REAL ACTIVITIES EARNINGS MANAGEMENT AND THE FINANCIAL PERFORMANCE OF QUOTED MANUFACTURING COMPANIES IN NIGERIA

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Article history:	Abstract:
	This research paper investigated the relationship between real activities based earnings management and the financial performance of manufacturing companies in Nigeria. The sample consisted of thirty four (34) manufacturing companies listed on the Nigeria Exchange (NGX). Period covered spanned from 2005 to 2019. Data was collected from the annual reports of sample companies and the Nigeria Exchange (NGX) data portal. Ordinary least square (OLS) and Philip-Peron (PP) unit root diagnostic methods were implemented for data analysis. Findings of the research revealed that From the data analyses, real activities based earnings management (REMG) had a positive and non-significant relationship with net profit margin (NPMG) and earnings per share (EPSH). Thus, REMG leads to improvement in NPMG and EPSH. However, the effect of REMG on financial performance is not sufficient to support the use of these earnings management methods. It was thus recommended among others things that: manufacturing companies in Nigeria should as much as possible discourage the use of real activities based earnings management practice as its benefits to the organization tends to be short term and may end up compounding financial difficulties in the future. Finally, it is recommended that manufacturing companies in Nigeria should adopt real activities based earnings management practices only when it is absolutely necessary for the survival and success of the organization. Thus, earnings management should be employed only as a last resort to avoid looming financial difficulties that may otherwise threaten the continued existence of the company.

INTRODUCTION

Earnings management involves the manipulation of company earnings for the individual's private benefit or towards a pre-determined target. The said target can be motivated by a preference for more stable earnings, in which case management is said to be carrying out income smoothing. Opportunistic income smoothing can in turn signal lower risk and increase a firm's market value. Opportunistic earnings management could decrease the quality of financial reporting (Dimitropoulos, Asteriou, Kousenidis & Leventis, 2013). Other possible motivations for earnings management include the need to maintain the levels of certain accounting ratios due to debt covenants, and the pressure to maintain increasing earnings and to beat analyst targets (Richardson, Tuna & Min, 2002; Subramanyam, 1996).

Management may be tempted to manage earnings upwards if a loan agreement specifies higher earnings as a precondition to access financing. In this case, the firm would appear to be benefitting from this type of earnings management. Alternatively, earnings may also be managed opportunistically if the motivation is personal benefit. An example of this would be managing earnings upwards in order to qualify for a performance based bonus that is tied to the firm's earnings. This is to some extent predicated on how restrictive or flexible accounting rules and standards are. Thus, earnings management takes place when managers in the use of judgments structure transactions to alter financial reports in such a way that mayy mislead stakeholders on the underlying financial and economic performance

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of the firm or influence contract based outcomes that are dependent on reported financial information (Nwaobia, Kwarbai, & Fregene, 2019).

Earnings management can either the form of accrual-based earnings management or real activity-based earnings management. In the first form which incidentally is most prevalent form in literature - the recognition of is either shifted to some time in the near future or shifted forward to be recognised before its due date. Our interest in this research paper is on real activity-based earnings management which according to Roychowdhury (2006) can be conducted by reducing the cost of goods sold through the overproduction of inventory and utilizing reducing discretionary expenditures, including R&D, advertising, and selling, general & administrative expenses. Managers can manipulate earnings upwards or downwards through real transaction (Lan & Subhrendu, 2010). Thus, managers can accelerate sales through increasing price discount or more credit terms. The additional sales will boost current period earnings. Real earnings management is a practice carried out by managers that deviates from the normal operation from normal operation of the firm with the primary objective of meeting short-term earnings goals (Rowchowdhury, 2006).

While some of such activities may be motivated by the need to save the organization from an impending crisis; for example, artificially boosting earnings in order to give the impression that the organization is performing much better than it is actually doing so as to attract new investors or clients without which it may go under. Others may be motivated by the individual greed of owners or management who for example, may indulge in such practice in order to earn higher pay or bonuses and other related benefits or increase market value of the firm's equity in order to earn higher capital gains or increased dividends. Syed, Ali, Safdar, and Yasir (2011) noted that earnings management is a tool which is much like a weapon. If used correctly, it can be of great benefit to the user; but if it is mishandled or goes into the hands of the wrong person, it can cause much harm. They argued that earnings management has helped more companies to get out of a crisis than land them into a crisis. The intent of this research paper is to investigate the effect of real activities based earnings management on the financial performance of manufacturing companies in Nigeria.

STATEMENT OF PROBLEM

According to Nag, (2015) as cited in Bhasin, (2015) earnings management practices help in reducing the risk of a company by increasing the share price and, on the other hand, it helps to boost a profit trend for the company. Various benefits, like ease of raising capital by issue of shares, defy takeover bids by other companies, and offering its own shares in takeover bids all go in favour of the earnings management practices. Moreover, the practice also helps to reduce the fluctuations of income/profit of the company, which help it to gain a good image in the market. However, Remenaric, Kenfelja and Mijoc (2018) argued that even though earnings management can have a positive impact on a company's business in the short term; in the long run, it will likely result in decreased stock prices, insolvency, and even bankruptcy. They further asserted that earnings management is at the root of numerous accounting scandals, as well as many accounting reforms, which is why doubts in the transparency and honesty of financial reporting arise.

This was likely the in the widely publicized cases of earnings management in Nigeria in corporations like Lever Brothers PLC, Intercontinental bank, and Oceanic bank both of which eventually went bankrupt and that of Cadbury PLC that led to lose of most of the company's market value and was unearthed due to fraud investigations (Musa, & Kamardin, 2016; Okugbo & Okike, 2011; Abdullahi, Enyinna & Stella, 2010; Ajibolade, 2008). In view of the issues associated with the subject matter, this research paper is intended to investigate the relationship between real activities earnings management and financial performance of manufacturing companies in Nigeria.

RESEARCH OBJECTIVES

The major objective of this research paper is to investigate and determine how real activities earnings management practice affect the financial performance of quoted manufacturing companies in Nigeria. The specific objectives of the study are to:

- Determine whether real earnings management practice significantly affects the net profit margin of quoted manufacturing companies in Nigeria
- Determine whether real earnings management practice significantly affects the Earnings Per Share of quoted manufacturing companies in Nigeria

POSITIVE ACCOUNTING THEORY

According to Setyorini and Ishak, (2012) positive accounting theory describes business organizations in terms of a collection of contracts – a nexus of contracts. For example, there are contracts with managers, suppliers of capital, employees, government and regulators and most importantly with investors. The contracts are necessary to get individual parties to act to maximize the wealth of the owners. However, there will be contracting costs associated with the contracts, for example, costs of negotiating with and maintaining and monitoring the performance of the parties involved. Thus, the theory holds that firms will seek to minimize the contracting costs and this will affect the policies adopted, including the accounting policies (Graffikin, 2007). Setyorini and Ishak, (2012) further stated that individuals act to maximize their own utility and management chooses or discriminates against specific accounting

standards based on self-interests. For example, managers have incentives to choose accounting standards which report lower earnings due to tax, and political and regulatory systems (Osho & Ayorinde, 2018). Conversely, they also have incentives to make accounting choices that inflates earning in order to qualify for performance based remunerations and bonuses. The positive accounting theory proposed three hypotheses to help unravel the motives of management for choosing a specific accounting rule or method over another one. These include political cost hypothesis, bonus plan hypothesis, and debt covenant hypothesis.

The **Political Cost Hypothesis** predicts that large firms are more likely to use accounting choices that reduce reported profit. Size, capital intensity, and market share are proxies for political attention. Umobong and Ibanichuka, (2016) argue that political cost hypothesis assumes that the higher the political cost imposed on the firm the higher the possibility of managers deploying accounting methods to deter reported profits in the current period and push it to future periods. High profit can result on increased political pressure in form of higher taxes or stiffer regulations such as amendments in standards of reporting. The theory explains that bigger and not small firms possess a higher propensity to deploy accounting selection techniques to mitigate reported gains. **The Bonus Plan Hypothesis** suggests that Managers of organizations with bonus plans are more inclined to selecting accounting techniques that pull reported earnings from future to the present period with the intention to raise bonuses due for personal gains in the current year. The hypothesis explains that managers of firms with bonus plans are more likely to use accounting methods that raise or optimize present period reported income (Umobong & Ibanichuka, 2016). A manager facing the prospect depicted above will likely have an incentive to manipulate accounting records if nothing at least to hold on to the job for a longer period and hope that the finances of the firm improve. Finally, in the **Debt Covenant Hypothesis,** A debt covenant may include a proviso that a certain value for an accounting ratio be maintained or impose limits to investing and financing activities. If the borrower violates the debt covenant, the lender might increase the interest rate, requiring additional financial security, or calling for immediate repayment. Therefore, debt covenants provide incentives for earnings management either to reduce the restrictiveness of accounting based constraints in debt agreements or to avoid the costs of covenant violations (Beneish, 2001; Rani, Hussain & Chand, 2013).

REAL EARNINGS MANAGEMENT

Real earnings management is a practice carried out by managers that deviates from the normal operation from normal operation of the firm with the primary objective of meeting short-term earnings goals (Rowchowdhury, 2006). This activity is motivated by managers' desire to mislead at least some stakeholders into believing certain short-term financial reporting goals have been met in the normal course of operations. These activities are less likely to be challenged by regulators on purely business decision and for realizing short-term benefit. In realising the short-term goals, the repercussions of real earnings management have cost impact on future cash flows. Lan and Subhrendu, (2010) further stated that besides changing accounting policies, managers can also manipulate earnings upwards or downwards through real transactions. For example, managers can accelerate sales through increasing price discounts or more credit terms. The additional sales will boost current period earnings. Also, managers can increase production. When more units of product are produced, managers can spread the fixed overhead costs over a much larger number of units hence lowering the fixed costs per unit. By reducing cost of goods sold, they can report higher operating margins. The other transactions involve selling fixed assets and cutting research and development expenses (Lan & Subhrendu, 2010).

Real earnings management has advantages over accrual earnings management which is not easily detected by regulators or auditors, and it is easier to achieve the desired profit target. The disadvantage of real earnings management is that the worse impact is due to the firm's future cash-flow. Therefore, this manipulation must be really anticipated by stakeholders because it endangers the survival of the firm. Managers have different considerations in choosing both earnings manipulation techniques, managers also tend to use both techniques to achieve the desired profit target (Zang, 2012). Previous empirical research has classified real earnings management practices through three categories of activities: Operating Activities Decisions; Investment Decisions; Financing Decisions. The manipulation of operating activities refers to increasing sales, reducing discretionary expenses, and increasing the production to avoid reporting losses or recording lower earnings. Sale activities manipulation refers to the decisions of managers to temporarily boost sales by offering easier credit terms or higher discounts on sales prices. Manipulating earnings through this method will temporarily boost sale volumes, which leads to higher earnings and a lower current period cash flow due to surplus in sales (Roychowdhury, 2006; in Belal & Hasnah, 2018).

Manipulation through investment decisions refers to manipulating earnings through sales of long-term assets and myopic investments in research and development. The deviation of spending discretionary expenses from normal to abnormal activities to influence reported earnings is one technique used by managers in real earnings management. Reducing such expenses will increase the reported earnings during the same period. Roychowdhury (2006) in an empirical research indicated that managers use R&D, selling, general, and administrative, and advertising discretionary expenses in manipulating earnings to avoid recording losses (Belal & Hasnah, 2018).

Managing earnings through financing decisions refers to the process of affecting earnings per shares through stock repurchases and stock option. Unlike the above mentioned techniques, this method of REM (stock repurchase) does

not affect the reported earnings; rather, it is used to shore up the reported earnings per share (Belal and Hasnah, 2018).

Roychowdhury (2006) developed the model for the calculation of real activities management (REM). According to him, real activities-based earnings management can be conducted by reducing the cost of goods sold through the overproduction of inventory and utilizing reducing discretionary expenditures, including R&D, advertising, and selling, general & administrative expenses. Managers can manipulate earnings upwards or downwords through real transaction (Lan & Subhrendu, 2010). Thus, managers can accelerate sales through increasing price discount or more credit terms. The additional sales will boost current period earnings. The abnormal level of production costs is used to measure the reduction in the cost of goods sold through the overproduction of inventory since the fixed cost per unit declines with an increasing volume of production, while the abnormal level of discretionary expenditures is used to measure the reduction in discretionary expenditures.

EMPIRICAL REVIEW

Nguyen, Nguyen and Phung (2019) evaluated the influence of real activities earnings management on firm performance of the energy listed firms on Vietnam. Data collected constituted 29 energy companies on the stock market for the period 2010 to 2016. They utilized regression analysis and panel data fixed effects model and random effects model. The results determined that real activity earnings management positively impacts on firm performance. This implies that increasing current sales activities will have a positive impact on current earnings. However, this may be pernicious to the company in the future. Further, there is a positive association between firm size, cash from operating activities, growth opportunities and firm performance while firm leverage and tangible asset have a negative association. Research results are significant for regulators and investors in emerging markets.

Olotu, Salawu, Adegbie and Akinwunmi (2019) examined the relationship between earnings management and performance of quoted manufacturing companies in Nigeria. A sample of 56 companies that remained continuously listed on the NSE during the study period and that also possess usable data was purposively drawn. Data were analyzed using descriptive and inferential (Correlation and Multiple regression) statistics. The results revealed that of the three performance measures employed in the study, only inventory turnover is influenced jointly by AEM and REM. The study concluded that earnings management shows no evidence of enhancing the performance of companies.

Olaniyi and Abubakar (2018) examined the effect of real earnings management on future financial performance in listed consumer goods companies in Nigeria for the period 2001 to 2016. Data for the research was sourced from the audited financial statements of the 22 quoted companies. Sales manipulation (earnings management), ROE and EPS (financial performance) and control variables (firm size, growth and financial strength) were analysed using panel Generalized Method of Moments. The study revealed that consumer goods companies in Nigeria manipulate their earnings through sales even though this manipulation appeared to improve the financial performance albeit with insignificant outcome. They concluded that subsequent increase in future financial performance as a result of increase in investment obscure the true picture of financial statement published by such companies. They suggested that accounting standards be harnessed to limit opportunistic management discretion in treating financial statement transactions, minimise flexibility of standards, while stiffer penalty be meted to firms indulging in the act.

Yulius (2017) explored the relationship between accrual earnings management, real earnings management and firm value in Indonesia using a sample of 162 non-financial listed companies during the research period 2012 until 2015. The research made use of the purposive sampling method and data was analyzed using multiple regression method. The findings of the research indicated that accrual earnings management has positive and significant influence on firm value. While, real earnings management has negative and significant influence to firm value. Thus, ease in detecting accrual earnings management can induce investors to judge whether a company is worth its public value or not.

METHODOLOGY

For the purpose of this research, the ex post facto research design is considered to be the appropriate design. This is because the ex post facto research examines past occurrences in order to understand and make predictions about the current state and future occurrences. Data for the research were collected from secondary sources – specifically from the annual financial reports and accounts of the companies in the sample. The period covered in the research was 16 years spanning from 2004 to 2019. Data on Real Activities Based Earnings Management **(REMG)** was collected using the model developed by Rowchowdhury, (2006) is currently the most widely used for detecting real activities earnings management. Financial performance is measured in terms of Net Profit Margin (NPMG) and Earnings per Share **(EPSH)** while firm size **(SIZE)** is incorporated into the equation above as moderating variables. The basic method of analyses adopted for this research effort is the Ordinary Least Square **(OLS)** Multiple Regression Analysis technique. In order to proactively take of some of the problems associated with the OLS method, certain diagnostic tests will be conducted. This will include test of normality and unit root test. Where it is shown that the dataset is not normally distributed, it will be converted to its log form which will also ensure that it is standardized for uniform interpretation. Thus, in this study the following models will be used to test the proposed hypotheses:

$$NPMG = \beta_0 + \beta_1 REMG + \beta_2 SIZE + \varepsilon \ldots \ldots 1$$
$$EPSH = \beta_0 + \beta_1 REMG + \beta_2 SIZE + \varepsilon \ldots \ldots 2$$

NPMG = Net Profit Margin (Dependent Variable)
EPSH = Earnings Per Share (Dependent Variable)
REMG = Real Activities Based Earnings Management (Independent Variable)
SIZE = Firm Size (Moderating Variable)

DATA AND ANALYSIS

Table 1: Summary of Unit Roots Test Results Phillip Peron Method

	T-Stat (5%)	Prob.	Order of integration
NPMG	-2.8669.	0.0000	I(0)
EPSH	-2.8669	0.0000	I(0)
REMG	-2.8669	0.0000	I(0)
FSIZ	-2.86699	0.0000	I(0)

Table 1 shows the unit roots test results using Phillip-Peron methods. The results show that all variables vis-à-vis; Net Profit Margin (NPMG); Earnings Per Share (EPSH); Real Earnings Management (REMG) and the moderating - Firm Size (FSIZ) were all stationary at level I(0) order of integration using the Phillip-Peron unit roots test method. These results imply that on the basis of Phillip Peron unit roots test methods, the data is stationary (no unit root) in its present form. Thus, the absence of unit root in the data set implies that the ordinary least square (OLS) regression model is appropriate for further analysis.

Table 2: Regression Result

Dependent Variable: NPMG
Method: Panel Least Squares
Sample: 2005 2019: Periods included: 15
Cross-sections included: 34: Total observations: 510

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.334904	0.072476	-4.620928	0.0000
DACC	-0.008161	0.004223	-0.193378	0.8467
FSIZ	0.060788	0.010004	6.076206	0.0000

R^2 = 0.0681; Adjusted R^2 = 0.0625; F-Stat = 12.319; Prob (F-Stat) = 0.000;
Durbin-Watson Stat = 2.038

From the regression results in table 2 above, the coefficient of regression (B) for the relationship between real earnings management and net profit margin gave a value of 0.0015. This indicates a positive relationship between the variables. Thus, a unit increase in real earnings management is predicted to lead to a commensurate increase in net profit margin and vice versa. However, the finding was not statistically significant considering that the accompanying probability of t-statistic value of 0.922 was much higher than the acceptable confidence limit of 0.05. However, the moderating variable (FSIZ) had a positive and statistically significant relationship with net profit margin - a coefficient of regression value of 0.0608 and probability of t-statistic value of 0.000. In all, the coefficient of determination value of 0.0681 implies that only about 6.81% of the variations in net profit margin can be attributed to variations real earnings management (REMG) and firm size (FSIZ).

Table 4.5: Regression Result – Model Two

Dependent Variable: EPSH
Method: Panel Least Squares
Sample: 2005 2019: Periods included: 15
Cross-sections included: 34: Total observations: 510

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-7.527005	4.908798	-1.53337	0.1258
REMG	0.001393	0.010532	0.132294	0.8948
FSIZ	1.482611	0.677598	2.18804	0.0291

R^2 = 0.1141; Adjusted R^2 = 0.083; F-Stat = 9.418; Prob (F-Stat) = 0.0477;
Durbin-Watson Stat = 1.8567

Table 3 the coefficient of regression (B) for the relationship between real earnings management and earnings per share (EPSH) gave a value of 0.00139. This indicates a positive relationship between the variables. Thus, a unit increase in real earnings management is predicted to lead to a commensurate increase in earnings per share (EPSH) and vice versa. However, the finding was also not statistically significant considering that the accompanying probability of t-statistic value of 0.922 was much higher than the acceptable confidence limit of 0.05. However, the moderating variable (FSIZ) had a positive and statistically significant relationship with net profit margin with the implication that increase in firm size (FSIZ) is predicted to be accompanies by increase in financial performance in terms of earnings per share (EPSH). The coefficient of regression (B) gave a value of 1.443 and probability of t-statistic value of 0.0291. The coefficient of determination value of 0.1141 implies that only about 11.41% of the variations in earnings per share (EPSH) can be attributed to variations real earnings management (REMG); and firm size (FSIZ).

DISCUSSION OF FINDINGS:
Real Earnings Management and Net Profit Margin

Evaluating the relationship between real earnings management and net profit margin of manufacturing companies in Nigeria, we find a positive relationship between the variables. The coefficient of regression gave a value of 0.001520 which indicates that a one unit increase in real earnings management is predicted to a 0.001520 units increase in net profit margin and vice versa. However, the result was not statistically significant as the computed t-statistic for the relationship gave a value of 0.0979 which is less than the critical t-statistic value 1.962. The finding is further corroborated by the computed probability of t-value of 0.9221 which is higher critical limit. Real activities management method of earnings management focuses on real transactions such as sales, production or R&D to manipulate earnings towards a predetermined end (Lan & Subhrendu, 2010). Thus, real activities management can be used to improve earnings profile for example by increasing number of units produced in order to reduced unit fixed cost or improve sales by offering incentives to both buyers (customers) and sellers (sales staff).

This will have the effect of boosting current period earnings but may also lead to reduced sales/production in the next period. Thus, when properly utilized to the benefit of the organization, real earnings management can predictably improve financial performance in terms of net profit margin. In a similar study, (Khuong, Liem & Minh, 2020; Nguyen, Nguyen & Phung, 2019) reported that real earnings management was positively related to financial performance. However, Nguyen, et. al, (2019) further noted that companies experiencing financial difficulties are more likely to manage earnings through real activities. On the other hand, Olaoye and Akinleye (2020; Abeer (2019) found negative relationship between real activities management and financial performance which is likely as a result of employing the technique when the firm is already facing financial difficulties as reported by Nguyen, et. al, (2019). In both cases, their findings were statistically significant.

Real Earnings Management and Earnings Per Share

The findings showed that there was a positive relationship between real earnings management and the earnings per share of manufacturing companies in Nigeria. The reported coefficient of regression gave a value of 0.00139 which implies that a one unit increase in the use of real earnings management would lead to a 0.00139 units increase in financial performance in terms of earnings per share. This further affirms our findings in the relationship between real earnings management and net profits margin which was also similar to the findings of Khuong, et. al, (2020); and Nguyen, et. al, (2019). However, as noted in that case, several authors also reported a negative relationship between real earnings management and financial performance (Olaoye & Akinleye, 2020; Abeer, 2019). As with the case, above, the relationship between real earnings management and earnings per share was not statistically significant considering that the computed t-statistic for the relationship gave a value of 0.1323 which is less than the critical t-statistic value of 1.962. This means that the magnitude of effect of real earnings management on earnings per was low thus leading to the conclusion that real earnings management does not significantly affect earnings per share as evidenced in hypothesis five above.

CONCLUSIONS AND RECOMMENDATIONS

Manufacturing companies employing real earnings management practices experience improvement in net profit margin but its contribution to the company's financial improvement is not sufficient to support the use of the method. Real earnings management practice contributes to improved earnings per share reported by manufacturing companies in Nigeria. But the contribution of real earnings management to earnings per share is not of sufficient magnitude to engender meaningful improvement in financial performance. Overall, it is concluded that earnings management do not have a meaningful impact on the financial performance of quoted manufacturing companies in Nigeria. It is recommended that manufacturing companies in Nigeria should as much as possible discourage the use of real activities-based earnings management practice as its benefits to the organization tends to be short term and may end up compounding financial difficulties in the future. Finally, it is recommended that manufacturing companies in Nigeria should adopt real activities-based earnings management practices only when it is absolutely necessary for the survival and success of the organization. Thus, it earnings management should be employed only as a last resort to avoid looming financial difficulties that may otherwise threaten the continued existence of the company.

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