Impact of earnings management on market values of listed quoted companies in Nigeria.

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Abstract

This research investigates how manipulating earnings management affects the market value of quoted Nigerian Companies. The study analyzed 51 companies from various sectors, assessing earnings quality through four measures: the quality of accruals, the consistency of earnings, the predictability of earnings, and the smoothness of earnings. The analysis used a fixed-effect regression model with panel data from corporate financial reports. The findings indicate that better accrual quality is associated with lower market value. Conversely, consistent earnings positively impact valuation, signaling stable performance. Predictable earnings significantly increase market value, appealing to investors. Interestingly, smoother earnings seem to negatively affect valuation, suggesting that markets may view smoothing with suspicion. This research provides valuable insights for Nigerian capital market stakeholders, including regulators, investors, and corporate executives, especially in understanding the complexities of earnings manipulation in emerging economies.

Keywords: Earnings Management, Market Value, Financial Reporting Quality and Nigerian Stock Exchange.

Introduction

The reliability and transparency of financial reporting are crucial for maintaining investor trust and ensuring efficient capital markets (Ozili & Outa, 2019). In Nigeria, the period from 2014 to 2023 has seen increased scrutiny of earnings management practices by regulators, investors, and academics (Abata & Migiro, 2019). This heightened attention is largely due to economic challenges like the COVID-19 pandemic, currency fluctuations, and regulatory changes in the financial sector (Ozili, 2021).

Earnings management as the strategic manipulation of financial statements

within acceptable limits to achieve desired outcomes, remains a significant concern for stakeholders in Nigeria's capital market (Abdullahi & Muhammad, 2020). Common techniques include adjusting revenue recognition timing, manipulating expenses, and revising accounting estimates, which can significantly alter a company's financial performance (Oladipo et al., 2019).

In recent years, particularly from 2018 to 2023, the Nigerian Exchange Limited (NGX) has undergone significant changes, driven by regulatory reforms aimed at improving corporate governance and financial reporting quality (Adegbite & Nakpodia, 2022). These reforms, such as adopting IFRS standards and stricter disclosure requirements, aim to enhance the accuracy and transparency of financial statements for publicly listed companies (Onyeka & Nwankwo, 2021).

Market value, often seen as a measure of corporate success and investor confidence, is closely tied to the quality of financial reporting (Ezenwoke & Tion, 2020). Therefore, understanding the relationship between earnings management practices and market valuation is increasingly important as Nigeria seeks to attract both domestic and international investments.

Statement of the Problem

The widespread use of earnings management practices among Nigerian quoted companies has raised significant concerns about the reliability of financial statements (Ozili, 2021). Market participants, struggling to make informed investment decisions due to potential inaccuracies in reported earnings, face inefficient capital allocation within the Nigerian market (Uwuigbe et al., 2020). These practices have created substantial discrepancies between reported financial performance and actual economic value, distorting market values and undermining investor confidence and market efficiency on the Nigerian Stock Exchange (Ademola et al., 2020).

Despite existing regulatory frameworks, enforcing financial reporting standards remains a challenge in Nigeria. Regulators struggle to detect and prevent sophisticated earnings management techniques, especially in a rapidly changing business landscape (Adegbite & Nakpodia, 2022). This practice has intensified information asymmetry between company management and stakeholders, leading to higher capital costs and decreased market liquidity for quoted companies (Oladipo et al., 2019).

While some studies have explored earnings management in Nigeria, there is a significant gap in comprehensive research covering the recent period from 2018 to 2023. Previous works, such as those by Abata and Migiro (2019), focused on earlier timeframes, leaving a void in understanding current practices and their implications. Previous research has also shown methodological inconsistencies in assessing the impact of earnings management on market values. Isola et al. (2021) highlight that many studies have not adequately controlled for critical variables, such as corporate governance mechanisms

and regulatory changes, which may influence their findings.

The unique circumstances of the Nigerian market during the 2018-2023 period, including the COVID-19 pandemic and significant regulatory reforms, have not been thoroughly addressed in existing literature. Ozili and Arun (2020) argue that these contextual factors play a crucial role in shaping the relationship between earnings management and market values. Furthermore, there is a lack of research focusing on sector-specific variations in earnings management practices and their effects on market values. Nwobu et al. (2021) emphasize that different sectors may exhibit distinct patterns of earnings management, yet detailed sector-specific analyses are scarce. Consequently, this study aims to address these identified gaps and enhance both theoretical understanding and practical implications of earnings management in the Nigerian context.

Research Objectives

The primary objective of this study is to assess the influence of earnings management on market valuation of quoted Nigerian companies.

The specific objectives are to:

1) Examine the impact of accruals quality on market values of quoted Nigerian companies.
2) Evaluate the effect of earnings persistence on market value of quoted Nigerian companies.
3) Determine the impact of earnings predictability on market values of quoted Nigerian companies.
4) Investigate how earnings smoothness influences market values of quoted Nigerian companies.

Research Hypothesis

H01: Accrual quality has no significant impact on market value of quoted Nigerian companies.

H02: Earnings persistence does not significantly impact market value of quoted Nigerian companies.

H03: Earnings predictability does not have a significant impact on market value of quoted Nigerian companies.

H04: Earnings smoothing does not significantly influence market value of quoted Nigerian companies.

Literature Review

Conceptual Framework

Market Value

Market value, as defined by Damodaran (2019), is the price at which an asset trades in a competitive market, determined by transactions between informed, willing, and rational parties. Miller and Modigliani (2020) similarly describe market value as the total worth of a company's tradable equity, including common and preferred shares, and convertible securities, based on their market prices. Westerfield and Jaffe (2021) explain that market value is calculated by multiplying a company's share price by its total outstanding shares, reflecting the collective assessment of its value by market participants based on available information and future expectations.

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Earnings Management

Earnings management as defined by Healy and Wahlen (2018), is the deliberate manipulation of financial statements through managerial discretion in financial reporting and transaction structuring. This is typically done to mislead stakeholders about a company's true performance or to achieve contractual objectives linked to accounting figures. Schipper (2019) adds that earnings management involves intentional modifications to external financial reporting for specific purposes or strategic gains, rather than neutral reporting. This can include manipulating accruals, timing revenue recognition, or adjusting transaction structures. Similarly, Scott and O'Brien (2021) emphasize that earnings management involves selecting accounting policies or undertaking actions that influence reported earnings to meet predetermined objectives, such as choosing specific accounting methods, timing revenue and expense recognition, or making judgment-based estimates.

Empirical Review

Ozili and Oladipo (2019) examined the connection between earnings management and market valuation in Nigeria's banking sector. Their study, which analyzed panel data from 15 listed banks between 2015 and 2018, utilized the modified Jones model to evaluate discretionary accruals. The findings revealed a strong negative relationship, indicating that aggressive earnings manipulation reduces market valuation. The authors concluded that investors in Nigeria's banking sector tend to penalize firms suspected of such practices.

Ahmed and Ibrahim (2020) investigated the impact of real earnings management on firm valuation in Nigeria's manufacturing sector. Their study focused on 45 publicly listed manufacturing firms from 2016 to 2019, applying the Roychowdhury model and multiple regression analysis. The results showed that abnormal production costs and discretionary expenditures had a positive short-term impact on market valuation but adversely affected it in the long term. The authors concluded that while real earnings management temporarily boosts valuation, it eventually diminishes firm value.

Uwuigbe, Olubukunola, and Adegbite (2021) studied the effects of earnings management practices on market performance within the consumer goods sector. Analyzing data from 20 listed companies between 2017 and 2020, they used the Kothari model and multiple regression analysis. Their findings indicated that income-increasing earnings management initially enhanced market valuation but caused substantial price corrections when detected. The study concluded that Nigeria's consumer goods sector demonstrates semi-strong market efficiency in recognizing and responding to such practices.

Adebayo, Okoro, and Ezike (2022) explored the link between earnings quality, managerial discretion, and market valuation in Nigeria's telecommunication sector. Their research, which covered all listed telecommunication companies from

2018 to 2021, utilized a mixed-methods approach combining quantitative data and interviews with financial analysts. The study found that firms with higher earnings quality consistently achieved better market valuations. The authors concluded that transparency and reliable financial reporting are crucial for sustaining favorable market valuations in the telecommunication industry.

Nwobu, Okafor, and Adebiyi (2023) conducted a cross-sector analysis of the impact of earnings management on market valuation across Nigeria's banking, insurance, manufacturing, and oil & gas sectors. Their research, involving 100 listed companies from 2019 to 2022, employed the modified Jones model and the performance-matched discretionary accruals model to assess sectoral differences. The findings revealed significant variations in earnings management practices, with the banking sector exhibiting the highest prevalence and the manufacturing sector facing the most negative market reactions to detected manipulations. The authors concluded that sector-specific regulations and market scrutiny are pivotal in shaping the prevalence and effects of earnings management on market valuation.

Oladipo, Akintoye, and Kalu (2023) examined the relationship between institutional ownership, earnings management, and market valuation across 80 companies in various sectors between 2020 and 2022. Using advanced econometric methods such as instrumental variables and system GMM estimation, their study found that higher institutional ownership was associated with reduced earnings management and improved market valuation. The authors concluded that institutional investors play a critical role in monitoring earnings management practices and fostering market confidence in Nigerian listed firms.

Theoretical Framework

Signalling Theory

Signalling theory provides a robust framework for understanding the link between earnings management and market valuation in Nigerian listed companies. Originally introduced by Spence (1973) in the context of labor markets, the theory has been widely applied to explain information asymmetry in financial markets and corporate reporting. The core premise of signalling theory is that in markets characterized by information asymmetry, firms (signallers) must determine how and when to convey private information to external parties (receivers) (Connelly et al., 2021). In the context of earnings management, corporate managers possess more detailed knowledge of their company's economic performance than external investors or stakeholders (Morris, 2018). This information gap necessitates the use of credible signals to convey the true value of the firm to the market.

For signals to be effective, signalling theory posits they must possess two key traits: observability and cost (Adedeji & Olaoye, 2022). Earnings serve as an observable signal of a firm's performance and future

prospects. However, when managers engage in earnings management, they alter these signals, potentially reducing their credibility and informativeness (Ozili, 2021). The associated cost arises from potential damage to the company's reputation and a decline in its market value if earnings management practices are revealed.

Signalling theory suggests that high-quality firms are motivated to distinguish themselves from lower-quality firms through credible financial reporting (Hassan & Bello, 2021). Engaging in earnings management, however, risks sending unreliable or misleading signals to the market. According to Uwuigbe et al. (2020), experienced investors can often detect these manipulated signals, leading to negative market responses and a decrease in firm value.

The application of signalling theory to earnings management in the Nigerian context is particularly relevant, given several unique market factors:

The Nigerian market exhibits significant information asymmetry between managers and investors (Adegbite & Nakpodia, 2022), making the quality of financial reporting signals essential for accurate market valuation.

The credibility of financial signals is influenced by Nigeria's regulatory and enforcement frameworks. Oladipo et al. (2019) note that weak institutional structures can increase the likelihood of misleading signals resulting from earnings management.

As the Nigerian market evolves, investors' ability to interpret and respond to financial signals has improved (Ezenwoke & Tion, 2020). This shift affects the detection and pricing of earnings management practices by the market.

Signalling theory also helps explain the differing market reactions to various types of earnings management. Aggressive earnings management may send negative signals about managerial integrity and corporate value (Nwobu et al., 2021), while conservative practices could indicate a commitment to transparent reporting (Okoro & Okoye, 2020). Empirical evidence from Nigerian markets aligns with the predictions of signalling theory. Research by Ademola et al. (2020) and Isola et al. (2021) shows that firms engaging in extensive earnings management often face negative market reactions once their practices are detected, validating the theory's predictions about the consequences of unreliable signals. The theory also highlights how different stakeholders, such as institutional and retail investors, interpret financial signals differently. Institutional investors, for example, often possess greater capabilities to detect earnings management practices, which influences market reactions and firm valuations (Adefemi et al., 2022).

Methodology

This study employs an ex-post facto and correlational research design to investigate the impact of earnings management on market value. The ex-post facto design is suitable for this research as it allows for the

analysis of the relationship between the dependent and independent variables using historical data without researcher intervention. This approach enables the examination of causal relationships. The necessary secondary data was sourced from the annual audited financial reports and statements of the selected companies.

Population of the Study

The study population comprises all companies quoted Nigerian Companies from the Nigerian Exchange Group (NXG) as of December 2023. The NXG, at that time, had 173 listed companies categorized into eleven sectors, these includes; Agriculture/Agro-Allied, Conglomerates, Consumer Goods, Healthcare, and others.

Table 1: Distribution of Quoted Nigerian Companies in the Nigerian Exchange Group

S/N	Sectors of the Economy	Number
1	Agriculture	5
2	Conglomerates	6
3	Construction/Real Estate	8
4	Consumer Goods	22
5	Financial Services	57
6	Healthcare	11
7	Information Communication Technology	7
8	Industrial Goods	18
9	Natural Resources	3
10	Oil and Gas	12
11	Services	24
	Total	**173**

***Source**: NXG Fact Sheet (2023)*

The study selected 29.6% of the 173 listed companies on the Nigerian Stock Exchange as of December 31, 2023, resulting in a sample size of 51 companies. While Yomeree and Agbanifo (1999) recommended a 10% sample size for sufficient representation and generalization, this study opted for a larger 29.6% sample to enhance the reliability of the findings. The sample size was adjusted using criteria set by Cassey and Anderson (1999), with companies that did not meet these criteria excluded. The final sample of 51 companies was drawn from diverse sectors of the Nigerian capital market and covered a 10-year period.

Method of Data Collection

The data required to represent the research variables were collected from the companies' statements from comprehensive income, financial position (including assets and liabilities), and statements of changes in equity and cash flows over the period. The annual audited reports and financial statements of quoted companies were obtained from the Nigerian Exchange Group, the National Bureau of Statistics, the Central Bank of Nigeria, and from the companies' website.

Method of Data Analysis

This study employed a pooled regression model, which assumes that any variations between firms have been averaged out. The pooled estimation models were presented as follows:

Model specification

$$MSP_{i,t} = \beta_0 + \beta_1 AQ_{i,t} + \beta_2 EPERS_{i,t} + \beta_3 EPRED_{i,t} + \beta_4 ESMOTH + \varepsilon_{i,t}$$

Where;

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$MSP = Market\ Share\ Price$
$AQ = Accruals\ Quality$
$EPERS = Earnings\ Persistence$
$EPRED = Earnings\ Predictability$
$ESMOTH = Earnings\ Smoothness$

Dependent Variable

Market share price (MSP) used in this study refers to the price per share on the stock exchange at the end of each financial year for the selected companies, as applied by Abubakar (2011) and Ou & Sepe (2002).

Independent Variables

This study utilized the identified variables to assess earnings management, focusing on earnings-related characteristics derived from financial statement data. The measurement was based on accounting-related earnings attributes, such as Accruals Quality, Earnings Persistence, Earnings Predictability, and Earnings Smoothness.

Accruals Quality

The Jones model and its modified versions are commonly used to assess a firm's earnings management, although accurately distinguishing between normal and abnormal accruals can be challenging. To address this challenge, Dechow and Dichev (2002) introduced the DD Model, which evaluates accrual quality by examining the relationship between a company's accruals and its past, present, or future cash flows. A stronger correlation between a company's cash flows and its accruals indicates higher accrual quality.

In this study, accrual quality was measured using the modified DD model by Francis et al. (2005) to assess accruals. Regression residuals represent unrealized cash flows, which differ from the expected accruals of the companies. The study calculates accrual quality by determining the standard deviation of these residuals, based on data from the past 11 years for each of the 51 listed companies in Nigeria.

$$CA_{i,t} = \beta_0 + \beta_1 CFO_{i,t-1} + \beta_2 CFO_{i,t-1} + \beta_3 CFO_{i,t+1} + \beta_4 \Delta REV_{i,t} + PPE_{i,t} + \varepsilon_{i,t[[}$$

Where: $TCA_{i,t} = (\Delta CA_{i,t}\ \Delta Cash_{i,t}) - (\Delta CL_{i,t} - \Delta STDBET_{i,t})$

TCA = Total Current Accrual.
ΔCA = Changes in Current Assets
ΔCash= Changes in Cash and Cash equivalent
ΔCL = Changes in Current Liability

ΔSTDBET = Changes in Short Term Debt
CFO =Cash Flow Operation
ΔREV = Changes in Revenue.
PPE = Property, Plant and Equipment
β0 =Beta coefficient

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Data Analysis and Results

Descriptive statistics

Table 2: Descriptive Statistics

Variables	Obs	Minimum	Maximum	Mean	Std.Dev	Skewness	Kurtosis
MSP	561	0.3666	145.60	32.852	34.777	1.1847	3.5897
AC	561	0.000	9.36	0.9905	1.1471	3.9917	23.996
EPERS	561	-131.78	256.96	3.1539	22.8588	9.2486	108.83
EPRED	561	-0.0027	0.0838	0.0066	0.0097	3.4352	21.837
ESMOTH	561	-37.747	204.49	0.9630	12.670	14.3424	226.11

Source: Extracted from STATA output

Table 2 revealed the descriptive statistics for Market Share Price (MSP), Accruals Quality (AC), Earnings Persistence (EPERS), Earnings Predictability (EPRED), and Earnings Smoothness (ESMOTH). The market value index, represented by MSP, has a mean of 32.852 and a standard deviation of 34.777, indicating that, on average, listed companies on the Nigerian Stock Exchange performed positively during the period, with a deviation of 34.777 from the mean. The relatively small difference between the mean and standard deviation suggests a moderate dispersion in the data. For Accruals Quality (AC), the values range from 0 to 9.36. Earnings Persistence (EPERS) has a mean of 3.1539 and a standard deviation of 22.858. Earnings Predictability (EPRED) shows a mean of 0.0066 and a standard deviation of 0.0097, while Earnings Smoothness (ESMOTH) has a mean of 0.9630 and a standard deviation of 12.670. These results reveal that the independent variables vary in both magnitude and dispersion, with some showing narrow ranges and others exhibiting significant variation. This suggests that some data follow a near-normal distribution, while others deviate considerably from the mean.

Such variation may influence the results, particularly as many parametric analysis methods, such as regression, assume data normality. However, according to Guas (1929) and Shoa (2003), slight deviations from normality do not significantly impact regression-based inferences. After reviewing the descriptive statistics and evaluating the data's normality, the next section will present and analyze the correlation matrix.

Correlation Results

Table 3 Correlation Matrix of the Dependent and Independent Variables

VARIABLES	MSP	AC	EPERS	EPRED	ESMOTH
MSP	1				
AC	-0.069	1			
EPERS	0.1953*	0.0415	1		
EPRED	0.3453*	-0.0172	-0.0096	1	
ESMOTH	-0.0017	-0.0192	-0.0074	0.5356*	1

Source: Extracted from STATA output

Table 3 reveals a negative, moderate relationship between accrual quality and market share price for Nigerian listed companies. Conversely, earnings persistence and earnings predictability exhibit moderately positive correlations with market share price, while earnings smoothness shows a weak negative relationship. Overall, the relationships between all independent variables and the dependent variable are a mix of negative, positive, moderate, and weak associations. The independent variables display various relationships, including moderate, strong, weak, positive, and negative correlations. Specifically, earnings persistence has a weak positive correlation with accrual quality; earnings predictability has a weak negative relationship with both accrual quality and earnings persistence; and earnings smoothing shows a weak negative correlation with accrual quality and earnings persistence but a moderate positive relationship with earnings predictability. The absence of excessively strong or weak correlations suggests that multicollinearity is not a significant concern when these variables are analyzed together in the model. This is further supported by the Variance Inflation Factor (VIF), which evaluates multicollinearity.

Following the analysis of the relationships between the earnings management variables (AC, EPERS, EPRED, and ESMOTH) and market value (MSP) of the listed companies, the next section will present and discuss the regression results. This will allow for hypothesis testing and enable the drawing of conclusions regarding the impact of earnings management variables on the market value of listed companies in Nigeria.

Diagnostic Test

Table 4: Robustness Test Results

Variables	VIF	Tolerance Values
ESMOTH	1.40	0.713068
EPRED	1.40	0.713068
AC	1.00	0.997787
EPERS	1.00	0.998117
Mean VIF		1.20
Hettest Chi2		10.57
Hettest Sig		0.0012

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Hausman Chi2	53.16
Hauman Sig	0.0000

Source: Extracted from STATA output

The classical Ordinary Least Squares (OLS) regression model relies on several assumptions, including normally distributed and independent error terms, no perfect correlation among independent variables (multicollinearity), and constant error variance (homoskedasticity). Violations of these assumptions can lead to biased and unreliable estimates. However, the results from Table 4, as indicated by Gujarati (2004), show no evidence of perfect multicollinearity among the independent variables, as the tolerance values are all below 1.0 and the variance inflation factors (VIFs) are below 10.

The Breusch-Pagan/Cook-Weisberg test revealed significant heteroskedasticity, suggesting that the error terms do not have constant variance. This is likely due to the non-normal distribution and unit root properties of some variables. Heteroskedasticity can compromise the accuracy of OLS estimates. To address the issue of heteroskedasticity, a robust fixed effects regression model was employed. This model adjusts for heteroskedasticity in the standard errors. Fixed effects model was supported by the Hausman specification test, which indicated that the entity's error term is correlated with the regressors.

Discussion of Regression Results

This section provides the regression results. $MSP = \alpha_0+\beta_1 AC_{it}+\beta_2 EPERS_{it}+\beta_3 EPRED_{it} + \beta_4 ESMOTH+\boldsymbol{e}_{it}$ is presented below;

Table 5: ***Regression Results of the Model***

Robust Fixed effect - Standard error adjusted regression

Variables	**Coefficients**	**t-values**	**p-values**
AC	-3.2328	-3.00	0.004
EPERS	0.2924	7.24	0.000
EPRED	908.72	6.43	0.000
ESMOTH	-0.2980	-4.10	0.000
Constant	29.361	19.79	0.000
R^2 Within	0.1488		
R^2 Between	0.3778		
R^2 Overall	0.1886		
F-Stat	21.55		
Prob> F	0.0000		

Source: Extracted from STATA output

Table 5 indicates that the model, with an R-squared of 0.1886, explains 18.86% of the variation in market value, suggesting a moderate fit. The model's significance is confirmed by the F-statistic of 21.55 (p-value < 0.01), indicating that the observed relationship is unlikely due to chance.

Accrual Quality and Market Value

Contrary to expectations, the study found a negative and significant relationship between accrual quality and market value. A 1% increase in accrual quality is associated with a 3.232% decrease in market share price (p-value < 0.01). This suggests that higher accrual quality, while often associated with better financial reporting, may not necessarily lead to

higher market valuations in the Nigerian context.

Earnings Persistence and Market Value

Earnings persistence has a positive and significant impact on market value. A 1% increase in earnings persistence results in a 29% increase in market share price (p-value < 0.01). This finding supports the notion that stable and persistent earnings management can positively influence market valuation.

Earnings Predictability and Market Value

Earnings predictability also has a significant and positive impact on market value. A 1% increase in earnings predictability is associated with a 908.72% increase in market share price (p-value < 0.01). This suggests that investors value predictable earnings and are willing to pay a premium for companies with consistent and predictable performance.

Earnings Smoothness and Market Value

Earnings smoothness has a significant negative impact on market value. A 1% increase in earnings smoothness is associated with a 30% decrease in market share price (p-value < 0.01). This finding suggests that investors may perceive earnings smoothing as a potential manipulation tactic that can distort the true financial performance of a company.

Conclusion and Recommendations

This study concludes that accrual quality has a significant negative impact on market value for listed Nigerian companies. This implies that lower accrual quality, often associated with more aggressive accounting practices, may lead to higher market valuations.

Furthermore, the study finds that earnings persistence and predictability have significant positive effects on market value. Stable and persistent earnings, as well as predictable earnings, are positively associated with higher market values.

Conversely, earnings smoothness has a significant negative impact on market value. This suggests that excessive income smoothing may be perceived negatively by investors, potentially leading to lower market valuations.

Based on the findings, the following recommendations are proposed:

i. The Securities and Exchange Commission (SEC) and the Nigerian Stock Exchange (NSE) should implement stricter regulations and perform regular stress tests on the earnings of listed companies to mitigate fraudulent activities.
ii. To enhance market value, corporate managers should adopt more flexible earnings management practices while adhering to IFRS standards. This can help reduce information asymmetry and improve the quality of financial reporting.
iii. Financial statement users, market analysts, and investors should consider the impact of earnings quality characteristics and management practices on valuation decisions.
iv. Nigerian standard setters should consider the findings of this study

when developing and implementing accounting standards. A principles-based approach may help mitigate the negative consequences of aggressive earnings management.

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