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A REVIEW OF EARNINGS MANAGEMENT DETERMINANTS

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Abstract

Provision of useful information that can permit informed economic decision by investors is a primary function of accounting. A fundamental characteristic of accounting information lies in the predictive ability of information provided to users. Such information can enhance the ability of investors to predict performance of an entity. Firms manipulate earnings in order to report a favorable performance and protect the image of the company. This act misleads investors with the aim of inducing them to increase investment in the firm or attract prospective investors. The study aims at reviewing earnings management determinants. The study adopts review approach within the range of documentary literature. The study reveals that, among the issues of earnings are determining factors of earnings management which includes Performance, Leverage, firm size, corporate governance, auditors, ownership concentration, dividend policy, effective tax rate etc. These factors are useful to investors in making informed decision regarding their investments. The earnings quality of a firm's reported earnings can boost the confidence of investors and attract further investments in the Nigerian capital market which will foster growth in the economy. The contribution of this study is to highlight the issues and relevant variables that affect earnings management in reporting of corporate financial performance. This study recommends that management should introduce ways to curb earnings management practices among unscrupulous individuals. Further, both existing and potential investors are advised to increase vigilance in the activities of firms through observation of a firms' financial statement to detect earnings management practice in order to make informed investment decision.

Keywords: Earnings Management, Agency Theory, Stakeholder Theory, Corporate governance, Leverage.

1. Introduction

Provision of useful information that can permit informed economic decision by investors is a primary function of accounting. A fundamental characteristic of accounting information lies in the predictive ability of information provided to users. Such information can enhance the ability of investors to predict performance of an entity. The

financial statement which provides information on the earnings generated by economic activities of a firm is of major interest to both internal and external stakeholders such as managers and investors. Information on a firm's earnings during a reporting period serves as a basis of tax computation by government, assessment of the performance of a company and for determination of the amount of profit available for distribution as dividend to

shareholders. Therefore, the earnings reported of a period serve as a yardstick for determining the value of a firm. The future earnings of a firm is also an importance factor used by investors when assessing the both current and future value of a firm (Ansari et al., 2012).

Earnings management may arise as a result of agency problem. Managers could manage earnings to window – dress financial statements with the aim of improving their position (Iturriaga & Hoffman, 2005), obscuring facts that stakeholders ought to know (Loomis, 1995), or influencing contractual outcomes that depend on reported accounting numbers (Shipper, 1989; Dechow & Skinner, 2000). Instances when firms reported losses in the previous year; influencing short-term stock prices and fulfilling capital market expectations; carrying out lending agreements, and obtaining bonuses through management compensation contracts (Healy & Wahlen, 1999; Dechow & Skinner, 2000).

Firms manipulate earnings in order to report a favorable performance and protect the image of the company. This act misleads investors with the aim of inducing them to increase investment in the firm or attract prospective investors. Several motives have been identified in the literature on the motives for engaging in earnings management practices. One of the reasons identified is the issue of manager's incentive or bonus. Managers are eager to report a favorable earning where the reward for such performance is tied to the earnings of the company. Earnings management was found to be associated with management's desire to maximize compensation and enhance shareholders' value (Bhat, 1996).

The collapse of large firms in the global market during the early 20th century such as Worldcom and Enron as a result of corporate fraud which involves the overstatement of reported profits of both firms. In Nigeria, the corporate scandal that involved Cadbury (Nig) and Lever-brothers (Nig) Plc were reported. Ajayi, (2006) cited in Okaro, Okafor and Ofoegbu (2013). These have led to the rallying call for increased regulation in business environment through effective corporate governance mechanism and enactment of laws to guide business activities. Corporate fraud through manipulation of

reported earnings can negatively affect reputation of a business, leads to huge financial loss to a company and prevents investment in shares of such company (Burnaby, Howe & Muchlmann, 2011).

Corporate scandals prevalence among notable firms in Nigeria such as Oceanic Bank, Savannah Bank, Afri Bank, Union Bank, First Inland Bank, Intercontinental Bank, African Petroleum Plc and Cadbury Nigeria Plc (Okaro, Okafor & Ofoegbu, 2013; Alao, 2016; Akinyemi, 2012) among others have led to decline in public confidence on the information provided on the financial report of firms and casts doubt on the reported earnings. These have led arrests and prosecution by the Economic Financial Crimes Commission (EFCC) of high profile managers within some of these firms. These scandals have caused threat to the reliability of the financial statement by users as it has cast doubts especially on the reported earnings of banks. Investors and other stakeholders will lose confidence on the credibility of the financial system; reduce the level of investment in banks and growth in the industry at large. The ability of the Nigerian government to provide essential services is deterred by the rising cases of sharp practices by companies through manipulation of income to reduce the income taxes available for remittance to the government. These have affected revenue generation for the government and reduce amount of funds required to fund developmental projects for the benefits of its citizens. Such unethical practices have been found among oil and gas firms who engaged in earnings manipulation to reduce reported profits and ultimately remit lower income taxes (Bello, 2017; Abubakar, Mansor & Wan-Mohamad, 2021).

Several studies have been carried out on impact of earnings management on factors such as financial performance & firm size (Cyril et al., 2020; Freedom and Jaggi, 1992; Kingsley et al., 2016; Waqas, 2020; Zhu & Tian, 2009; Shehu, 2011), corporate governance (Roodposhti & Chashmi, 2011; Abubakar, Mansor & Wan-Mohamad, 2021; Bello, 2017).

The main objective of this paper is to review literatures on earnings management in order to assess factors which determine earning management practices of firms. The

study then makes recommendations for determinants to be adopted in studies related to earnings management.

2. Literatures Review

Concept of Earnings Management

Earnings can be managed by either real earnings manipulation or discretionary accruals. Discretionary accrual is more appropriate for managers to manage the earnings in terms of cost, value relevance and complexity of financial reporting (Roychowdhury, 2006). Scott (2014) Defines earnings management as the choice of accounting policies by the managers to attain a specific objectives. Earnings management is negatively correlated to earnings quality. Hadani, Goranova and Khan, (2011) observed that earnings management is responsible for information asymmetry and have negative impact on financial reporting quality.

Earnings management is an unethical practice which involves is a deliberate attempt to arrive at a desired level of earnings using different means (Bello, 2011). Earnings management includes various deceitful actions by managers when exercising judgment in financial reporting. Thus, the use of accounting choice to achieve a personal goal and cover any other manipulations is also referred to as earnings management (Bugshan, 2005; Murya, 2010).

Healy and Wahlen (1999) cited in Ewert and Wagenhofer (2011) "Earnings management is commonly understood as intentionally misrepresenting or concealing financial information about the firm's economic position by a manager". Fischer and Rosensweig (1995) cited in Cyril et al (2020) define earnings management as: "Actions by division managers which serve to increase (decrease) current reported earnings of a division without a corresponding increase (decrease) of the long-term economic profitability of the division".

Dechow (1994) states that, cash flow from operations which is described as one of the element of earnings is not considered to be the best measure for performance even though the ability to generate cash determines the success of a company. The timing and matching of cash from operations (such as credit sales) is the major weakness that undermines its ability to be used as a measure of

performance. However, the principle of revenue recognition and matching concept are usually used to overcome the shortcomings in the use of cash flow as a performance measure.

Determinants of Earnings Management

Several studies have investigated the relationship between earnings management and other factors that influence the practice of earnings management. Below are some of the categories of determinants of earnings management.

Financial Performance

The level of performance (measured by profitability) of a company can influence the attitude of management towards engaging in earnings management. Accordingly, there is high tendency for firms with low reported earnings or performance to engage in earnings management activity in order portray good image of the organization. Other motives such as incentive for managers whose bonus is linked to the performance of the organization. It has been argued that the economic performance of firms can influence the level of reporting quality. Thus, the urge to manipulate earnings is higher among firms with poor financial performance. Management engages in this practice in order to impress shareholders and persuade potential investors (Freedom & Jaggi, 1992).

According to Kenton (2019) cited in Cyril et al (2020), financial performance is "a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. The term is also used as a general measure of a firm's overall financial health over a given period. Analysts and investors use financial performance to compare similar firms across the same industry or to compare industries or sectors in aggregate. To that extent, there are many ways to measure financial performance, but all measures should be taken in aggregate. Line items, such as revenue from operations, operating income, or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt."

The decisions by management of a firm to either engage in earnings management practices or not are largely affected

by financial performance of the firm. This action will influence the level of reporting quality of the financial statement issued by the firm. The nature of information provided is determined by the benefits anticipated by the firm and economic demand of its immediate environment (Kingsley et al, 2016).

Firm Size

The size of a firm (measured by its Assets or Sales) is considered vital in representing financial position of a firm. The size of a firm provides a useful basis for predicting the performance of an organization by investors and researchers. Total Sales represents the market share of an organization as such, it is used to represent size of a firm. Also, Natural log of total assets have been used as a proxy to measure the firm size in previous studies (Kausar et al, 2011; Chen et. Al., 2005; Ghazali, 2010; Hasan & Ahmed, 2012).

There is an expected increase in agency problem between shareholders and management of a firm due to the increase in size of the firm. Also, as firm increase in size (or performance) there is tendency for information asymmetry to increase (Abed et. al., 2012). Grey and Clarke (2004) opined that firms that have resources and reports higher profits due to their large size are less likely to engage in earnings management practices through discretionary accruals. In earning management studies, quite a number of studies control for firm size including Zhu and Tian (2009) and Shehu (2011).

The larger firms are usually more regulated and come under scrutiny. These companies tend to present quality financial reports as they disclose more information. Such companies usually have more auditing exercise with improved internal control system in place to ensure compliant with necessary standards, detect fraud and fairly present financial statements (Kingsley et al., 2016). Thus, smaller firms tend to have deficiencies in internal control procedures are motivated to engage in earnings management so as to present a favorable financial report. Larger firms have higher demands to improve on accounting quality due to the perception of having a vital economic role as an entity within the society (Cooke,

1991).Larger firms engage in less income smoothing activities due to such economic or political scrutiny.

Cormier et al. (1998) found that large firms have higher chance of being subjected to intervention from the people that are considered influential due to their political connections. These firms are more likely to be involved in manipulations of earnings through reduction of earnings to cater for costs associated with the political interventions. They delay disclosure of profits using various accounting methods that may or may not be in tandem with the accounting standard regulating their business environment.

Financial Leverage

In order to finance its operations company uses a mixture of owner's equity and debt (Waqas, 2020). "To finance capital using more debt, the higher will be the financial leverage of the firm. The higher amount of financial leverage has bad impact on the company's future earnings per share. It is for this reason, this factor is taken under consideration as it shows negative impact on the company's profile when the value of financial leverage is high. Debt to equity ratio is used to Measure Company's financial leverage" (Nasirzadeh et al., 2012) cited in Waqas (2020).

For the sake of financing their business activities in the capital market, firms require financial resources to achieve this objective. This can be achieved through debt, equity mixture of both. This is what constitutes the financial structure of a firm (Moro, Lucas & Grimm, 2012). Previous studies on capital structure have shown that cost of debt is cheaper than cost of equity in financing an investment (Modigliani & Miller, 1958). According to Roodposthi and Chashmi (2011) in a study of earnings management and corporate governance, borrowing at a lower interest rate provides an opportunity to decrease cost of capital. Consequently, to prevent violation of debt agreements, managers of highly leveraged firms are more likely to engage in earnings management practices such that can reduce estimate of debt holders and adjust assessment of probable bankruptcy. The study also controlled for leverage (Roodposthi & Chashmi, 2011).

Januarsi, Badina and Febrianti (2014) examined the relationship between leverage and earnings management as moderated by corporate strategy among manufacturing companies listed in Indonesia. Both accrual and real earnings management were used to determine the relationship between the dependent and independent variables. The study found positive relationship between leverage and accrual earnings management. However, there was a statistically significant negative association between leverage and real earnings management. This supports previous findings where a negative relationship was found between leverage and earnings management (Lobo & Zhou, 2001; Chung, Firth & Kim, 2005; and Lee, Lev & Yeo, 2007). In conclusion, the study found that the corporate strategy employed by companies by diversifying their investment does not moderate the relationship between leverage and accrual earnings management.

Dividend Policy

Charfeddine et al (2013) examined the determinant of earnings management in Tunisia. Using a data of 19 listed companies during the period of 2003-2009, the study found that firm size, indebtedness of a firm, CEO duality, dividend policy and managerial property have significant impact on earnings management activities. These variables were used as independent factors that determine earnings management. The residuals of discretionary accruals from models proposed by Dechow et al. (1995) (modified Jones model), Kothari et al. (2005) and Raman and Shahrur (2008) were used as proxies for earnings management and regressed over the determinants.

The impact of earnings management on dividend policy in Nigeria was investigated Ibrahim et al (2015). Using a sample of 19 non-financial firms listed in Nigeria in 2014, the study reveals that earnings management has no significant impact on dividend policy as proxied by dividend pay-out ratio of firms. The study also found that leverage and size of firm are major determinants of firms' dividend payment. Additionally, the managers have their personal motive such as bonus or compensation for improved performance that influences their attitudes towards engaging in earnings management rather than the need to pay dividend to shareholders. The need to meet expected dividend payment level influences attitude of

management to review their earnings. Firms who reported low level of earnings are less likely to pay dividend than firms who reported higher earnings. Thus, managers will aim to manage discretionary accruals in such a way to meet up with expected dividend level (Daniel et al., 2007).

Effective Tax Rate

It is the rate at which any firm or individual is taxed. It is already predicted that when the tax rate increases, it triggers towards the manipulation of the earnings sometimes. Mostly earnings management is the process of getting the advantage of excess amount to hide their poor performance, so decrease in the tax rate may lead the organization to use excess amount saved by giving less amount of tax (Nurdinah & Herlina, 2015).

Both countries and companies are interested in tax. It forms a source of revenue to a country and an expense to a company. Tax reduces the reported earnings and available profit to be either retained or paid as dividend to shareholders. It is essential for both parties in achieving desired objective (Mulyadi & Anwar, 2015). Using discretionary accrual to measure earnings management, and effective tax rate as tax management measurement, it was found that there is significant impact of corporate governance to earnings management and tax management (Erickson et al. 2006; Mulyadi & Anwar, 2015).

Effective tax rate was used as a proxy for corporate tax avoidance to examine the relationship between in a Nigerian case study by Ahamd Mansor and Wan-Mohamad (2021). The study was conducted on a sample of 72 non-financial firms listed in Nigeria. Data were extracted from financial statement of the selected firm over a period of 5 years. Using real earnings management as proposed by Roychowdhury (2006), the study found a positive relationship between effective tax rate and earnings management. Managers are motivated to decrease liability for their own benefit such as bonus or reward from company. They achieve their desired objective through real earnings management activities that can lead to reporting of lower income for which less tax liability will be incurred (Ahmad, Mansor & Wan-Mohamad, 2021).

Ownership Concentration/Ownership Structure

The level of control as a result of increased shareholding by individuals can influence the decision making of a firm by those with higher shareholding. Large shareholder can exert much control over the affairs of a firm due to their voting rights. Ownership concentration is a measure of the existence of large shareholders' in a firm (Thomsen & Pedersen, 2000).

The incentives to monitor activities of management are higher among firms with large shareholders. The expected benefits from such monitoring activity are higher than the associated costs among firms who have existing large shareholders than those with less (Roodposhti & Chasmi, 2011). It has also been argued that sufficient incentives for large shareholders to monitor the activities of managers within a firm are being provided by the level of ownership concentration. Hence, shareholders with less equity holding have little or no incentive to monitor management which can be attributed to the high costs of monitoring that may likely outweigh any derivable benefit from such activity (Ramsey & Blair, 1993). Less opportunity for earnings management exists where a firm has large shareholders. This is consistent with the agency theory as proposed by Jensen and Meckling (1976).

In a study conducted by Susanto, Pirzada and Adrienne (2019) on listed Indonesian Firms, it was found that managerial ownership has no statistically significant influence on earnings management. A Sample of 132 non-financial firms were selected for the study and financial data for a period of 5 years were used. The study also concluded that firm size, Audit quality, director size and independence have no significant impact on earnings management. However, financial leverage and Institutional ownership are significant relationship with earnings management. Financial leverage is positively related while institutional ownership is negatively related to earnings management.

Board of Directors

The responsibility for preparation and presentation of financial statement lies with the board of directors. In line with this, the board members are expected to act in this best interest of the shareholders and ensure that the

financial statement is prepared in line with regulatory requirement, free from material errors and fraud. All financial reports are expected to be prepared with adherence to the accounting standards and best practices guided by corporate governance policies (Olayinka, 2012).

The composition of the board is vital in encouraging effective monitoring. The monitoring mechanism of a firm is dependent on the involvement of board member (insider) as a CEO in management of the company or outside director. Some studies find that having an external director separate from management increases monitoring efficiency and reduces manager's opportunistic behavior to engage in earnings management (Weisbach, 1988; Cornet et al., 2007; Roodposhti & Chashmi, 2010). Most of these studies find a negative relationship between earnings management and board independence. An increased independence of CEO by reducing CEO duality role will likely decrease earnings management. The studies proposed for a separation of role between management and board of directors where CEO is an outsider i.e not doubling as both director and CEO. On the contrary, some studies in Asia found no significant relationship between board independence and earnings management (Adulrahman & Mohammed, 2006; Hashim & Susela, 2006; Shah et al, 2009). Also, Hashim & Devi (2008) in a study conducted in Malaysia found a positive relationship between board independence and earnings management via income smoothing. The study concluded that firms with higher number of independent CEO engage in income smoothing activities. In contrast, Board size and Independence have both been found to have no significant effect on earnings management (Susanto, Pirzada & Adrienne, 2019; Florence & Susanto, 2019; Alexander & Christina, 2017).

Auditor

Auditors play a vital role in detecting material misstatements and errors within the financial statement. The ability of an audit to detect discrepancies that can affect the quality of the financial report can mitigate the chances of earnings management. However, the effectiveness and efficiency of auditor is determined by his/her ability to detect errors. Factors such as independence of auditors, risk of litigation and reputation

influences that attitude of auditor to discharge his duties diligently in reporting errors or correcting such when identified (Nelson, Elliot & Tarpley, 2002). Several studies have found a relationship between audit quality and earnings management. For example, A study found no significant association between audit committee independence and earnings management (Baker & Cotter, 2009; Nelson & Jamal, 2011).

Independence of auditor will enhance capacity to adequately discharge duty without fear or favor. In Nigeria, auditors have compromised their independence in engaging in unhealthy competition to lobby for audit assignments. This has led to a reduction in audit fees charged in order to entice client. Unfortunately, the quality of work is also reduced as a result of this. Prior studies on auditors' Independence and Earnings Management contend that high fees paid by a company to its external auditor increases the economic bond between the auditor and the client and thus the fees may impair the auditor's independence (e.g. Li & Lin, 2005; Frankel, 2002). Studies by Katman and Omar (2015) found the presence of an effective audit committee will prevent management from involving in manipulation of accounting profits. Establishment of an audit committee that are independent of management negatively affect earnings management practices by management. This is evident in large companies.

2.1 Theoretical Framework

Several theories have been found through the literature to explain voluntary disclosure practices, including agency theory, signaling theory, capital need theory, and legitimacy theory.

Signaling Theory

Although the signaling theory was originally developed to clarify the information asymmetry in the labour market (Spence, 1973), it has been used to explain voluntary disclosure in corporate reporting (Ross, 1977) cited in Nermeen (2014). The theory shows how information asymmetry problems can be reduced by the party with more information that gives signaling it to others. According to signaling theory, managers who expect a high level of future growth signal that to investors (Julie, Norziana & Muftah, 2011). This theory is based on signals

sent to stakeholders via the financial statements prepared and made available by the management of an enterprise. The information contained such as increased revenue, profit generated etc will inform relevant stakeholders such as shareholders on the potential of the firm and create an expectation of future dividend or capital appreciation in their minds. Information asymmetry that exists between investors and management has been able to create a signaling effect by sending information via financial report to impress investors. The information also signals existence of a better performance of the company as compared to their competitors. By so doing, they attract more investments and enhance a favorable reputation to the public (Verrecchia, 1983).

Agency theory

Jensen and Meckling (1976) define the agency relationship as "a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent." From a firms' point of view, Principal refers to the shareholders who appointed the managers to serve as agent of the firm. In discharging the duties as agents of the firm, the principal (shareholder) have delegated responsibilities for carrying out the affairs of the company. The agent has fiduciary duty to act in the interest of his principal by exercising great skills, honesty, confidentiality etc in discharge of his duties. Shareholders delegate strategic and operational decision making to managers to act on their behalf. Consequently, managers are expected to act and make decision that maximise shareholders' value and ensure that debt will be repaid. However, as agency theory describes, managers make use of their position and power for their own benefit (Julie, Norziana & Muftah, 2011).

Stakeholder Theory

Freeman (2001) states "Corporation has stakeholders, that is, groups and individuals who benefit from or are harmed by, and whose rights are violated or respected by, corporate actions". Stakeholder theory assumes that an organisation's management decisions cannot be taken in the absence of consideration of stakeholders' interests. Hence, the satisfaction of those stakeholders must be sought in order to continue operating within the

stakeholders' context. That is, firms are taking actions in order to fulfill the expectations of particular stakeholders who have the power to impact on their performance (Deegan 2009). Firms will thrive to maintain positive business relationship with stakeholders and build good reputation in their business environment. To convince a particular stakeholder, firms have incentive to disclose specific information that shows that they are in compliance with regulatory requirements. Firms disclose sustainability and corporate governance report to disclose good practices such as equal opportunity in labour employment, corporate social responsibility, engaging in green revolution to control pollution etc. As such, stakeholder theory tells how managers should morally act because they have a fiduciary relationship to stakeholders (Julie, Norziana & Muftah, 2011).

3. Conclusion and Recommendations

The need to improve quality of financial reporting through appropriate disclosures cannot be overemphasized following corporate scandal witnessed during the 20th century. Most of these were largely due to the unethical practices by management of firms through manipulation of reported earnings. Previous literatures have shown that managements engage in these practices of income smoothing (earnings management) to achieve personal objective such as reward for performance linked targets. The needs to identify issues that determine earning management have been explained in the literature. Some of the motives for engaging in such practices are classified as either within the direct control of management (endogenous) or determined by external forces (exogenous) which are vital elements that influence earnings management (Kingsley et al, 2016). However, other studies have classified earnings management based on incentives or constraints, both of which were found to

have significant or insignificant effect on earnings management (El haj & Mansor, 2018). In this study, we examined various literatures on earnings management determinants and findings documented by previous research. Corporate Governance, Ownership Structure, Firm Size, Leverage, Financial Performance, Auditor, Board of Directors, Effective Tax Rate and Dividend Policy are found to be determinants of earnings management practices in an organization.

There exists a level of information asymmetry between management and shareholders/investors where management fails to disclose appropriate information that can influence investment decision by shareholders/investors. Decisions taken by an investor based on the available financial information can either lead to increase in investment where reports are favorable or divestment if found otherwise. Management may strive to retain investors or persuade new investment by disclosing manipulated earnings or payment of tax based on earnings even if such decision may lead to future poor performance or collapse of the business.

Further studies using earnings management (especially real earnings management) as moderating effect and information asymmetry on corporate governance or corporate performance measures will help to provide further insights on earnings manipulation activities. This will assist stakeholders in assessing the real status of a firm and enhance objective decision in contracting with an organization. This study recommends that management should introduce ways to curb earnings management practices among unscrupulous individuals. Further, both existing and potential investors are advised to increase vigilance in the activities of firms through observation of a firms' financial statement to detect earnings management practice in order to make informed investment decision.

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