CEO discretion, political connection and real earnings management in Nigeria

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Abstract

Purpose – The purpose of this paper is to examine the influence of CEO discretion on the real earnings management and to explore whether the discretion of the CEO to ensure accurate and reliable financial reports is influenced by the political connection of board members.

Design/methodology/approach – Using the generalized method of movement to control the potential endogeneity on the sample of listed companies in Nigeria, the study conducted several checks using Driscoll–Kraay panel data regression with standard error to robust the main findings.

Findings – The paper provides evidence that CEO Discretion reduces the tendency of real earnings management and improve the reporting quality. However, the CEO's discretion to provide reliable financial reports and to reduce the likely earnings manipulation is overturn by the presence of politically connected directors.

Originality/value – Existing studies on CEO attributes and earnings management in Nigeria fail to explain why CEOs were involved in corporate financial scandals. This paper suggests that the presence of politically connected directors is what override and upturn the CEO discretion to dwell into real earnings manipulations. Prior studies measured political connection using a dummy variable (Chaney *et al.*, 2011; Osazuwa *et al.*, 2016; Tee, 2018), this paper measured political connection using the proportion of politically connected directors. This is on the idea that the presence of more politically connected directors may give them the power to override the CEOs decision.

Keywords Real earnings management, CEO discretion, Politically connected directors, Credible financial reporting, Corporate Governance, CEO expertise

Paper type Research paper

1. Introduction

There currently exists an important question on whether chief executive officer (CEO) uses his discretion to affect company's decision. According to Hambrick and Finkelstein (1987), CEOs vary on how much discretion they possess. The authors suggest that managers decision is a function of his or her own characteristics. CEO factors (characteristics) such as tenure, shares and expertise were used as enormous factors that increase his or her discretion (Finkelstein and Boyd, 1998).

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In this paper, we limited our focus on the effect of CEO characteristics on the real earnings management. This is because CEOs in Nigeria are appointed to take decisions and manage the firm in the best interest of shareholders (Securities and Exchange Commission, 2014). Thus, the financial reports presented by the CEO supposed to reflect the true economic reality of the firms and to provides the capital market participant the necessary information to take informed decision. However, the collapse of giant firms such as WorldCom and Enron in US, Chinese Aviation Oil in Singapore, and Cadbuhry in Nigeria have posed a threat on the quality and transparency of financial reports. This is because in many instances the financial statement contains inflated and rosy earnings manipulation (Rezaee, 2005).

Earnings manipulation involve manager's deliberate interference in the reporting pattern of the firm to gain some personal benefits. Managers can use their discretion to managed earnings either by accrual or real earnings manipulation. Accrual earnings management (AEM) is the deliberate change in the accounting procedures or estimates used in preparing the financial statement (Zang, 2012). Real earnings management (REM), on the other hand, involve departures from normal operational practices, purposely to mislead shareholders that the financial statement has been met using the normal operational practice (Roychowdhury, 2006).

Earnings management has cost so much to investors and had in many times threaten the growth of the global economy. For example, the collapsed of Enron, WorldCom and Qwest in the USA have resulted in loss of market capitalization of about $460bn (Cotton, 2002). In Nigeria, the case of Skye bank, Arik Airline and Sterling bank have cost the Asset Management Corporation a whooping sum of $366m to salvage the companies from collapse (Premium time, 2017, February 15). Recent studies indicated increase in earnings management through real activities manipulation (Cohen *et al.*, 2008; Li *et al.*, 2016; Zang, 2012). Such practice involves departure from normal operational process that has a direct consequence on the market value of the firm (Roychowdhury, 2006). In Nigeria, Abubakar (2016) and Adamu *et al.* (2017) evidenced the existence and increase in real earnings management practice.

Notwithstanding, scholars such as Geiger and North (2006) established that Chief Executive Officers (CEOs hereafter) play a significant role in the firm's financial reporting. Generally, CEOs are charged with the responsibilities of managing the daily affairs of the firm. In Nigeria, the Securities and Exchange Commission requires the CEOs to demonstrate the highest level of integrity and to prepare the financial statement that contains a true and fair view of the reporting entity. Since then, investors, regulators and shareholders have begun to blame the CEOs for the scandalous and poor earnings information.

It is reported that CEOs in Nigeria have been responsible for most of the large scale financial scandals and abuses of corporate governance, e.g. Cadbury in 2006, liver brothers in 1997, Skye bank and Arik airline in 2016, and Oando in 2017 (Okaro *et al.*, 2013; Sanusi, 2010; AMCON, 2017). Despite the involvement of CEOs in corporate financial scandals, little studies have been conducted on the effect of CEO attributes and earnings management in Nigeria. Most of the existing studies largely concentrate on the effect of CEO duality (Adeyemi and Fagbemi, 2010; Dabor and Adeyemi, 2009; Ehikioya, 2009; Salihi and Kamardin, 2015). Yet, there are limited studies that examine the relationship between CEO discretion or attributes (CEO ownership, expertise, tenure) on real earnings manipulation in Nigeria.

These attributes could help in engineering the CEO's active monitoring against the possible earnings management (Ali and Zhang, 2015; Baik *et al.*, 2011; Jiang *et al.*, 2013). However, the effectiveness of the CEO to shape the reporting quality may be difficult if the board is politically connected. This is because the discretion of the CEO over the financial statement is subject to ratification of the board. Therefore, the director's political connection may determine the effectiveness of the CEO to provide accurate and reliable financial information. There are two views on how the political connection of board members may impact on the CEO to enhance financial reporting quality. On one hand, political connection, according to helping hand theorists, enables the firms to derive some benefits that can improve the conditions for doing business. For example, the bureaucratic hurdles to obtain a license to carry out transactions may be lower due to a political network; or, the opportunity of gaining the business for governmental bodies and public authorities (Aburime, 2009). Therefore, one can expect that politically connected directors would prevent accounting figures manipulations. On the other hand, some scholars point out that earnings quality is lower if the firm is politically connected (Al-dhamari and Ku Ismail, 2015; Chaney *et al.*, 2011). In this regard, Braam *et al.* (2015) and Kamyabi and Shokrian (2016) argue that political connection is positively associated with real earnings manipulations.

This study, therefore, examines the effect of CEO discretion on earnings management through real activities manipulation in Nigeria. The study also explores the extent to which politically connected directors moderate the relationship between CEOs discretion and real earnings management. We consider political connection in Nigerian because findings on the political connection from other emerging markets such as Malaysia and China provided that political connection is characterized by corporate governance problems and poor earnings quality (Al-dhamari and Ku Ismail, 2015; Fan *et al.*, 2007). In addition, there was evidence in Nigeria that politically connected firms experienced poor performance compared to non-connected firms (Osazuwa *et al.*, 2016). To date, the limited studies provided no definite answer on whether the CEO's discretion to provide accurate and quality financial reports may be improved or dissipated by the level of board political connection.

Using the generalized method of movement (GMM) on the sample of 400 firm-year observations from the Nigerian Stock Exchange for the period of 2012-2016, we provide evidence that CEO discretion reduces the tendency of real earnings management and improve the reporting quality. Specifically, we find that CEO ownership and CEO financial expertise reduced the possibilities of real earnings manipulation. Additionally, the study evidenced that the discretion of the CEO to ensure accurate financial reports and to reduce the likely earnings manipulation is overturned by the presence of politically connected directors. This finding suggests that politically connected directors may overpower the CEO to deteriorate the reporting quality.

Our study makes unique contributions in the following ways: first, to the best of our knowledge, this paper is one of the earliest researches that provide evidence on the moderating role of director's political connection on the relationship between CEO discretion and real earnings management in Nigeria. Existing studies on CEO discretion and earnings management fail to explain why CEOs were involved in corporate financial scandals. Our study suggests that the presence of politically connected directors is what override and upturn the CEO to dwell into real earnings manipulations. Secondly, unlike previous studies that measured political connection using a dummy variable (Chaney *et al.*, 2011; Osazuwa *et al.*, 2016; Tee, 2018), this study measured political connection using the proportion of politically connected directors on the board. This is on the idea that the presence of more politically connected directors on the board may override the CEO's decision. Thirdly, most of the prior studies on earnings management mostly concentrate on accrual earnings e.g. (Bala *et al.*, 2018; Ngan, 2013), this study shed more light on managing earnings through real activities manipulation.

In Section 2, we introduced the literature review and development of hypotheses; Section 3 presents the research methodology and variables measurement. Then, Section 4 outlined the empirical results and additional analysis, while the conclusion of the study is in Section 5.

2. Literature review and hypothesis development

2.1 Earnings management

Healy and Wahlen (1999) define earnings management as the use of accounting estimate and judgment to restructure firm's transaction target at misleading some stakeholders on the economic reality of the firm. Similarly, earnings management is also seen as accounting treatment, deliberately used by managers to smooth the reported earnings as contain in the financial report (Chandren, 2016). In general, earnings management is divided into accrual and real earnings management. The accrual earnings management (AEM) occur when managers use accounting method and estimates to manipulate the reported earnings and thus mislead the stakeholders (Healy and Wahlen, 1999). On the other hand, REM involves the intentional deviation from the normal operational process with the aim of misleading the users on the economic reality of the firms (Roychowdhury, 2006). It involves manipulating real activities that have a direct bearing on the cash flows to achieve the projected profit. In highlighting the real earnings management, it is important to note that REM is different from AEM in the sense that REM is perfected during the accounting year, while AEM is normally done at the end of the accounting period. For example, a company may engage during the accounting year in overproduction to reduce the production cost or offering of discount to increase sales (Cohen and Zarowin, 2010; Zang, 2012). Recently, Nasir *et al.* (2018) posit that fraudulent firms were found to perfect their activities by means of real earnings management.

2.2 Hypothesis development

Recent studies indicate that the CEO plays a significant role in shaping the accounting outcome of the reporting entity (Habib and Hossain, 2013; Jiang *et al.*, 2013; Kouaib and Jarboui, 2016). There is also evidence that CEO attributes such as ownership, financial expertise and tenure assist the CEO to maintain the high-quality financial report. In addition, some scholars such as Baatwah *et al.* (2015) and Zhang (2009) assert that CEO attributes increase his ability to avert and safeguard firm's resources by reducing the possibilities of earnings manipulation.

The following sub-sections discussed the hypotheses development concerning the CEO attributes and their relationship with earnings management.

2.2.1 CEO ownership and earnings management. In line with agency theory, CEO ownership is expected to align his interest with those of shareholders (Jensen and Meckling, 1976). This is on the idea that managers with substantial shares would use their power to take good decision that would safeguard their investment. In Nigeria, the position of the CEO is recognized as the highest ranking officer entrusted with the responsibility of preparing and presenting the financial statement (Securities and Exchange Commission, 2011). The Securities and exchange commission in Nigeria requires that the remuneration of CEOs include stock options and bonuses. Thus, CEO ownership is considered a valuable mechanism that encourages the CEO in enhancing the quality of financial reports in Nigeria (Securities and Exchange Commission, 2011). Accordingly, stakeholder's theory urges that CEO is anticipated to protect the interest of all stakeholders by ensuring the appropriate accounting policies and procedures are selected (Patrick *et al.*, 2015).

Many scholars provided evidence on the relationship between CEO ownership and earnings management. For example, Santiago-Castro and Brown (2011) suggest that CEO with higher shareholding uses his voting power to influence the reporting quality of the firm. Similarly, Vu *et al.* (2017) propose that CEO's share ownership mitigates the agency conflict since CEO with higher ownership may likely improve the financial performance.

On the other hand, scholars such as Healy (1985), Bergstresser and Philippon (2006) and Yang *et al.* (2008) point out that directors with substantial voting shares can use their power to engage in opportunistic earnings management. The findings of Laux and Laux (2009) provide convincing evidence that CEO ownership does not have a significant relationship with earnings management. This study hypothesizes as follows:

H1. Ceteris paribus, CEOs with larger shareholdings are negatively associated with real earnings management.

2.2.2 CEO expertise and earnings management. The CEO being the highest ranking officer is expected to use his discretion to choose the appropriate accounting policies and to determine what information should be disclosed on the financial report (Cheng and Lo, 2006). In Nigeria, the CEO is required to be knowledgeable in the areas of companies' operations and to demonstrate integrity and credibility to earn the confidence of board and shareholders (Securities and Exchange Commission, 2014). In essence, financial expertise is an essential factor that assists the CEO in managing the resources of the firm (Zouari *et al.*, 2015). It is alleged that CEO with financial expertise plays a significant role in implementing appropriate accounting policies and overseeing the financial reporting process (Baatwah *et al.*, 2015). Empirically, prior studies have provided evidence that CEO financial expertise constrains the effect of earnings management. For example, Jiang *et al.* (2013) reveal that CEO with financial expertise provides enhanced quality earnings information. They further urge that financial expertise guided the CEO to detect and reduce the trend of real earnings management. Also, Baatwah *et al.* (2015) find a negative association between CEO financial expertise and real earnings management activities. In short, CEO with more financial and prior working experience in finance is more likely to use his skills to improve the reporting quality. Building on this argument, the study hypothesizes that:

H2. Ceteris paribus, CEO financial expertise is negatively associated with real earnings management.

2.2.3 CEO tenure and earnings management. There has been a serious debate on whether earnings management is different in the first or last year of the CEO services (Ali and Zhang, 2015). Some scholars highlight that longer CEO tenure is associated with team and cohesion (Michel and Hambrick, 1992; Zhang, 2009). Managers with longer tenure devoted their time to monitors firm's activities. This is because, with longer tenure, managers become knowledgeable and have experience, which contribute to efficiency of the CEO in decreasing the cost of earnings activities (Hu *et al.*, 2015). The findings of Jiang *et al.* (2013) demonstrate that longer period spent by CEOs enhance their personal knowledge to improve the decision making of the firm. Invariably, CEO tenure increases his ability to detect accounting error, earnings misstatement and fraud in reporting (Baatwah *et al.*, 2015).

Longer CEO tenure signals financial reporting quality (Baatwah *et al.*, 2015). Therefore, CEO tenure can increase his familiarity with company financial reporting processes and allow him to take important decision to enhance the repotting quality of the firm. A recent study in Brazil shows that CEO's long term of office helps in reducing the magnitude of discretionary accruals and build his reputation in the capital market (Dal Magro *et al.*, 2018). This study hypothesizes that:

H3. Ceteris paribus, CEO tenure is negatively associated with real earnings management

2.2.4 Political connection and real earnings management. The proponents of grabbing hand theory established that suggests that government facilitate the appointment of directors to pursue their interest by extracting the resources of the firm which could affect its value (Wang, 2015). Thus, the presence of politically connected directors may have a positive effect on earnings management (Boubakri *et al.*, 2012). It is also highlighted that political connection destroys firm's value and further manifests low earnings quality as politician will extract the rent generated by such connection (Shleifer and Vishny, 1994). For example in Malaysia, Al-dhamari and Ku Ismail (2015) and Bliss and Gul (2012) assert that politically connected firms are associated with higher earnings management and low earnings quality.

On the other hand, it is suggested that firm's desire to source for favors through tax waivers, government subsidy and easy access to loans and contract has been the reason why firms become politically connected (Faccio, 2006). In this context, political connection may lead to enhanced firm value. Extant literature found that politically connected firms are likely to be bailout by government, and thus, may have high market values (Ang *et al.*, 2013; Faccio *et al.*, 2006). Some scholars advocated that companies with politically connected directors are more likely to have better earnings quality than those without such connection (Song *et al.*, 2011). The study, therefore, hypothesized that:

H4. Ceteris paribus, political connection is negatively associated with real earnings management.

2.2.5 CEO discretion, political connection and real earnings management. Considering the position of CEO in corporate financial reporting, it is, therefore, expected that CEO could use his discretion (ownership, financial expertise and tenure) to provide concise and improve earnings quality (Jiang *et al.*, 2013). However, the discretion of the CEO to improve the reporting quality may be attenuated by the level of board political connection. This is on the fact that the CEO's ability to take economic decisions may be subjected to approval of the board. For example, the Nigerian Securities and Exchange Commission states that the CEO should be submissive to the board (NSEC, 2011). Therefore, the discretion of the CEO to improve the reported earnings may depends on his relationship with the board.

Existing literature on political connection suggests that connected board members can help their firms to attain key resources, through government subsidy, tax waivers and award of contract (Bliss and Gul, 2012; Chaney *et al.*, 2011). On the other hand, Faccio (2006) and Habib *et al.* (2017) urge that politicians will extract some benefit through rent-seeking thereby entrenching the resource of the firm. Thus, the cost and or benefit of political connection depends on whether the marginal benefit exceeds the associated cost of having that connection. Consequently, the directors with political connections can use their power to impair or empower the CEO's ability in ensuring reliable and quality financial reports. Based on this argument, the study hypothesizes that:

H5. Ceteris paribus, political connection will moderate the negative relationship between CEO discretion (CEO ownership, CEO expertise and CEO tenure) and real earnings management.

3. Research method

3.1 Data collection

The population consists of 170 listed companies in Nigeria between the years 2012-2016. Table I provides the sample selection procedure. From Table I, 55 financial service companies were excluded and 14 companies were delisted by the Nigerian Stock Exchange during the study period. In addition, 9 companies from alternative securities exchange market were eliminated[1]. Finally, 12 companies were dropped due to incomplete information for the computation of real earnings management and other variables of the study. Consequently, a final sample of 400 firm-year observations was used.

Data on real earnings management matrix were generated from the Thomson Routers database, while data on political connection and CEO attributes (CEO ownership, expertise, tenure) were manually collected from the annual reports of the sampled companies.

3.2 Model specification and measurement of study variables

3.2.1 Dependent variables. Consistent with Braam *et al.* (2015) and Zang (2012), this study measured REM using Roychowdhury's (2006) model. The model is decomposed into three different sub-components: abnormal production cost, abnormal cash flow from operations and abnormal discretionary expense. Each model is estimated as follows:

Abnormal Cash flow from Operations (Ab_CFO):

For the estimation of abnormal cash flow from operations (Ab_CFO), the following normal cash flow formula is used. First, we run the following cross-sectional regression for every firm-year.

$$\begin{aligned} \mathrm{CFO_t/Asset\ t{-}1} &= \alpha_0 + \alpha_1[1/\mathrm{Assets\ t{-}1}] + \beta_1(\mathrm{Sales\ t/Assets\ t{-}1}) + \beta_2 \\ &\quad \times (\Delta\mathrm{Sales}\ t/\mathrm{Assets\ t{-}1}) + \text{€t} \end{aligned} \tag{1}$$

CFO_{it} denotes operating cash flow for firm i and in year t. Asset it −1 represents lagged total assets. Sales is current year sales and Δsales represent changes in total sales i.e. current year sales minus last year's sales. While €t represents the error term. The difference between the actual cash flow (ACFO) and normal cash flow (NCFO) is known as abnormal cash flow from operation.

Therefore, abnormal cash flow is the estimated residual from Equation (1). Consistent with Cohen *et al.* (2008), we multiply the residual by minus one (−1) to generate the abnormal cash flow from operations (Ab_CFO). So that the higher the amount, the more likely that the firm is cutting the CFO.

Abnormal Discretionary Expenses (Ab_DEXP):

DEXP is constructed as sum of selling, general and administration expenses, research and development and advertisement expenses. Thus, the following cross section regression (CSR) are run for every firm and year to get the normal DEXP:

Sample procedure	No	No
Firm listed on Nigerian Stock Exchange as at 31/12/2016		170
less		
Financial Services companies	55	
firms from Alternative Securities		
Exchange Market	9	
Dead and delisted firm during the period	14	
Firms without complete data on CEO ownership, expertise and tenure	12	90
Firms in the final sample		80
Number of years		5
Firm-year observations		400

Table I. Sample selection procedure

$$\mathrm{DEXP\ it}/\mathrm{Asset\ it}-1 = \beta_0 + \beta_1[1/\mathrm{Assets\ it}-1] + \beta_2(\mathrm{Sales\ it} - 1/\mathrm{Assets\ \ it}-1) + €\mathrm{it} \tag{2}$$

$DEXP_{it}$ = Sum of selling, research and development, administrative and advertising expenses. Assets it −1 = lagged total asset, sales it − 1 = lagged sales, and finally €it = Error term. The abnormal DEXP is the difference between actual discretionary expenses and the normal discretionary expenses as in equation (2).

Thus, Ab_DEXP is the predicted residual from equation (2) for every firm-year observation. Consistent with Cohen *et al.* (2008), we multiply Ab_DEXP by a negative one (−1) to generate the final Ab_ DEXP. The higher the level of residual, the possibility that management managed their earnings through real activities manipulation.

Abnormal Production Cost (Ab_PROD):

Production cost is the sum of cost of goods sold (COGS) and changes in inventory (Δ Inv) for the year. The model is detail below

$$\mathrm{COGS}_{\underline{t}}/\mathrm{Asset}_{t-1} = \alpha_0 + \alpha_1[1/\mathrm{asset\ \ t}-1] + \beta\ \ [\mathrm{Sales\ \ t}/\ \ \mathrm{Assets\ \ t}-1]\ \ +\ \ €\mathrm{t} \tag{3}$$

Next, the changes in inventory is measured using the following regression:

$$\Delta\,\mathrm{Inv}_t/\mathrm{Assets\ it}_{-1} = \alpha_0 + \alpha_1[1/\mathrm{Assets\ i}_{t-1}] + \beta_1[\mathrm{Sales\ i}_t/\mathrm{Assets\ i}_{t-1}] + \beta_2[\Delta \mathrm{sales\ it} - 1/\mathrm{Assets}_{t-1}] + €\mathrm{t} \tag{4}$$

where $\Delta\ Inv_{it}$ is defined as changes in inventory in period t. Using equations (3) and (4), the normal level of production is estimated as:

$$\mathrm{PROD\ i}_t/\ \mathrm{Assets\ it}-_1 = \alpha_0 + \alpha_1[1/\ \mathrm{Assets\ it}-_1] + \beta_1[\mathrm{Sales\ it}\ /\ \mathrm{Assets\ it}-_{1]} + \beta_2[\Delta \mathrm{sales\ it}/\ \mathrm{Assetsit}-_1] + \beta 3\,[\Delta \mathrm{sales\ it}-_1/\mathrm{Asset\ it}-_1] + €\mathrm{it} \tag{5}$$

where $PROD_t$ = production cost in year *t* for firm i, Δ sales t − 1 = lagged changes in the sales, €t = error term. Thus, to compute abnormal production, we use the following equation.

The abnormal production cost (Ab_PROD) is the difference between the actual and the normal production costs for every firm-year. Thus, Ab-PROD is the predicted residual from equation (5). High level of Ab_PROD is an indication that firms managed their earnings through overproduction.

Real Earnings Management Matric:

Consistent with Baatour *et al.* (2017) and Braam *et al.* (2015), we take the aggregate from the three components i.e. equations (1), (2) and (5) to arrive at a single variable (REM). Therefore, real earnings management is mathematically calculated as follows. REM = Ab_CFO+ Ab_DEXP + Ab_PROD.

3.2.2 Independent variables. As documented in the existing literature, this study measured CEO ownership as percentage of voting shares held by CEO to the total shares issued (Kim and Lu, 2011). CEO financial expertise is a dummy variable coded 1 if the CEO has an accounting, business or finance qualification and 0 if otherwise (Zouari *et al.*, 2015), while CEO tenure is measured as the number of years being the CEO in the company (Abdul Latif *et al.*, 2016).

3.2.3 Moderating variable. In this study, we used political connection (POLCON) as moderating variable. Unlike previous researches that measured POLCON using a dummy variable (Chaney *et al.*, 2011; Faccio, 2006; Hashmi *et al.*, 2018), in this study, political connection is measured as proportion of politically connected directors on the board. A director is defined politically connected if he or she is a former or serving member of parliament, commissioner, minister, governor and or Head of state. The director is also politically connected if his wife or relatives are current or former members of parliament, commissioner, minister, governor, ambassador, president and or members of political parties.

3.2.4 Control variables. In this study, firm age (AGE) is selected as a control variable and is measured as the number of years since the listed date of the company (Kibiya *et al.*, 2016). We included leverage (LEV) as the total interest bearing liabilities to the total asset (Braam *et al.*, 2015), firm's size (FSZ) is measured as the natural logarithm of the total asset (Abdul Latif *et al.*, 2016). Finally, CEO nationality is a dummy variable coded 1 if the CEO is from foreign country and 0 if otherwise (Masulis *et al.*, 2012).

3.3 Regression equation

This study proposed two econometric models in the analysis. Model 1 tests the effect of CEO discretion (i.e. CEOOW, CEOEX and CEOT) on real earnings management. Model 2 tests how political connection of board members moderates the relationship between CEO discretion CEOOW, CEOEX and CEOT) and real earnings management in Nigeria.

Model 1

$$\begin{aligned} \mathrm{REM} = {} & \beta + \beta_1 \mathrm{CEOOW}_{it} + \beta_2 \mathrm{CEOEX}_{it} + \beta_3 \mathrm{CEOT}_{it} + \beta_4 \mathrm{POLCON}_{it} + \beta_{5i} \mathrm{AGE}_{t} \\ & + \beta_6 \mathrm{FSZ}_{it} + \beta_7 \mathrm{LEV}_{it} + \beta_8 \mathrm{CEONAT}_{it} + €\mathrm{I} \end{aligned} \tag{1}$$

Model 2

$$\begin{aligned} \mathrm{REM} = {} & \beta + \beta_1 \mathrm{CEOW}_{it} + \beta_2 \mathrm{CEOEX}_{it} + \beta_3 \mathrm{CEOT}_{it} + \beta_4 \mathrm{POLCON}_{it} \\ & + \beta_5 \mathrm{POLCON} * \mathrm{CEOW}_{it} + \beta_6 \mathrm{POLCON} * \mathrm{COEX}_{it} + \beta_7 \mathrm{POLCON} * \mathrm{CEOT} \\ & + \beta_8 \mathrm{POLCON} * \mathrm{CEONAT} + \beta_9 \mathrm{AGE}_{it} + \beta_{10} \mathrm{FSZ}_{it} + \beta_{11} \mathrm{LEV}_{it\,+12} \mathrm{CEONAT}_{it} \\ & + €\mathrm{it} \end{aligned} \tag{2}$$

where REM stand for real earnings management, CEOW is CEO ownership, CEOEX represents CEO financial expertise, CEOT stand for CEO tenure. Moreover, POLCON stand for political connection, FSZ stand for firm's size, AGE means firm's age and LEV is financial leverage, CEONAT represent CEO nationality.

3.4 Descriptive statistic

From the descriptive statistics displayed in Table II, the mean, minimum and maximum value of REM is 0.293, −1.969 and 4.632, respectively. This implies that Nigerian listed companies engaged in both income decreasing and increase earnings management through real activities manipulation. This is a prove on the existence of real earnings management and low earnings quality.

The mean value of CEO ownership is 0.045, indicating that only 5 per cent of voting shares is controlled by the chief executive officers. This is comparatively lower than 14.90 per cent reported by He *et al.* (2015). The mean, minimum and maximum value of CEO's financial expertise is 0.85, 0.00 and 1.00. This indicates that 85 per cent of CEOs have financial, accounting and business expertise, which can help the CEO's to improve the earnings quality. This is comparatively larger than the 15 per cent reported by Baatwah *et al.* (2015). Additionally, the average CEO tenure is 6 years and maximum value is 29. The average tenure is comparatively higher that 2.4 reported by Chou and Chan (2018) and 4.9 years reported in the Chinese Market by Hu *et al.* (2015). Furthermore, the average value of politically connected directors (POLCON) is 0.269. This signifies that about 27 per cent of board members in Nigeria are politically connected. This results is comparatively lower than the 32 per cent for Malaysian companies as reported by Al-dhamari and Ku Ismail (2015).

Regarding the control variables, the average firm's age is 22.388, signifying that listed firms have 22 years after listing on the floor of the Nigerian Stock Exchange. This is comparatively lower than 27 years of listed companies in Egypt as reported by Bassiouny *et al.* (2016). We also noted that Firm size (FSZ) is 7.202bn. The coefficient of leverage (LEV) is 0.561, indicating that 56 per cent of total asset is financed by external source. The value is relatively higher than 20 per cent reported by Ali and Zhang (2015) and 50 per cent for Chinese firms reported by Chi *et al.* (2016). Finally, Foreign CEOs (CEONAT) account for 0.415, an indication that 45 per cent of listed firms in Nigeria are headed by the foreign CEO's. This is higher than 9 per cent for Turkish listed firms as reported by Polovina and Peasnell (2015).

3.5 Univariate analysis

Table III presents the Pearson correlation matrix for the entire study variables. The result shows that the highest correlation coefficient is −0.3866 between CEOW and AGE. This is less than the 0.8 suggested by Hair *et al.* (2014), indicating the absence of multicollinearity problem.

From the correlation matrix, the correlation between REM and CEOW is negative and significant at 1 per cent significance level. Likewise, evidence from Table III also indicates that CEOEX and CEOT have a negative coefficient with REM at 5 per cent and 1 per cent significance level respectively, this demonstrates that financial expertise CEO and longer tenured CEO are negatively associated with REM. Conversely, the coefficient of CEONAT indicates postive significant relationship with REM. Regarding political connection, the coefficient indicates that POLCON is positively correlated with REM, signifying that political connection increase firms involvement in real earnings manipulation.

Table II.
Descriptive statistic

Variable	Obs	Mean	Minimum	Maximum	SD
REM	400	0.293	−1.969	4.632	0.713
CEOW	400	0.045	0.000	0.636	0.117
CEOXP	400	0.850	0.000	1.000	0.358
CEOT	400	6.205	0.000	29.000	5.392
POLCON	400	0.269	0.000	0.857	0.153
AGE	400	22.388	2.000	51.000	13.594
FSZ	400	7.202	5.631	9.170	0.715
LEV	400	0.561	0.007	2.486	0.292
CEONAT	400	0.415	0.000	1.000	0.493

Table III. Correlation matrix

Variables	REM	CEOW	CEOXP	CEOT	CEONAT	POLCON	AGE	FSZ	LEV	VIF
REM	1									
CEOW	−0.245***	1								1.53
CEOXP	−0.181***	−0.109**	1							1.04
CEOT	−0.180***	0.361***	−0.002	1						1.21
CEONAT	0.195***	−0.201***	−0.030	−0.120**	1					1.25
POLCON	0.209***	−0.211***	0.080	0.005	0.121**	1				1.09
AGE	0.102**	−0.387***	0.055	−0.064	0.334**	0.083*	1			1.34
FSZ	0.356***	−0.338***	−0.022	−0.233***	0.317***	0.177***	0.085*	1		1.27
LEV	0.145***	−0.084*	−0.108**	0.087*	0.087*	0.131**	0.172***	0.065	1	1.08

Notes: The table provides the correlation variances of the study variables; ***significant at 0.01 level; **significant at 0.05; and *at 0.1 level

3.6 Regression result

Table IV presents the regression result on the relationship between the dependent, moderating and independent variables. However, as the data contained both cross sectional and time series variant, we conducted a test for heteroscedasticity, autocorrelation and cross-sectional dependency to avoid presenting biased statistical inference. In addition, the study performed Lagrangean multiplier test and the result indicates significant value, which means GLS is preferred against OLS. Then we performed the Hausman specification test, and the results indicate significant value, which means that fixed effect estimator is better. However, we cannot use the fixed effect since our data set indicates presence of heteroskedasticity, first-order (AR1) autocorrelation (Table IV). To correct these problems and to avoid potential endogeneity among the selected variables, the study employed the GMM. Blundell *et al.* (2001) show that GMM correct the problem of unobserved heteroscedasticity, auto correlation, endogeneity, measurement error and omitted variables. If variables are endogenous, the co-variance between the explanatory variables and error term are non-zero, which may amount to biased and inconsistent inference.

Thereafter, we tested the consistency and validity of the instruments taking all the regressors as exogenous variables and the lag of the independent variables as endogenous variables. The results of the Hensen test as displayed in Table IV shows that the instruments are valid as the p-value is 0.541 and 0.842 for Model 1 and 2, respectively. Likewise, the test for first and second-order serial correlation indicates that the error terms are not serially correlated after the GMM.

In Table IV, evidence from the regression result (Model 1) indicates that CEOW is negative and significant ($\beta = -3.466$, $p = 0.000$), suggesting that having more shares by the CEO's increase his ability to improve the reporting quality. This is consistent with Kim and Lu (2011) and Ghosh and Moon (2010), who also find that CEOW improves firm's market valuation. This finding supports our hypothesis that ownership by CEO increases his capacity to constrain the frequency of real earnings manipulations. However, finding from the interaction term between POLCON and CEOW indicates that politically connected directors overturn the negative relationship, thereby influencing the CEO with ownership to deteriorate the reporting earnings.

Regarding CEOEX, the coefficient of the regression indicates that CEO financial expertise has a significant negative influence on real earnings manipulation ($\beta = -0.218$, $p = 0.000$), signifying the role of CEO with financial expertise in mitigating the effect of earnings manipulation. This is consistent with the requirement of Nigerian Securities and Exchange

Table IV.
Multiple regression result using GMM

GMM	Model 1		Model 2	
REM1	β	p-value	β	p-value
l.REM	0.404	0.000***	0.559	0.000
CEOOW	−3.466	0.000***	−2.162	0.000
CEOEX	−0.218	0.000***	−0.820	0.004
CEOT	0.029	0.000***	0.040	0.000
POLCON	0.399	0.075*	0.619	0.000
CEOW*POL			6.927	0.000***
CEOEX*POL			0.139	0.004***
CEOT*POL			0.127	0.000***
AGE	−0.016	0.000***	−0.004	0.000
FSZ	0.299	0.000***	0.203	0.000
LEV	−0.098	0.143	0.023	0.318
CEONAT	−0.075	0.070*	−0.133	0.000
Constant	−1.603	0.000**	−1.371	0.000
Prob > F	0.000		0.000	
Breusch and Pagan LM test	0.000		0.000	
ARI	0.024		0.004	
AR2	0.333		0.334	
Hansen test	0.541		0.842	
Pesaran's cross sectional dependence	0.000		0.000	

Notes: Model 1 = direct effect, model 2 = moderating effect, CEOW = CEO ownership, CEOEX = CEO expertise, CEOT = CEO tenure, CEONAT = CEO nationality, POLCON = Political connection, AGE = firms age, FSZ = firms size, LEV = leverage; ***; **; *indicate 1, 5 and 10% levels, respectively

Commission (NSEC) 2011 that CEO should use his skills, knowledge, and expertise to provide accurate and credible financial reporting. The results supported the findings of Baatwah *et al.* (2015) and Jiang *et al.* (2013), who conclude that CEOEX reduces the magnitude of earnings manipulation and improve the timely financial report. The finding also buttresses our hypothesis that financial expertise CEO's are less likely to manipulate the reported earnings. However, the interaction of politically connected directors (POLCON) with CEO expertise (CEOEX) indicates that POLCON override and upturn the negative coefficient to positive significant (β = 0.139, p = 0.000). This suggests that, despite CEO's ability to use his expertise in providing quality financial statement, the presence of POLCON in the firm overstretch his discretion and make him incapable of providing a quality financial report.

On the CEO tenure, the result indicates that CEO tenure is positively related to real earnings management (β = 0.029, p = 0.000), implying that longer serving CEOs are more likely to entrench the resource of the firm. This can be explained by the idea that longer tenure enables the CEOs to manage earnings aggressively to depend their position. The possible reason for the positive relationship between CEOT and REM may be attributed to the weaknesses in corporate governance and increasing level of corruption that characterized the Nigerian economy (Okougbo and Okike, 2015; Securities and Exchange Commission, 2014). This finding is in supports of Baik *et al.* (2011) and Zouari *et al.* (2015), who show that longer serving managers use the opportunity to engage in managing the reporting earnings. The results are also consistent with outcome of Fang *et al.* (2018) who find that managerial slack turned to increase in CEO's final years in office.

As for the interaction effect, the result shows that the interaction of politically connected directors with CEO tenure indicates that politically connected directors along with longer serving CEOs are more likely to dwell more into real earnings management. This is evidenced by the coefficient value of (β = 0.127, p = 0.000) at 1 per cent significance level. This result suggests that politically connected directors has further strengthen the positive relationship between CEO tenure and real earnings management.

The coefficient of the direct effect of POLCON is positive and significant (β = 0.399, p = 0.075). This finding suggests that firms with politically connected directors experience high earnings manipulation. The finding is consistent with previous researches (Al-dhamari and Ku Ismail, 2015; Faccio *et al.*, 2006; Osazuwa *et al.*, 2016) that political connection is associated with poor performance and low earnings quality. It also supported the result of Hashmi *et al.* (2018), who confirm that politically connected firms in Indonesia are more associated with lower earnings quality than non-connected firms.

As for the control variables, we find that AGE is negative and statistically significant (β = −0.016, p = 0.000), suggesting that old listed firms are less associated with real earnings manipulation. The coefficient of FSZ is reported to be positively significant with real earning management (β = 0.299, p = 0.000), implying that larger firms in term of asset are more likely to engage in low quality reported earnings. Finally, the coefficient of LEV is negative but statistically insignificant with real earnings manipulation (β = −0.098, p = 0.143) Moreover, we find that the coefficients of CEO's nationality (CEONAT) is negative and significant (β = −0.075, p = 0.070), suggesting that foreign CEO is associated with less real earnings manipulation. This is consistent with Du *et al.* (2017), who assert that foreign CEOs are less likely to engage in earnings management and can provide resources and expertise to solve the problems of narrow decisions.

3.7 Regression results using lagged independent variables

Following Al-Jaifi (2017), we used one year lagged of the studied variables to test whether our main results suffered from reversed causality. The result in Table V shows that the coefficient of the regressors are consistent with what is reported in the main analysis. Table V shows that CEOOW, CEOEX and CEOT have a negative relationship with real earnings manipulations, which is consistent with the result of the main analysis as reported in Table IV. Regarding the POLCON, the result of Table V indicates that POLCON is positive and significantly related to real earnings management, signifying that political connection increase the frequencies of real earnings manipulations. Regarding the interaction effect, the outcomes signify that POLCON override and upturn the negative association between CEOT and real earnings management. While POLCON is also found to reverse the relationship between CEOOW and earnings management.

3.8 Robustness checks using alternative estimation method

In this section, we robust our main findings by using Driscoll–Kraay standard residual as an alternative method of estimation. This is essential in validating whether the findings are robust to alternative estimation model. We compared the two results. Interestingly, the result in Table VI (additional analysis) is closely related to what is obtained from the main analysis. Specifically, the coefficient and direction of CEO ownership, CEO expertise are negative and significant in both the robust and the main analysis.

Also, the result of POLCON is positive and significant which mirrors that of the main analysis. For the moderating effect, the coefficients on the interaction terms indicate that political connection moderates the relationship between CEO attributes and real earnings management. Hence, we can conclude that our findings are consistent and robust as we find that CEO power constrained and reduced the likely tendency of earnings management. Also, we find that politically connected directors override and upturn the ability of the CEO to provide accurate and reliable financial statements. Exceptionally, the coefficient of

Table V. Multiple regression result using lagged independent variables

Variables	Model 1 β	p-value	Mode 2 β	p-value
CEOOW	−0.623	0.000***	0.768	0.053*
CEOEX	−0.394	0.000***	−0.490	0.000***
CEOT	−0.012	0.003***	−0.048	0.000***
POLCON	0.685	0.000***	−0.336	0.187
*CEOW*POL*			−7.278	0.000***
*CEOEX*POL*			0.274	0.256
*CEOT*POL*			0.124	0.000***
AGE	0.00119	0.392	0.000	0.527
FSZ	0.235	0.000***	0.246	0.000***
LEV	0.234	0.004***	0.218	0.007**
CEONAT	0.089	0.000***	−0.181	0.031***
constant	−1.313	0.000***	−1.029	0.000***
R^2	0.215		0.239	
Prob > *F*	0.000		0.000	

Notes: Model 1= direct effect, model 2 = moderating effect, CEOW= CEO ownership, CEOEX = CEO expertise, CEOT = CEO tenure, CEONAT = CEO nationality, POLCON = Political connection, AGE = firms age, FSZ = firms size, LEV = leverage; ***; **; *indicate 1, 5 and 10% levels, respectively

Table VI. Alternative estimation on the effect of CEO power on real earnings management

Drisc/Kraay Std. Err. *REM1*	Model 1 Beta	p-value	Model 2 Beta	p-value
CEOOW	−0.658	0.011**	0.515	0.393
CEOEX	−0.374	0.002***	−0.466	0.001
CEOT	−0.011	0.045**	−0.043	0.028
POLCON	0.655	0.001***	−0.332	0.869
*CEOW*POL*			−6.027	0.065*
*CEOEX*POL*			0.293	0.115
*CEOT*POL*			0.105	0.031**
AGE	0.000	0.992	−0.001	0.116
FSZ	0.248	0.000***	0.258	0.000
LEV	0.205	0.012**	0.188	0.004
CEONAT	0.079	0.001***	−0.170	0.116
Constant	−1.396	0.000***	−1.126	0.001
R^2	0.216		0.231	
Prob > *F*	0.000		0.000	

Notes: Model 1 = direct effect, model 2 = moderating effect, CEOW = CEO ownership, CEOEX = CEO expertise, CEOT = CEO tenure, CEONAT = CEO nationality, POLCON = Political connection, AGE = firms age, FSZ = firms size, LEV = leverage; ***; **; *indicate 1% 5% and 10% levels respectively

CEONAT in the additional analysis is opposite to what is found in the main analysis due to potentially endogeneity, which has been taking care of in the GMM model.

3.9 Robustness checks using comparison t-test technique

As indicated in both the main and robustness analysis, the political connection of board members deteriorates the reporting quality through real earnings manipulation. We also found that the interaction of politically connected directors on CEO attributes override and upturn the ability of the CEO to provide accurate and reliable report and thus deteriorate the reported earnings. To confirm this finding, we conducted a *t*-test to determine if a firm with high politically connected directors have higher earnings manipulation compared to their peers. Interestingly, the results as displayed in Table VII show that firms with presence of high POLCON are associated with higher earnings management compared to the firms with none or low politically connected directors.

3.10 Discussion and policy implication

In this paper, we argue that CEO as the highest-ranking manager plays a significant role in firm's decision making. Specifically, the outcome of the regression shows that CEO plays a significant role in the corporate financial decision due to their discretion to select the appropriate accounting method and prepared the financial reports. Our result specifically finds that CEOs with equity ownership and those with financial expertise are less associated with real earnings manipulations. Consistent with grabbing hand theory, our findings suggest that politically connected directors could reflect their preference in the firm's decision making.

This study has some important policy implications for the practice and future research. Firstly, our result indicates that CEOs in Nigeria used their discretion to improve the reported earnings and ensure accurate and reliable financial reporting practice. However, the findings on political connection imply that board members with political connection in Nigeria are more likely to entrench the resources of the firms and further override the CEO's discretion to improve the reporting quality. Therefore, this finding supported the argument that political connection may lead to low transparency, poor rating and endemic corruption (Conyon, He, and Zhou, 2015). Relatively, it is important that Nigerian companies should consider the CEO's personal attribute so that only CEOs with expertise and experience will be appointed to spare the affairs of companies in Nigeria.

The study has implication for the research on director's political connection and real earnings management. This is because agency theory expected the board members to monitor and ensure that CEOs did not use their discretion to manipulate the reported earnings. Hence, the outcomes that members with a political connection can overturn the CEO's discretion and influence them to entrench the resource of the firms can provide an opening for future research to explore more on the link between CEO attributes, political connection and real earnings management. Our study is limited to CEO discretion, political connection and real earnings management of listed companies in Nigeria and hence the data were exclusively collected from Nigeria. Future studies could explore other African countries with the similar political and institutional setting. Further, future studies could

Variable	Observation	Mean	Standard error	SD
High POLCON	177	0.466	0.053	0.690
Low POLCON	223	0.155	0.046	0.706
Combine	400	0.293	0.036	0.713
Diff		0.311		
t-value		4.43***		
p-value		0.000		

Note: ***, **, * significant at 1%, 5%, 10% respectively

Table VII. Comparison politically connected versus non-political connected firms explore this relationship on other streams of earnings management e.g. accretive earnings management, share repurchased and initial public offer (IPO).

4. Conclusions

Using the GMM, the study examines whether CEO plays a significant role in constraining the real earnings manipulation and if the discretion of the CEO is limited to the presence of politically connected directors on the board. The motivation behind our study is the consistent demand by the investors and regulators for reliable financial reports. There are many pieces of evidence that CEO who supposed to provide accurate and credible financial reporting were in most cases involved in fraudulent activities that end in misleading investors and shareholders e.g. Enron and WorldCom in the USA, Cadbury, African Petroleum and Liver brothers in Nigeria. We predicted that the involvement of CEO's in corporate financial scandals is been influenced by the presence of politically connected directors. Specifically, we find that CEO ownership and CEO expertise mitigate the effect of real earnings manipulation.

However, the study evidenced that the presence of politically connected director's overturns and overrides the CEO's ability to provide an accurate and reliable financial report. The study shows that the moderating effect of political connection on the CEO factors can lead to deteriorating earnings quality. Thus, the findings provide insight to regulators, investors and financial analysts that the role of CEO's attributes in financial reporting quality is subject to the level of firm's political connection.

Note

1. ASEM is a market mainly for small and entrepreneurial businesses with different listing requirements essentially registered to raise capital for growing their business to become publicly listed company. In addition, the financial reporting of these companies differs from the general population.

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