
Earnings Management Impact on Cost of Capital: An Empirical Investigation of Non-Finance Listed Firms in Nigeria

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Abstract

Capital is a very veritable item in undertaking any business enterprise. If the capital structure is faulty, the business will find it difficult to survive. Generally, the cost of capital is a major pitfall for most businesses operating in Nigeria due to high interest rates, therefore for an existing business, capital can easily be built up through earnings. It is against this background that this study examines the influence of earnings management on Nigeria cost of capital among publicly traded non-finance companies on the floor of the Nigeria exchange group using a data set from the period of 2011 through 2020. The Modified Jones discretionary accrual model measures was used; the independent variable of earnings management was considered while the cost of debt, cost of equity, and weighted average cost of capital are the dependent factors. As a result, the study incorporated the variables of leverage and cashflow into the models. The panel fixed and random effect regression procedures are the econometric methods used in this study. Taking all of this into account, the study found that cost of capital is unaffected by earnings management. The study recommends that the traditional ways of reviewing cost of capital balancing between loans and equity is still the best option in arriving at an optimum cost of capital among listed non finance companies.

Keywords: Capital, Firms, Earning, Cashflow, Debt, Equity

1. Introduction

The link between the cost of capital and the management of earnings is critical. Companies have several reasons to keep an eye on their earnings. One of these is the cost of capital, although it's not the most critical. The amount a business pays for the utilization of capital is referred to as the "cost of capital." However, the cost of capital serves a variety of functions for a company. The ability of a company to raise money from the capital markets is a major factor in today's corporate decisions. The weighted average cost of capital (WACC) is used to make investment decisions and discount future cash flows. Interest and dividends are the costs of holding debt or shares in a company. Debt, on the other hand, is often less expensive than equity in terms of capital expenses. Due to the lower level of risk that loan distributors face compared to equity distributors, this is the fundamental reason for the difference. To put it another way, an investor's expectation of profit is directly proportional to the level of risk he is willing to accept. Investing returns are correlated with the product's level of risk. Based on a portfolio's risk profile, the Capital Assets Pricing Model (CAPM) predicts the portfolio's projected return rate. This is a famous depiction of the link between an investment product's risk and its predicted return.

The investor's risk is reflected in the cost of capital. There is also a possibility of information leakage as part of this. Evidence from Francis, J., et al (2005) shows that information risk is

linked to the cost of capital. To add to this, Easley, D., & O'hara, M. (2004) look into the function of private and public knowledge in setting the cost of capital. The information risk is primarily comprised of two components. According to Francis, J., Nanda, D., & Olsson, P. (2008), voluntary disclosures and the quality of earnings are both influenced by accrual quality. A substitute and a complementary connection between a firm's earnings quality and the disclosures it publishes have been seen Francis, J., Nanda, D., & Olsson, P. (2008).

Research shows that managers' incentive packages have a far stronger link to earnings management than previously thought. Investors, on the other hand, should be aware of the intents of companies. Equity (dividends paid) and debt (interest payments) have differing effects on a company's financial performance. In general, equity has a less impact on the management of earnings. This may be attributable to the people who first proposed paying out the dividend. There is no guarantee that loan repayments will be paid, but the dividends are decided by the shareholders. The company, on the other hand, sets the price it is willing to pay. A common feature of debt agreements is the inclusion of dividend limitations, which are based on accounting information. Firms may appear more lucrative than they actually are if they have bigger earnings. The fundamental argument against influencing debt arrangements through earnings management is because it is unclear whether or not these activities only delay the inevitable.

Earnings management is the subject of a great deal of research. A significant portion of this research, however (Gangeni, C. 2006; Ronen, J., Tzur, J., & Yaari, V. L. 2006; Bergstresser, D., & Philippon, T. 2006), examines the incentive schemes of managers as a cause for the adoption of earnings management. This is only one of the many reasons why earnings management is necessary Stolowy, H., & Breton, G. (2004). The primary goal of earnings management is to have some control over actual revenue. The management's personal incentive to control earnings is provided by the incentive systems. Although the company's incentive is to lower real costs and maximize real revenues (cash flows). In addition, research has been done on accounting procedures that can help companies increase their profits Skinner, D. J. 1993; Gietzmann, M., & Ireland, J. 2005). However, just a few research have sought to explore the association between income management and the cost of debt. The impact of earnings management on the cost of capital for publicly traded non-finance enterprises in Nigeria is also examined in this research.

2. Conceptual Literature

2.1 Cost of Capital

There are two types of capital: debt and equity. Companies that use debt to fund their operations are taking out short-term loans from lenders, who expect them to pay back the money plus interest. In return, the lender is compensated with interest on the loan. With equity financing, investors buy stock in the business and partake in its profits in exchange for a percentage of the company's revenue. As a generic term, "cost of capital" refers to the many expenses an organization incurs when obtaining funding from various sources.

2.2 Cost of Debt

Borrowing funds from financial institutions or from government bonds (debentures) for a predetermined period of time at a predetermined interest rate was an option for the corporation Wakida, N. R. (2011). This statistic is valuable since the company can utilize a variety of bonds, loans, and other forms of debt; thus, it can give an estimate of how much the company is paying to employ debt financing. Investors can get a sense of a company's riskiness by comparing its cost of debt to that of other similar companies. Tax-deductible interest payments further reduce the company's debt costs.

2.3 Cost of Equity

Investors are entitled to future dividends from their investment in a firm since they become a shareholder and hence are entitled to a stake in its future profits, which cannot be predicted at the beginning Wakida, N. R. (2011). Retaining profits is a way for businesses to raise money. If the current market price for equity shares falls, the minimal rate of return required by shareholders on funds they give to prevent this reduction in equity share prices will be the opportunity cost of retained earnings Wakida, N. R. (2011). Equity capital, in contrast to debt capital, does not have a predetermined end date for repayment. Most equity capital comes from a combination of preferred stock and accumulated other comprehensive income (OIC). Prior to preferred stock, common stock is usually the most expensive equity vehicle. The cost of debt can also climb if a company increases its leverage dramatically, as lenders become concerned about the company's capacity to repay its loans. The claims of common stockholders are always riskier than those of lenders, according to Gitman, L. and Zutter, C. (2012), hence the cost of equity always surpasses the cost of debt.

2.4 Weighted Average Cost of Capital

A lower weighted average cost of capital and reduced capital expenditures can both be achieved with an ideal debt-to-equity ratio (WACC). Firms are subject to constraints imposed by debt holders, who are aware of the prospect of wealth transfer to equity holders, as well. Debt holders, on the other hand, will have a hard time influencing a company's activities once a covenant has been agreed upon. On the other hand, shareholders appear to value a sound capital structure and adhere to the rules set forth in corporate bylaws Wald, J. K. (1999). Debt holders, on the other hand, are aware of the advantage they have over equity investors. Debt, on the other hand, gives stock investors a leg up. In the M&M theorem, taxation boosts a company's value by attracting debt. An increase in a company's worth enhances the value of its shareholders. Companies with lower debt-to-equity ratios are more profitable and have a higher return on equity, according to empirical studies. Companies with better credit ratings and cheaper capital costs also benefit Francis, J., Nanda, D., & Olsson, P. (2008).

2.5 Earnings Management

Regardless of their industry or size, corporate earnings management is a complex and challenging trend. Earnings management has been defined by a variety of authors in the literature. Although this is the case, there is no consensus on the best way to define and explain the concept. Ubesie, M. C., Ogbu, S., & Mbah, C. C. (2019) describe earnings management as a tactic employed by the management of a firm to manipulate the company's earnings in order to meet a predetermined objective for the purpose of smoothing out revenues. Earnings management is defined by Obigbemi, Omolehinwa, Mukoro, Ben-Caleb, and Olusanmi (2016) as using loopholes in financial reporting rules to achieve personal, group or organizational objectives at the cost to another set of individuals. "Earnings management can take the shape of creative accounting, such as recognizing expected revenues in the books as turnover for the present year, as well as the reduction in the cost of research and development," according to Obigbemi, Omolehinwa, Mukoro, Ben-Caleb, and Olusanmi (2016). As Obigbemi and colleagues (2016) highlighted, earnings management could also include the accumulation of accumulated expenses in a bid to portray a different financial picture of the company's current state. Profit management, according to Isa, M. A., & Farouk, M. A. (2018), is the practice of consciously reducing earnings swings to a level considered typical by the company. Profit management, according to Nwaobia, Kwarbai, and Fregene (2019), refers to a set of techniques used to manipulate reported earnings by management, including the use of accounting methods, expense acceleration, expense under-accrual, and revenue deferral (depending on the target objective). Misrepresentation of genuine revenue and assets by corporations or other organizations is referred to as "systematic misrepresentation" Omoye, A. S., & Eriki, P. O.

(2014) or "new ways of defining income, assets and liabilities" Donaldson, T. and Werhane, P.H. (2009).

2.6 Theoretical Framework

2.6.1 Signaling Theory

This is known as symmetric information, and it refers to the fact that investors have the same knowledge as the company's executives. Managers, on the other hand, often have more up-to-date knowledge than investors do. asymmetric information is what Ehrhardt, Michael C. and Eugene F. Brigham. (2011) refer to this phenomenon as and the optimal capital structure. Managerial signals to investors are thought to be the basis of the signaling hypothesis, which holds that financial decisions made by corporations are intended to disrupt power imbalances. Financial communications policy relies heavily on these signals. Debt or shares will only be issued if there are not enough internal resources to finance the planned projects or if the risk does not equal anticipated earnings, according to Gangeni's theory (2006). Identifying patterns in the types, levels, and levels of trustworthiness of the information presented will be the primary goal in this scenario. Managers will not issue new equity if the current stock price is less than the fair value of their shares (given their inside information). As a result, the stock price tends to decline when new shares are issued.

3. Empirical Literature and Hypotheses Development

3.1 Earnings Management and Cost of Debt

Interest is the only actual expense of borrowing money. In several cases, researchers used a method called the marginal cost of debt Prevost, A. K., Rao, R. P., & Skousen, C. J. (2008). According to Prevost and colleagues, the yield spread on a corporate bond is compared to the yield spread on a Treasury bond. Nevertheless, this ignores the true cost of interest to a business. Bonds created through bonds, however, reflect accrual quality in the bond market, as demonstrated by Prevost and colleagues Prevost, A. K., Rao, R. P., & Skousen, C. J. (2008). A manager's attempt to inflate earnings will be spotted by bond markets because greater debt costs are correlated with a higher rate of accruals Prevost, A. K., Rao, R. P., & Skousen, C. J. (2008). As a result, the market places a premium on the quality of the disclosures and the risk of information leaks (Francis, J., et al 2005; Prevost, A. K., et al 2008). Debtors, on the other hand, incur a variety of risks in addition to those faced by equity holders. Debt is cheaper than equity, which means that in a world where there are no limits, companies would sell their equity and just take on debt. Furthermore, if a company simply has stock, the equity investors bear all of the risks. Discontinuity and failing earnings are among these dangers. When a company takes out a loan, the first risk is shared by all shareholders. The more debt a company has, the more risk is transferred to its creditors. Hence, the study states the first hypotheses as;

H₀₁: Earnings Management has no significant effect on the cost of debt of listed non-finance firms in Nigeria

3.2 Earnings Management and Cost of Equity

To prevent dividend cuts, CFOs will do anything, from laying off employees to rejecting profitable ventures. Investors' aversion to stock price drops that coincide with dividend decrease announcements led DeAngelo, et al (2006) to draw this conclusion. The fact that some shares do not pay dividends shows that equity investors do not always expect to receive a dividend. The share price reflects a dividend distribution of \$0. As a matter of fact, the management has taken this approach. When investors expect a dividend and are disappointed, the market reacts with dissatisfaction.' Investors' expectations of returns are altered when dividends are decreased. Since equity is projected to return a bigger profit than debt, this is an important factor to consider when evaluating an investment. In the event that future profits do not increase the (anticipated) value of equity holders' investments, equity holders run the risk

of losing money. Return on equity generates less predictable cash flows. Holders of debt receive a higher dividend than those who own stock. Interest is a fixed cost, but dividends are based on a company's performance. As a result of these two variables, stock holders have a higher risk profile than debt holders. Debt holders also receive payment before equity holders in the event of discontinuity. Nonetheless, it is important to point out that debt holders are typically denied any compensation in the event of discontinuity. Hence, the study states the second hypotheses as;

H0₂: Earnings Management has no significant effect on the cost of debt of listed non-finance firms in Nigeria

4. Methodology

The study used an expo-facto and non-experimental research strategy in accordance with existing literature to take a firm-level approach. The research is long-term and will go for a total of ten years. From 2011 to 2020, non-financial companies listed on the Nigerian Exchange Group's floor will be employed (NGX). Purposive sampling was used since companies were only included in the sample if they met specified requirements. As a result, the study only considered non-finance firms that have accumulated all relevant data over the course of their existence. The number of non-finance firms in the final sample was calculated using data for all research variables that was available for a period of ten years. Hence, the study expresses the econometric models as:

$$CODT_{it} = \beta_0 + \beta_1 JOSA_{it} + \beta_2 DETA_{it} + \mu_{it} \dots (1)$$

$$DIYD_{it} = \beta_0 + \beta_1 JOSA_{it} + \beta_2 CFOA_{it} + \mu_{it} \dots (2)$$

$$WACC_{it} = \beta_0 + \beta_1 JOSA_{it} + \beta_2 CFOA_{it} + \mu_{it} \dots (3)$$

Where:

CODT=Cost of Debt

DIYD=Cost of Equity

WACC=Weighted Average Cost of Capital

JOSA=Modified Jones Discretionary Accrual Measure of Earnings Management

DETA=Debt to Asset Ratio

CFOA=Cashflow from Operations

β_0 = Constant

β_1 - β_2 = Slope Coefficient

μ =Stochastic disturbance

i = i^{th} firm

t =time-period

5. Empirical Results and Discussion

5.1 Descriptive Analysis

Table 1. Descriptive Statistics.

VARIABLES	MEAN	SD	MIN	MAX	NO OBS
CODT	3.91	5.92	0	85.96	299
DIYD	4.56	5.48	0	51.72	299
WACC	3.54	3.00	0	29.10	299
JOSA	-0.06	0.12	-0.49	0.48	299
CFOA	0.12	0.11	-0.28	0.48	299
DETA	56.35	18.97	4.28	123.35	299

Source: Author (2023)

The descriptive statistics of the study are summarized in the table above. The average cost of debt (CODT) is 3.91 percent, with a standard deviation of 5.92 percent, as shown in the table. The average cost of equity (DIYD) is 4.56, while the standard deviation is 5.48. WACC has a mean of 3.54 and a standard deviation of 3.00, according to the findings. JOSA's mean was -

0.06 and its standard deviation was 0.12, according to the data in the table. There is a standard deviation of 0.11 for the cashflow (CFOA) control variable in the table. There is a standard deviation of 18.98 for leverage (DETA).

5.2 Correlation Analysis

The Pearson correlation coefficient (correlation matrix) was used to examine the relationship between the variables, and the findings are shown in the table below.

Table 2. Correlation analysis.

	CODT	DIYD	WACC	JOSA	CFOA	DETA
CODT	1.00					
DIYD	-0.03	1.00				
WACC	0.28	0.83	1.00			
JOSA	-0.10	0.12	0.03	1.00		
CFOA	0.03	-0.11	-0.09	-0.60	1.00	
DETA	-0.02	-0.01	-0.08	-0.22	0.01	1.00

Source: Author’s computation (2023)

The correlation between the variables of interest shows that earnings management and the cost of debt have a negative and weak link (-0.10). Earnings management and the cost of equity have a positive and weak correlation (0.12). The relationship between weighted average cost of capital and earnings management is both favorable and poor (0.03). As for the control, we discover a weak but favorable link between cash flow and loan costs (0.03). There is a correlation between the cost of equity and cashflow that is weak and negative (-0.11). In general, the weighted average cost of capital is negatively correlated with cash flow (-0.09). Managing cash flow and maximizing earnings has a strong and negative correlation (-0.60). There is a correlation between leverage and the cost of debt that is both negative and weak (-0.02). There is a correlation between leverage and the cost of equity that is both negative and weak (-0.01). There is a correlation between leverage and the weighted average cost of capital that is both negative and weak (-0.08). There is a correlation between leverage and earnings management that is both negative and modest (-0.22). However, since a correlation test does not capture cause-and-effect relationships, the study will require regression findings to test the hypothesis.

5.3 Regression Results

Here, the study employs panel data regressions using OLS pooled findings to investigate the relationship between dependent and independent variables and to test the hypotheses, as shown in the table below.

Table 3. Regression Result.

	M1-CODT		M2-DIYD		M3-WACC		M3-WACC		M3-WACC	
	CODT Model (FIXED Effect)	CODT Model (RANDOM Effect)	DIYD Model (FIXED Effect)	DIYD Model (RANDOM Effect)	WACC Model (FIXED Effect)	WACC Model (RANDOM Effect)	WACC Model (FIXED Effect)	WACC Model (RANDOM Effect)	WACC Model (FIXED Effect)	WACC Model (RANDOM Effect)
C	9.82 {0.000} **	7.08 {0.000} **	5.76 {0.000} **	5.50 {0.000} **	4.09 {0.000} **	4.05 {0.000} **	4.09 {0.000} **	4.05 {0.000} **	4.09 {0.000} **	4.05 {0.000} **
JOSA	-1.46 {0.601}	-2.47 {0.368}	-2.83 {0.474}	0.16 {0.964}	-2.34 {0.232}	-1.93 {0.291}	-2.34 {0.232}	-1.93 {0.291}	-2.34 {0.232}	-1.93 {0.291}
DETA	-0.11 {0.000} **	0.006 {0.008} *								
CFOA			-11.75 {0.009} *	-7.80 {0.046} *	-5.91 {0.008} **	-5.22 {0.011} *	-5.91 {0.008} **	-5.22 {0.011} *	-5.91 {0.008} **	-5.22 {0.011} *
F-stat/Wald Stat	8.19 (0.01) *	7.28 (0.03) *	5.11 (0.01) *	7.86 (0.02) *	4.23 (0.02) *	7.68 (0.02) *	4.23 (0.02) *	7.68 (0.02) *	4.23 (0.02) *	7.68 (0.02) *
R- Squared	0.06	0.05	0.04	0.03	0.03	0.03	0.03	0.03	0.03	0.03
Hausman Test	18.01 (0.0001) *		3.31 (0.1907)		0.81 (0.6678)		0.81 (0.6678)		0.81 (0.6678)	

Note: (1) bracket { } are p-values

(2) *, **, implies statistical significance at 5% and 1% levels respectively

Using the F-statistics and Wald-statistics in the table above, the study can see that the fixed and random effect regression models are all statistically significant at a level of 5 percent (model 1: 8.19 (0.01); model 2: 5.11 (0.01); model 3: 4.23 (0.02)) and [model 1: 7.28 (0.03); model 2: 7.86 (0.02); model 3: 7.68 (0.02)]. It was found that [model 1: 6 percent; model 2: 4 percent; model 3: 3 percent] for fixed effect and [model 1: 5 percent; model 2: 3 percent; model 3: 3 percent] for the coefficient of determination (R-squared). Both the independent and control variables in all three models had a significant impact on the costs associated with debt, equity,

and weighted average capital. Based on the null hypothesis that a random effect model is preferable to a fixed effect model, the Hausman test was used to pick from the two panel regression estimation findings. It is clear from looking at model 1's p-value that the alternative hypothesis should be accepted at a level of significance greater than 5 percent or 1 percent, depending on whether the study use the Hausman test (0.0001). As a result, the study should base the conclusions and suggestions on the fixed effect panel regression results. As a result, fixed effect outcomes tend to be statistically more appealing than random effect ones. Model 2's p-value (0.1907), on the other hand, suggests that the study should accept the null hypothesis and reject the alternative hypothesis at a level of significance greater than 5% or 1% for the Hausman test. As a result, the study should base the conclusions and recommendations on the random effect panel regression results. This suggests that random effect outcomes are statistically more enticing than fixed effect results. It follows that the study should reject any alternative hypothesis that is less than 5 percent or 1 percent significant if the study examine model 3's p-value of 0.6678. As a result, the study should base on the conclusions and recommendations on the random effect panel regression results. The fixed effect is statistically less desirable than the random effect, hence this means that the random effect results are preferable. As a result of the preceding explanation, evaluating the hypotheses for models 1, 2, and 3 required an examination of the findings of the fixed, random, and random effect. Fixed and random regressions were used to analyze each of the independent variables.

5.4 Discussion of Findings

Accordingly, only a small number of discoveries in the literature are at odds with this study's current findings. As a proxy for cost of debt, the study finds that earnings management (Fixed effect regression = -1.46 (0.601)) has a negative but minor effect on capital costs (Fixed effect regression = -1.46 (0.601)). This therefore means the study should accept the null hypothesis {H₀₁: Earnings management has no significant effect on cost of debts of listed non-finance firms in Nigeria}. To put it another way, this means that increasing earnings management will have no effect on the cost of debt. Earnings management has previously been shown to have little effect on the cost of debt Prevost, A. K., Rao, R. P., & Skousen, C. J. (2008). According to Brav, A., et al (2005), earnings management greatly increases the cost of debt. However, the study disagrees. Earnings management (Random effect regression = 0.16 (0.964)) as an independent variable to the cost of capital when proxied by the cost of equity appears to have a positive and small influence on the cost of capital, according to the findings. This therefore means the study should accept the null hypothesis {H₀₂: Earnings management has no significant effect on cost of equity of listed non-finance firms in Nigeria}. As a result, an increase in profit management is unlikely to result in a considerable rise in the cost of equity. According to earlier empirical findings, earnings management has a negligible effect on the cost of equity DeAngelo, et al (2006). The study disagrees, however, with the findings of Prevost, Skousen, and Rao (2008), which found that effective earnings management lowers equity costs. As a further piece of evidence, the study shows that the weighted average cost of capital (Random effect regression = -1.93 (0.291)) appears to have a negative and minor impact on the cost of capital as an independent variable. This therefore means the study should accept the null hypothesis {H₀₁: Earnings management has no significant effect on weighted cost of capital of listed non-finance firms in Nigeria}. A rise in earnings management will not considerably lower the weighted average cost of capital. According to earlier empirical findings, earnings management does not appreciably lower the weighted average cost of capital DeAngelo, et al (2006). Though Brav, A., et al (2005) concluded that earnings management boosts weighted average cost of capital significantly, the study disagree.

6. Conclusion and Recommendation

Companies have several reasons to keep an eye on their earnings. One of these is the cost of capital, although it's not the most critical. The amount a business pays for the utilization of capital is referred to as the "cost of capital." However, the cost of capital serves a variety of functions for a company. The ability of a company to raise money from the capital markets is a major factor in today's corporate decisions. Based on the weighted average cost of capital, cash flows are discounted for investment decisions. Interest and dividends are the costs of holding debt or shares in a company. Debt, on the other hand, is often less expensive than equity in terms of capital expenses. Due to the lower level of risk that loan distributors face compared to equity distributors, this is the fundamental reason for the difference. To put it another way, an investor's expectation of profit is directly proportional to the level of risk he is willing to accept. Investing returns are correlated with the product's level of risk. Taking all of this into account, the study can say empirically that cost of capital is unaffected by earnings management. In view, enterprises should always aim to achieve an optimal balance between the cost of capital and other factors.

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