Accrual and Real Earnings Management: Firm Value Analysis

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Abstract:

The study examines the effect of accrual and Real Earnings Management (REM) on firm value of selected manufacturing firms in Nigeria. Tobin's Q was employed to measure firm value, while Larcker and Richardson's (2004) and Roychowdhury's (2006) models were used to proxy accrual-based and REM respectively. Purposive sampling technique was employed to select thirty-seven (37) listed manufacturing firms across conglomerates, health care, industrial goods, and consumer goods sectors in Nigeria. Panel regression analysis employed to analyse secondary data gathered for the study. The results reveal a negative and significant influence of accrual-based, while REM has a positive and significant influence on firm value of selected listed manufacturing firms in Nigeria. The study concludes that earnings management has a significant effect on firm value of manufacturing firms in Nigeria. The study recommends that REM be used only when absolutely necessary for the companies' survival and success.

Keywords:

Accrual, real earnings management, manufacturing firms, firm value, Nigeria

JEL Codes: R30, R39

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Introduction

Primary goals of business is to increase its earnings and the wealth of its stakeholders. Any organization's performance affects not just how much money it is worth as a whole, but also how well the sector as a whole is doing and how well the economy as a whole is doing. To achieve business owners' objectives in this regard, effective financial management, including initiatives to increase earnings should always be initiated (Kumar, 2020). According to Hernawati, Ghozali, Yuyetta and Prastiwi (2021), manufacturing sector is crucial to the nation's economy because it inspires the whole nation. They are crucial to the global economy because of how closely they are related to other sectors of the economy. The ability of resulting earnings to gauge a company's value. Investors are more concerned about firms with high value than firms with low value. As a result, firms management both executive and non-executive directors carry out their roles efficiently and effectively to improve firm's value in order to increase firms earnings. This is due to the sector's role in the economy's protection and restoration mechanisms as well as the fact that an industry's performance can influence other industries and the growth of an economy (Kumar and Ayedee, 2018; Dakhlallh, Rashid, Abdullah, Qawqzeh and Dakhlallh, 2020 Shittu, Taleat, Owojori and Aminu, 2023). More so, manufacturing sectors make up two-thirds of global trade, they are significant companies. According to the studies conducted by Kumar and Pandey (2018) and Kumar and Ayedee (2019), it was revealed that SMEs face intense rivalry in the market as a result of their inability to compete with the marketing and promotion strategies used by large multinational corporations. Similarly, Kumar, Syed, and Pandey (2020), scaling up operations can be aided by sustainable growth. Said that managers of firms should use internet resources and technology since doing so will keep them current and also enable organizations to compete on a global scale. In reality, a thriving and advanced manufacturing sector is essential for fostering economic growth because it offers long-term financing for long-term investments in the nation (Kumar and Pandey, 2018; Efuntade and Akinola, 2020).

Earnings Management (EM) is a type of management action that affects earnings, typically for pragmatic purposes. The goal of this approach is to show large profits in a single year by having managerial decisions appear as either periodic or yearly smooth earnings in the company's annual report (Shittu, Badmus and Onifade, 2022). EM can take the form of accrual-based or, in which cost recognition is either deferred to a time in the near future or moved forward to be recognized before it is due, or it can take the form of Real Earnings Management (REM), which involves lowering the cost of sales by producing excess inventory and utilizing less discretionary spending on things such as sales, marketing, as well as research and development (Gill, Biger, Mand, Mathur 2013; Kumar and Aggarwal, 2018; Boachie and Mensah, 2022). Literature have been conducted on EM and its influence on firm value (Mellado and Soana, 2019; Ayisi, Wenfang, Adu-Gyamfi, Sampene and Charles, 2021; Rahaman and Xiong, 2021). However, there have been conflicting and ambiguous findings regarding how EM techniques affect firm value. The majority of studies on EM in manufacturing companies particularly in Nigeria focused on firm performance and using accounting ratios such as Earnings Per Share (EPS), Return on Equity (ROE), Return on Asset (ROA), and Net Profit Margin for measurement while this current study considered Tobin's Q (market-based measure) to measure firm value. More so, the previous literature on accrual-based EM (Okafor, Ezeagbe and Innocent 2018; Olaniyi and Abubakar, 2018; Olatunji and Juwon, 2020; Salome, Ironkwe and Akani, 2021) measured accrual based using Dechow, Sloan and Sweeney (1995) model. Therefore, this study filled the research gap by examining the influence of Accrual-based EM and REM on firm value of selected manufacturing listed firms in Nigeria measuring accrual-based EM using Larcker and Richardson (2004) model.

Review of Literature

This paper reviews the accrual-based earnings management and firm value, real earnings management and firm value as well as signaling theory.

Accrual based earnings management and firm value

In order to accurately reflect the company's many activities, accrual control includes selecting accounting methods rather than changing the company's core business operations. As a result, managers have a lot of control over how to calculate earnings throughout the course of a year. The existence of accrual-based EM and its various associations with firm value have been reported in numerous studies (Sadiq, Othman and Keong, 2019; Edesiri and Confidence, 2020; Ayisi, Wenfang, Adu-Gyamfi, Sampene and Charles, 2022; Onaolapo and Shittu, 2022). There have been claims made that firm performance may be impacted by the extent of DA. Additionally, previous studies such as (Abdelkarim and Zuriqi, 2019; Jessica, 2020; Shittu, Oyedeji and Onifade, 2022) have shown that performance can affect the change in the amount of earnings management since firms may choose to manage earnings in response to lower or higher earnings. Contrary to enterprises with extraordinary performance, which engage in negative earnings reporting by generating a large loss, businesses travail economic challenges are more motivated to adjust earnings upward in order to get attention of invetsors. More so, according to Suprianto and Setiawan (2020), accrual-based EM is efficient as opposed to opportunistic. Dakhlallh *et al.* (2020) also provided evidence of poor performance as a result of accrual-based EM, a developing nation with significant political unpredictability and a shoddy regulatory structure, has already been mentioned. It was anticipated that lax regulations and oversight will affect firm value. As a result, the following hypothesis was formulated:

H_{01}: The higher Accrual-based earnings management the lower the firm value

Real earnings management and firm value

The system of adapting business operations to boost profitability in the current period in business operations is known as Real Earnings Management (REM). It can take many different forms, which include increasing production or overproducing to reduce cost of production and some overhead cost in order to boost present earnings. The findings of earlier studies on the influence of REM on firms' value (Ghaleb, Kamardin and Tabash, 2020; Tulcanaza-Prieto, Lee and Koo, 2020; Zimon, Appolloni, Tarighi, Shahmohammadi and Daneshpou, 2021; Ahmed, 2021; Salome, Ironkwe and Akani*,* 2021) are incongruent with one another. REM, however, affects firm value in one of two ways, depending on whether it is deemed efficient or opportunistic. According to the empirical evidence cited by (Ayisi *et al.*, 2021), organizations use REM to increase current earnings and efficiency. Their findings were compatible with the previous empirical studies of (Jiang, Habib and Wang, 2018; Khuong, Ha and Thu, 2019; Dakhlallh *et al.,* 2020). In contrast, REM were discovered to be inversely correlated with firm value by Shittu and Amao (2022).

In a study conducted by Onifade, Shittu, Aminu, Ajibola, (2023) into the effect of cloud accounting characteristics on performance of twenty-three (23) listed food and beverage firms in Nigeria. it was revealed that the firm's value is not much influenced by return on equity or firm growth. The study came to the conclusion that the performance of food and beverage enterprises in Nigeria is significantly impacted by the cost of software and the cost of training. Also, Shittu, Onifade, Aminu, and Ajibola, (2023) evaluated how REM affected the value of the company. The findings demonstrate that while irregular operating cash flow and abnormal production costs did not significantly affect company value, abnormal discretionary expenses did. Investors and analysts may anticipate strong results from profitable companies. As a result, these companies would probably employ opportunistic EM in order to satisfy investors' and analysts' expectations. As previously mentioned, inadequate rules and political instability in emerging nations contribute to their high propensity for income management. Against this backdrop, a hypothesis was formulated as follows:

H_{02}: The firm value decreases as real earnings management increases.

Signaling theory

The Signaling theory, which holds that not all economic agents share the same knowledge, served as the study's theoretical foundation developed by Spence (1977), which looked at the interaction between managers and investors in an environment of asymmetric information. Therefore, a company sends some signals through earnings management to compare itself to other companies or to the sector. The signaling hypothesis explains why businesses divulge information to the capital market which will manipulate results to announce bad news to the market while also proving their honesty, integrity, and confidence in their capacity to handle the current issues (Osma, Conde and Valeiras, 2022). According Rusydi (2021), ‘’EM is a deceptive signal since it encourages investors to take on more risk. Is also referred to as management interference in external financial reports that emphasizes personal interests’’. Of sure, this endeavor will be beneficial to management. On the other hand, because what is stated therein does not reflect the actual conditions, other parties that use the information in the financial statements may suffer.

METHOD

Problem Identification

The missing link between earnings management and firm value is crucial as earnings always regulate the value of a company which will invariably affect shareholders wealth.

Identification of Gap

The review of literature has identified that EM in manufacturing companies particularly in Nigeria has been affecting firm value. The current study considered Tobin’s Q (market-based measure) to measure firm value instead of accounting-based measurement that is most commonly used by previous study. More so, the previous literature on accrual-based EM measured accrual based using Dechow *et al.* (1995) model. Thus, this study employed Larcker and Richardson (2004) model in order to fill existing gap.

Objectives

The paper attempts to examine the influence of accrual-based earnings management and real earnings management on firm value of manufacturing firms in Nigeria.

Sampling

The study employed ex-post facto research design while population of the study consist of one hundred and thirteen (113) non-financial listed firms in Nigeria as of December 31, 2020. Purposive sampling was used to select from conglomerates sectors (5), health care (6), industrial goods (10), and consumer goods (16) for the study, for a total of thirty-seven (37) selected firms for the study. The data used for empirical analysis were obtained from the MachameRatios Database for study variables.

Table 1: Population and Sample selected for the Study

Sectors	Population	Sample	Percentage (%)
Conglomerates	5	5	100
Health Care	10	6	60
Industrial Goods	15	10	67
Consumer Goods	20	16	80
Total	**113**	**37**	**33**

Source: Authors' compilation, (2023).

Table 2: Measurement of Variables

S/N	Variable	Symbol	Type	Measurement and Sources
Y1	Firm Value	Tobin's Q	Dependent	Equity market value + Book Value (BV) of Total Debt (TD) ⁒ Equity BV + BV of TD, Darmawan, Sutrisno and Mardiati (2019).
X1	Real Earnings Management	REM	Independent	Rowchowdhury (2006) model. Abnormal Cash Flow from Operation *- plus Abnormal Production Cost plus Abnormal Discretionary Expenses *-1. Osman *et al.* (2022).
X2	Accrual Earnings Management	DA	Independent	Larcker and Richardson model (2004) model. = Total accruals EM of firm in year t., ⁒ Total Assets (TA) + Δ in income in year t., - Δ in receivables in year t. ⁒ TA + PPE which is firm Non-current asset + BV ⁒ TA + cash flow CFO in year t ⁒ TA. (Callao, Jarne and Wróblewski, 2017).
X3	Leverage	LEV	Control	Long-term debt divided by TA. Wenfang and Ayisi, (2020),
X4	Firm Size	FS	Control	Firm's TA. Moradi *et al.,* (2021)
X5	Firm Growth	FG	Control	Firm's revenue (Tulcanaza-Prieto *et al.,* 2020)
X6	Free Cash Flow	FCF	Control	Net CFO ⁒ by total liabilities (Elkalla, 2017)

Source: Authors' compilation, (2023).

Model Specification

The model for this study is as follows in line with the study of Ikebuje *et al.* (2021).

FV= f (REM, DA, LEV, FS, FG, FCF) (3.1)

The model is further experessed as follows:

$$FV = \beta_0 + \beta_1 REMit + \beta_2 DAit + \beta_3 LEVit + \beta_4 FSit + \beta_5 FGit + \beta_6 FCFit + \varepsilon \quad (3.2)$$

Where: FV= Tobin's Q

REM= Real Activities Earnings Management, DA= Discretionary Accruals, LEV= Leverage, FS= Firm Size, FG= Firm Growth, FCF= Liquidity, ε= error term, i=ith firm, t=time period

Data Analysis

Data obtained were analysed using STATA 15. Data analysis involves descriptive analysis, pearson correlation coefficient (correlation matrix) and panel regression analysis.

RESULTS

This section considered the results of analysis of accrual and real earnings management on firm value among listed manufacturing firms in Nigeria. Descriptive analysis of study variables was discussed, followed by correlation matrix as well as panel regression results in order to determine how accrual and real earnings management influence firm value.

Table 3: Descriptive Statistics

Variable	Tobin's Q	REM	DA	LEV	FS	FG	FCF
Mean	1.793	0.019	0.018	9.583	7.175	7.063	6.729
Standard Dev.	1.726	0.128	0.129	23.202	0.913	0.919	15.739
Minimum	-0.508	-0.605	-0.616	-26.441	5.093	4.935	-63.073
Maximum	14.987	7.523	7.424	87.529	2.313	2.238	70.319
Observation	407	407	407	407	407		407

Source: Authors' computation, (2023).

Descriptive Statistics

Descriptive statistics of the study variables shown in Table 3. Tobin's Q had a mean of 1.793 and a SD of 1.726, suggesting that sampled firms with a mean greater than or equal to 1.793 perform well, while companies with a score less than 1.793 are under perform. Values for minimum and maximum are -0.508 and 14.987, respectively. REM and DA have mean values of 0.019 and 0.018, respectively, suggesting that sampled companies participate in upward EM. With regards to control variables, leverage, firm size, firm growth, and free cash flow have mean values of 9.583, 7.175, 7.063, and 6.729, respectively.

Table 4: Correlation Matrix

ariable	Tobin's Q	REM	DA	LEV	FS	FG	FCF
Tobin's Q	1.000						
REM	0.023	1.000					
DA	0.021	0.008	1.000				
LEV	0.034	0.036	0.002	1.000			
FS	0.012	0.042	0.039	0.058	1.000		
FG	0.019	0.033	0.007	0.009	0.015	1.000	
FCF	0.097	0.065	0.062	0.002	0.007	0.003	1.000

Source: Authors' computation, (2023).

Pearson Correlation Coefficient Matrix

Pearson correlation coefficient (correlation matrix) was employed in examining the association among the variables under study as presented in Table 4. Tobin's Q shows that there exists a positive and moderate correlation between firm value and EM (Tobin's Q/REM = 0.023; Tobin's Q/DA = 0.021). Similarly positive associations exist between control variable and firm value and (Tobin's Q/LEV = 0.034; Tobin's Q /FS = 0.012; Tobin's Q/FG = 0.019; Tobin's Q/FCF = 0.097).

Table 5: Panel Regression Results

	Pooled OLS	Fixed Effect	Random Effect
C	2.32 (0.021)**	3.56 (0.000)**	2.71 (0.007)**
REM	-0.25 (0.799)	11.26 (0.000)**	10.99 (0.000)**
DA	0.13 (0.897)	-11.25 (0.000)**	-10.95 (0.000)**
LEV	3.23 (0.001)**	1.56 (0.119)	2.18 (0.029)**
FS	-2.07 (0.039)**	-2.26 (0.024)**	-2.93 (0.003)
FG	2.72 (0.007)**	1.44 (0.152)	2.59 (0.010)**
FCF	1.05 (0.293)	2.96 (0.003)**	2.94 (0.003)**
R-squared	0.265	0.317	0.299
Adj R-squared	0.252	0.290	0.190
F-Statistic	20.53	23.81	154.66
Prob.(F-statistic)	0.000	0.000	0.000
VIF	0.009		
Heteroscedasticity	13.2(0.00)		
Hausman		0.122	

Source: Authors computation, (2023).
Note: ** means significant at 5%

Panel Regression Analysis

The study employed a panel regression analysis, as shown in Table 5 for the study model. Ordinary least square pooled regression shows that the adj R-squared of 0.25. This suggests that the Dependent Variable (DV) among the manufacturing firms in Nigeria cannot explain 100 percent by all the study variables, it is just 25% of the systematic variations in the firm value in the pooled firms, that was jointly explained by the accrual based and REM. The OLS pooled regression model is valid for statistical inference, as indicated by the F-statistic value of 20.53 and its corresponding p-value of 0.000. Also, the VIF of 0.009, which is lower than the benchmark value of 10, suggests that multicollinearity is absent, and as a result, no Independent Variable (IV) has to be removed from the model. More so, The Hausman test was also used to distinguish between random and fixed effects. The study adopted a random effect model to describe the impact of EM on the firm value of chosen firms in Nigeria based on the hausman statistics ($p = 0.122 > 0.05$). The firm value as an IV (Tobin's Q) appears to be positively and significantly influenced by REM (=10.99, $p>|t|=0.000<0.05$). Contrarily, DA significantly and negatively affects company value (=-10.95, $p >|t|=0.000<0.05$). In the case of the control variables, LEV, FG, and FCF each revealed positive and significant influence on firm value (=2.18=0.029<0.05, =2.59=0.010<0.05, and =2.94=0.003<0.05), whereas FS (=-2.93, $p>|t|=0.003<0.05$) exhibited negative and significant influence on FV.

Findings, discussion and suggestion for further studies

The positive and significant impact of REM on firm value of selected listed manufacturing firms implies that manufacturing firm changes in activities and earnings have a direct influence on firm value of Nigerian listed manufacturing firms. Also, it suggests that management of selected firms manipulate reported earnings through REM in income statement in order to increase firm value. It supports the hypothesis formulated that firms value increase as the REM increase. This outcome is consistent with earlier empirical findings (Olaniyi & Abubakar, 2018; Khuong *et al.,* 2019; Salome *et al.,* 2021). However, the results differ from previous findings of various researchers that revealed negative influence of REM on firm value (Al-Zahrani, 2019; Rahman & Xiong, 2021). However, the negative and significant influence of DA on firm value submits that profitable firms engage in income-decreasing EM which implies that, managers of manufacturing firms in Nigeria does not partake in EM to improve firms value. It negate the hypothesis formulated that firms value increase as DA increases. The negative effect corroborate with previous empirical findings of (Dakhlallh *et al.,* 2020; Edesiri & Confidence, 2020). The result refutes the research findings of (Olotu *et al.,* 2019; Ayisi *et al.,* 2021). This means that managers of sampled firms tend to undertake more REM than DA to improve their value. In terms of control variables, the positive significant influence of leverage, firm growth, and free cash flow indicates that an increase in leverage as firms grow, as well as an increase in free cash flow, will be accompanied by an increase in firm performance as measured by Tobin's Q. However, it could be perceived that firm size establishing a negative link with firm value implies that firms did not make use of their total assets held to earn an expected return measured on a market basis.

Suggestion for further studies

Nevertheless, this research succeeded in answering the stated study objectives. Future studies can collect data across other sectors instead of four sectors (manufacturing companies) considered in this study. More so, this study only based its empirical findings on secondary data. However, future study can consider using primary data to seek opinion of concern stakeholders on how earnings management influence firm value.

CONCLUSION

The study examined the influence of DA and REM on firm value measured by Tobin's Q. Larcker and Richardson (2004) and Rowchowdhury (2006) models were employed to measure DA and REM respectively. More so, leverage, firm size, firm growth and free cash flow were considered as control variables. Four sectors which include conglomerates, health care, industrial goods and consumer goods. The study concluded that REM had a positive and significant effect, while DA had a negative and significant influence on the firm value of selected listed manufacturing firms in Nigeria. More so, firm size had negative and significant influence while free cash flow had positive and significant influence on firm value. It is recommended that REM only be implemented when it is absolutely necessary for the continued existence and profitability of businesses. To prevent false outcomes and limit managers' discretion, regulators like the securities and exchange commissions should enact regulations requiring clear financial information. Also, accounting standards should be used to minimize standard flexibility and limit opportunistic management discretion in handling financial reports and firms engaging in the practice should also face harsher sanctions.

Disclosure statement

N potential conflict of interest was reported by the author.

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