988). Firms with higher leverage are hypothesised to have lower earnings quality:

H_1. There is a relationship between accrual earnings of the financial report and information asymmetry in the Nigerian listed firm.

Also, the empirical evidence on the relationship between real earnings management of financial report and information asymmetry is mixed due to the complicated relationship between the two (Almasarwah, 2015; Nnadi, Omoteso, & Yu, 2015; Zhang, 2014; Ikram, 2013). Almasarwah (2015) stated that earnings management is the behavior of the enterprise management authority to take into account the accounting data, especially the accounting surplus, by various means within the scope permitted by the accounting standards to realize its interests or maximize the value of the enterprise. In the past, research on real earnings management has focused more on the concepts, motivations, and methods of earnings management.

H_2: There is a relationship between the real earnings of the financial report and information asymmetry in the Nigerian listed firm.

CONCLUSIONS AND RECOMMENDATIONS

As revealed from the previous studies on the financial reporting quality, by relating the quality of financial reports of listed companies in Nigeria with the extent to which they affect investors information asymmetry on a general note, we conclude that there is a significant impact. Both real earnings quality and accruals earning quality models are relevant to understanding the financial reports, that is, lower information asymmetry challenge. Therefore, uninformed users of financial reports are encouraged to rely on financial analysts to make efficient portfolio decisions. This is premised on the fact that financial analysts, going by the position of this study, will utilize the accrual-based measures in their assessment of financial report quality especially wherever there is the need to understand the motive of managers, considering what is popularly called 'facts behind the figures.

Also, if there is any need for the management of listed companies to use earnings manipulation, real earnings manipulation is recommended for them rather than the accrual-based approach. This it becomes expedient for the fact that accrual-based manipulations lead to information asymmetry or advantages to some investors and hence, distort the efficiency of the stock market. In addition to this, accrual manipulations can be easily detected with the use of accrual earnings measures.

This research is a conceptual paper; the study suggests for the future researcher to conduct an empirical study on the financial reporting quality using both real and accrual model for the Nigerian listed firms. Also, this study did not segregate investors in the listed firms into retail, institutional and foreign investors. The study suggests that other researcher(s) can move beyond this to put retail and institutional on one side, and foreign investors on the other side, then focus on each group in separate studies.

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