

# Earnings Management of Quoted Corporate Firms: Detecting and Rethinking the Key Drivers in an Insensitive Capital Market as a Panacea for Investors' Resource Abuse

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## Abstract

Both mechanistic and positive accounting theories were postulated to explain the drivers of earnings management. Scholars postulated the theories perhaps under the belief that market would always be sensitive to firm performance reports. Since the emergence of these theories, many empirical researches have been based on such a framework. They found that positive relationship exists between capital market and earnings management. The key questions we want to address in this present study is whether the direction will remain unaltered if market goes insensitive. In addition, if it has altered, what key factors could determine earnings management in the turn of the market? Given that some developing economies capital markets are now insensitive to performance stimuli for over a long period, the reality of metrics constituting the real drivers of earnings management needs rethinking for avoidance of investors' resource misallocation. In this study, we examined variables that could really constitute the key drivers using a cross-sectional survey research design in an insensitive market among the quoted firms in Nigeria. We analyzed data we obtained from survey using logistic regression model, which helped us to detect earnings management maximum likelihood in an insensitive stock market. The result revealed that market capitalization and compensation contracting based on share options negatively drive managers to engage in earnings management as opposed to mechanistic theories if market turns insensitive to performance. However, non- market based factors including debt covenant, compensation based on cash options, loss deletion and regulation positively drive managers to engage in earnings management practices whether market is sensitive or insensitive to performance report. Therefore, we found the key drivers of earnings management in an insensitive market to constitute non-market based compensation incentives. We recommend that in order to encourage earnings quality and eschew investors' resource misallocation, earnings management containment based on the efficient, sensitive market premises should be reviewed, and emphasis should be placed on non-market based containment strategies.

**Key Words:** Earnings; Earnings Management; Drivers, Market Capitalization; Market Sensitivity; Capital Market Insensitivity

## 1.1 Introduction

we seek empirical evidence through this study whether in an emerging insensitive capital market, the drivers of earnings management could take a different direction or dimension compared to when the market is efficient and sensitive to firm performance. This evidence will be very essential for making containment recommendations considering the fact that anecdotal evidence seems to suggest that earnings management drivers were at the root of failures of several corporate firms such as Enron, and WorldCom that eroded away huge investors' hard-earned resources (Fernandez and Garcia, 2007; Raymond et al, 2015). It is unfortunate anyway, that this occurred perhaps due to sketchy and scanty knowledge of earnings management key drivers existing under different market conditions. In Nigeria particularly, where we took our evidence, firms crumbled due to these phenomenon, which according to Schipper (1989) is a kind of manager intervention in external-financial reporting process to appropriate self-gain. Evidently, most investors under this covert intervention lost over 70% of their stakes in the market. Shareholders of some banks such as Oceanic Bank of Nigeria, Bank PHB and Afribank lost 100% of their share capital to the earnings hocus-pocus behaving managers. Most of these failures occurred when market was highly sensitive to firm performance. Starting from the post failures periods, most studies on the phenomenon have been directed towards determining the real drivers mainly under the framework of sensitive capital market behavior. But in this study, we make a difference by determining the drivers from the context of market insensitivity since market is taking a southward direction particularly in Nigeria. This change in market from bullish to bearish state can redefine earnings management drivers. Our ultimate aim is to determine whether the factors that drove earnings management during uptrend market could still constitute key drivers or whether those ones that were not the focus points are now turning to key drivers. We fear that unless this is determined, containment strategies would be impaired and investors' resources will remain at stake.

The reason why previous scholars embed their researches from the framework of market insensitivity is not farfetched. Scholars have been motivated to take this line of action involving determining earnings management from the context of market sensitivity, first, because earlier studies prior to the market bubbles such as Mechanistic Accounting Theory (MAT) of Ball (1972) postulate that firms in capital market can systematically misdirect investors in the market because those investors do not utilize information sources apart from that provided by the reporting firms. Second, although in an efficient and sensitive capital market, firms' information made available to the public is already incorporated into market stock prices and as such, investors cannot be misled by such information (Fama, 1970; Gilson and Kraakman, 1984), investors can largely be irrational in stock pricing. They can always depart from the fundamentals to price stock sometimes abnormally based on emerging market information (Nwude 2012). From these perspectives, researchers have always found market as a comfort framework to assess the motivation behind earnings management behavior since managers could engineer profit to redirect market focus for abnormal stock pricing for their private interests. Evidence of this can be found in the earnings management studies of Ramzi (2009), Lanouar, et al (2013), and Kothari et al (2005). In these, studies market capitalization, share options and expectations were found to be the key drivers behind managers' earnings management practices. This implies that managers' management of earnings is largely dependent on the ability of market to reflect their actions. However, since the global capital meltdown, most emerging economies' capital markets such as Nigerian stock market has turned inefficiently insensitive (Nwude, 2012). This development now raises a question. Does the contemporary market insensitivity provide a different set of incentives for earnings management? While this question remains, it is evident that according to Nwude (2012), the market bubbles for instance in Nigeria resulted in over 70% capital erosion, which must have caused the players in the capital market arena to become extremely bearish not exhibiting any bullish attitude despite huge profit report or high operational savings display as before. This shows perhaps an absolute loss of confidence in the capital market due to the capital loss wounds. Consequently, market insensitivity followed due to market participants' departures from the fundamentals. Following such bubbles, there has been a continual dwindling of firms' values based on market capitalization. This is despite the fact that firms' performances have not been plummeting. Using insensitivity in this context to mean market's inability to respond particularly positively to performance information as against the basic postulation of MAT, and Fama, (1970) and Gilson and Kraakman, (1984) efficient market theory, we doubt if the previous market tied variables that affect managers earnings hocus pocus still stand.

Therefore, based on this existing market reality, the need to detect and rethink earnings management determinants within the context other than market sensitivity has emerged particularly in developing economies and those economies where market has failed or market lies at the bottom or is trending downward. Otherwise, we fear that the containment strategies that work for sensitive market may be engaged in checking earnings management behavior of managers in an insensitive market. Take for instance; auditors may focus on market tied compensation such as market capitalization and equity options to monitor managers' earnings behavior without knowing that these no longer constitute incentives to them in managing earnings. Based on this, the key emerging question and issue we want to address is whether the market-based compensation factors such as share options, equity capitalization, and share based compensation contracts adjudged in an efficient sensitive capital market as key drivers of earnings management still drive managements' propensity to manage earnings. Specifically, we raised the following critical research questions. Does market-capitalization influence management's desire to engage in discretion accounting in an insensitive capital market? To what extent does compensation contracting based on share price or options influence earnings management in a market that is no longer sensitive? Do debt covenant, regulation, loss mitigation possibility and cash compensation based on earnings target contracting, influence corporate firms' earnings management where capital market is insensitive to performance? What are the effective earnings-management containment strategies applicable in an insensitive capital market? These for us are critical emerging questions around earnings management and they constitute gaps in literature as far as the market remains insensitive, which if not bridged could definitely encourage resource misallocation among investors. We provided answers to these questions and to have successfully achieved these, we deviated from the usual Ex-Post factor analysis of accrual and real activity manipulation regression using historical and discretionary accounting data. We engaged the instrument of survey, which enabled us to dig and search deeply the presence of earnings management maximum likelihood using multiple logistic regressions. We report that from the context of market insensitivity, market capitalization, share options and equity based compensation plans do not constitute among the key drivers of firms' earnings management contrary to general belief that market based incentives always constitute key determinants of earnings management. However, debt covenant, loss mitigation, regulation and cash based compensation still constitute key drivers of earnings management when market is both sensitive and insensitive. We recommend a rethink of containment strategies from both the context of sensitive and insensitive capital market. Therefore, to the best of our knowledge, no study in Nigeria has provided substantial answers regarding the drivers of earnings

management from the context of market insensitivity using survey instrument as we have done. We are the first to analyze earnings management drivers from the context other than market efficiency differentiating how managers respond to earnings management between efficient and inefficient market. From all ramifications, we made big contribution to literature on earnings management.

The remaining part of the paper is organized thus: section 2, deals with literature and hypotheses development, section 3 deals with methodology, while we dealt with result and discussion, and conclusion and recommendation in sections 4 and 5 respectively.

## **Literature and Hypotheses Development**

### **Conceptual Framework**

According to Lev (1989), earnings sometime called the bottom line or net income are the single most important item in financial statements. They according to him indicate the extent to which a company has engaged in value added activities. They are a signal according to him that helps direct resource allocation in capital markets. In fact, the theoretical value of a company's stock is the present value of its future earnings. Increased earnings represent an increase in company value, while decrease in earnings signal a decrease in that value (Lev, 1989). Little wonder then earnings have drawn attention of scholars over the years. Earnings are company's omen. It could portray how good or bad a company may be in the near future. The importance of earnings to firms' reputation cannot be overemphasized. Little wonder firms' has used various methods to display positively their profitability performance. The use of methods to display positively firms' earnings is regarded as kind of earnings management. Earnings management has been described by so many names such as: Income Smoothing, Accounting hocus-pocus, Financial Statement Management, The Numbers Game, Aggressive Accounting, Reengineering the Income Statement, Juggling the Books, Creative Accounting, Borrowing Income from the Future, Banking Income for the Future, Financial Shenanigans, Window Dressing and Accounting Alchemy. Projection of a company's earnings to achieve a purpose usually of self-interest is earnings management. According to Schipper (1989), earnings management is a kind of manager intervention in external-financial reporting process to appropriate self-gain. According to Alexandra (2006), earnings management is the manipulation of accounts and financial reports by a firm's management in order to present a view of the company, which does not accurately reflect its financial position or performance. It is often according to him referred to as creative accounting, and is blamed for the downfall of companies such as Enron and WorldCom, yet earnings management techniques may range from being deliberately conservative in nature, to blatant violations of Generally Accepted Accounting Practices and fraud. According to Vinciguerra (2004), there appear to be no one acceptable definition of earnings management due to the fact that it is considered a difficult concept to define and measure. Most definitions are based on the understanding of the motivating factor behind earnings management. For Healy and Wahley (1999), earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting number. From the definition, the driving force behind earnings management is to mislead investors and that is principally achieved by engineering the accounting figures. Earnings management is all about book cooking. Although in some cases, the practice may mean good for the investors, yet it has an underlying deception. Potential investors according to extant literatures are being drawn to overprice the shares of the earnings-managing firms.

### **Theoretical Framework, Empirical Review and Hypotheses Development**

Quoting Dechow and Skinner (2000) from Ramzi (2009), earnings management practices are directly linked to the accrual based accounting. Apart from accrual based earnings management, scholars have also detected earnings management through real activity manipulations (Roychowdhury 2006). Accrual accounting gives the managers the opportunity to create fictitious profits, hence an opportunity also to manage earnings. Because of their position as preparers of financial statements, they can report income that does not exist and this no doubt could enhance their position fraudulently especially where their pay packages are tied to high profit achievement. In fact, corporate managers can use the managerial latitude to maximize their own interests, sometimes at the expense of shareholders, creditors and other stakeholders' wealth (Ramzi, 2009). Maximizing self-interests in this context is the overall end for earnings management. The choice according to Ramzi, (2009) of the moment when revenues and charges are recorded creates a variation that constitutes the difference between cash and accrual based accounting. In this theoretical framework, we consider the factors that determine firms' propensity to engage in earnings management under the framework of capital market and non-market based.

Studies by Subhrendu and Ian (2008) show that early literature focus on earnings management was primarily on the impact of accounting choices on the capital market. There were two competing hypotheses in this regards. One is the mechanistic hypothesis and the other is the Efficient Market Hypothesis. The mechanistic hypothesis postulates firms earnings management can systematically misdirect investors because they do not utilize information sources apart from that provided by the reporting firm (Ball 1972). On the contrary, the efficient market hypothesis postulates that discretion accounting of managers cannot systematically mislead investors because stocks already reflected all available information (Fama, 1970). However, because earlier hypothesis failed to provide valid explanations of the motivation factors behind earnings management, positive accounting theory was developed by Watts and Zimmerman (1986), which shifted emphasis from capital market earnings research based on non-market internal compensation contractual perspective. This shift according to Subhrendu and Ian (2008), did not also provide answers to reasons behind earnings management. Therefore, earnings management drivers have returned to market based. Studies by Teoh et al (1998a) reveal that capital market has a role to play in determining the level of earnings management played by managers.

However, despite controversies, several theories have provided explanations of what make firms engage in earnings management. According to Lanouar et al (2013), politico-contractual theory by Watts and Zimmerman (1986) provides several explanations to the determinants of earnings management in an efficient capital market. Among such factors is a bonus plan for managers. Their theory shows that bonus-plan hypothesis supposes that managers apply accounting policies that enable them to satisfy their interests by postponing the results of future periods to the current one. They observed that the adoption of executive compensation policy that is linked to performance is geared towards encouraging managers to decision serving shareholders' interest. However, according to Lanouar et al (2013), such a compensation policy may not achieve the intended aim because of the opportunistic disposition of managers. At the end, the policy would be counterproductive to investors' interest. Empirically, positive relationship has been found to exist between earnings management when the bonus is between the upper and lower limit. This relationship can be found in the work of Healy (1985). Apart from bonus-tied compensation as a determinant factor of earnings management, companies can also act on managerial ownership by adopting a strategy compensation based on options and equities. Share options contract could drive management to engage in earnings management. Evidence from Yermack (1997) revealed that managers manipulate accounting and financial information when compensation is based on stock options. Therefore, to get more options, directors tend to influence their compensation criteria by cooking accounting figures.

In a positive accounting theory of Watts and Zimmerman (1986), market capitalization is shown to have a positive relationship with firms' propensity to engage in earnings management. This is since earnings management can be used according to Lanouar et al, (2013), from informative perspective. Thus according to Healy and Palepu (1995), earnings management is considered by managers as a means to signal to investors their expectations about the future. Scholars have indeed found firm size to be positively related to earnings management. When measuring a firm, shareholders depend on accounting information made available on stock market. Degeorge et al (1999) found that directors are motivated to engage in creative accounting to influence share prices, which they do according to Graham et al (2005) to hit a targeted level of share price. Capital market is therefore a motivation for earnings management. According to Erickson et al (1999) as quoted Alexandra (2006), the usage of accounting information contained in financial reports has led some academics to hypothesize that managers use earnings management with goal of influencing the firms' short-term stock price. A number of studies have been undertaken in this area, examining the practice of earnings management in various situations. They maintain that one of the most significant motivations for earnings management for capital market reasons is to encourage investment in a firm, through offering of stock. Research by Erickson (1999) as cited in Alexandra (2006) shows that firms report positive unexpected accruals, which increase income before initial public offers, seasoned equity offers as reported by Toeh et al (1998) in Alexandra (2006) and stock financed acquisitions. To ensure common interest between different stakeholders, firms can act on managerial ownership by adopting a strategy compensation based on options and equity (Lanouar et al, 2013). When the number of shares held by the leader increases, this could motivate manager to act in the interest of the shareholders (Jensen and Meckling, 1976). This implies that manager can also engage earnings management to engineer earnings when compensation is based on share options or equity values. In all these situations, earnings management has a purpose. It is used as a means of presenting financial statements in a rosy perspective so as to attract the goodwill of investors over the firms' stocks in the market. When the goodwill is captured, it would translate in stock overvaluation by the unsuspecting investors. Theory also shows that managers go for accounting choices that permit them to shift profits in future periods to current period by making a high debt to equity ratio (Lanouar, et al 2013). Watts and Zimmerman (1986) maintained that managers are moved to engineer accounting information when they are close the limit set by the creditors. This is called debt-covenant hypothesis. This according to Xiong (2006) is based on the fact that lenders often impose restrictions on the

payment of dividends, share buyouts and the issuing of additional debt in term of accounting figures and ratios to ensure the repayment of the firms' indebtedness. Therefore, the proposition is that firms that have many debt covenants have an incentive to commit earnings management so that they do not transgress on the terms of the covenant according Xiong (2006). Apart from debt covenant, firms can be driven to earnings management by the desire to cover loss report. DeGeorge et al (1999), found that it is essential for firms not to make losses and to achieve consistent growth. This is since according to Barth et al (1999), reporting continuous earnings growth is directly proportional to the pricing of a firm's premium. This provides support according to Alexandra (2006) to the loss cover hypothesis. Indeed, according to Lanouar et al (2013) some researchers argue that the preservation of reputation reflected on positive earnings report is also a motivation earnings management. Hence, according to them, some managers manage earnings upward for fear of being dismissed as a result of poor performance. The prevailing hypothesis in this regard is that firms with low performance are more intended to manage earnings. This proposition is expected to yield a positive relationship between the variables. in this matter of drivers of earnings management, regulation has also come to fore. Regulation is expected to play a role either positively or negatively. Positively for instance because, firms can increase earnings to meet up the equity requirement for listings in a stock market or for receiving assistance from the government or to meet up with minimum capitalization for licensing as in the case of banks. On the other hand, it could encourage downsizing of profit as means of tax evasion or avoidance. Healy and Wahlen (1999) noted that industries in particular the banking, insurance and utility industries are monitored for compliance with regulations linked to accounting figures and ratios. Alexandra (2006) observed that banks and insurance firms are often subject to requirements that they have enough capital or assets to meet their liabilities, while utilities are often only permitted to earn a normal return on their investments, thus leading to theory that such regulations give managers incentives to use earnings management.

Over all, empirically, Ramzi (2009) taking samples from French firms found positive relationship between market size and earnings management of firms. He concluded that the larger the company, the more the corporate managers tend to adjust earnings upwards. In consistent with the positive accounting theory, Lanouar (2013) found market capitalization in Tunisia positive and significant. Study by Yermack (1997) discovered that managers influence earnings to attract more options. Ramzi (2009) also found that debt covenant in among French firms negatively affected earnings management. This result is quite contrary to the positive accounting theory where such managers are expected to manage earnings upward in order to maintain expected debt-equity ratio to impress lenders. In Tunisia however, Lanouar et al (2013) found debt covenant to be positively associated with firms' earnings management propensity. Hence rather than leverage being a deterrent to firms' opportunistic behavior or earnings management according to Ramzi (2009), it motivates firms to according to Lanouar et al (2013) to be meddling with account information for hiding the reality and for personal gains. Mayor (1990) found that banks which are close to minimum capital requirements use earnings techniques such as overstating loan loss provisions, understating loan write-offs and recognizing abnormal realized gains on their investment portfolios, presumably so as not to breach the regulatory requirement. Studies have as well shown that almost half of the studied sample banks employed at least five out of seven methods of managing regulatory capital. Healy (1985) find that managers of firms with bonus incentive plan will carry out discretionary accruals to increase reported earnings thus increase their expected bonus.

In summary therefore, many factors such as market capitalization, compensation contract based on share options, debt covenant, Loss deletion or cover and regulation have all influenced earnings management to some extent. However, these factors were all studied under the belief that market always prices discretion component of earnings correctly or otherwise. In a positive accounting theory of Watts and Zimmerman (1986), they are expected to yield positive results in an efficient and sensitive capital market. At present, Nigerian capital market are not only inefficient but also insensitive, which is an indication that investors and those who may have market connected compensation contract may have lost confidence in market pricing of share prices. Hence, we have to find out what actually drive their earnings management in a situation of market insensitivity to performance report and how the market abnormality interact with other non-market based drivers in explaining managers' earnings management disposition.

### **Statement of Hypotheses**

Based on the above review, we postulate the following hypotheses stated in the null.

H1: Market capitalization does not negatively influence management's desire to engage in discretion accounting in an insensitive capital market.

H2: Compensation contracting based on share options does not negatively influence earnings management in a market that is no longer sensitive.

H3: Cash compensation based on earnings target contracting does not significantly influence banking firms' earnings management where capital market is insensitive to performance.

H4: Debt covenant by banking firms does not significantly constitute an earnings management driver in an insensitive market.

H5: The Extent to which loss possibility drives banks' earnings management in an inefficiently insensitive capital market is not significant and positive.

H6: The extent regulation drives earnings management when the market goes insensitive is not significant and positive.

### 3.1 Methodology and Data

We made use of a cross-sectional survey research design and a quantitative research method. We made sure through our detailed questionnaires that respondents understood that earnings management is being carried out through accrual and real activity manipulation. The study spans across two significant periods in Nigeria market history. The first cross-section was the period between 2000 and 2008 when market was highly sensitive (Nwude 2012), and the second section was the period between 2009 and 2014 when Nigerian capital market was highly insensitive and players bearish in nature. The period during when the capital was sensitive was assigned zero, otherwise, we assigned value 1. All data collected are therefore, reversed into figures. Questionnaires designed, which formed the instruments for our data collection take the likert forms with a 4-point scale ranging from 4, to 1. The higher the value is the more the likelihood of the managers managing earnings in an insensitive market. The responses are paired to permit the use of logistic binary regression analysis through which we were able to establish maximum likelihood ratio of the presence of the drivers in earnings management over the classified periods. Maximum likelihood ascertains how many times success is likely than failure. Therefore, 4 and 3 suggest 'Yes' or highly probable and we recoded them as 1 while 2 and 1 suggest 'No' or low possibility and we switched them off by recoding the responses to 0. The population of the study was 101 First Tier Security Company listed in the floor of the Nigerian Stock Exchange Market. We focused on the branches of those firms located within East-East geographical location in Nigeria. To be able to determine whether across the quoted firms, earnings management differs between highly and low quoted firms, we categorized the population into highly quoted and low quoted firms. Firms with current share prices of N20 and above were regarded as highly quoted share. This is because apart from being high-capitalized firms, deals on their shares are still reasonable. Low quoted firms are firms whose share prices are below N20. There are 25 firms that are highly quoted and 86 low quoted firms listed among the first tier security companies by Nigerian stock exchange. We assigned value 1 for highly quoted firms and 0 to low quoted firms. Within these firms, 2 respondents and 1 respondent from highly and low quoted firms respectively were randomly sampled. These respondents comprised directors, financial analysts and accountants directly connected with the preparation, interpretation and approval of financial statements for the firms sampled for study. In all, 136 questionnaires were distributed. To be able to determine the reliability of the primary data collected, the questionnaires were pretested. An item of the questionnaires 'market-capitalization influences management desire to engage in discretion accounting in an insensitive capital market' was pretested on 14 respondents with the aid of test-retest method, which tests the reliability of data. We found no issue as it affects the data reliability, given that the test yielded a significant and high-level coefficient Cronchbach Alpha of 0.98-a good fit for data reliability. Therefore, this indicates greater internal consistency of the scale, which signals par excellence in terms of reliability. The primary data collected were analyzed using multiple logistic regression analysis with the aid of Predictive Analytic Software. Logistic regression model expresses effects in the form of probabilities. In this case, the probability that EM is caused by market capitalization, share option compensation contract, cash based profitability target contract and other recognized variables in an insensitivity market was modeled using binary numbers 1 and 0. The probability (P) of success (the outcome of interest is present) was denoted by 1 and that of failure (the outcome of interest is absent) is 0. Based on the traditional Jones (1991) model, the likelihood of accrual management is given thus:

$$\frac{\Delta TACC_t}{TA_{t-1}} = \beta_0 \frac{1}{TA_{t-1}} + \beta_1 \frac{\Delta REV}{TA_{t-1}x} + \beta_2 \frac{PPE}{\Delta TA_{t-1}} + \epsilon \dots \dots \dots 1$$

6TACC is change in total accrual, which is profit minus cash flow from operational activities. TA<sub>t-1</sub> is the lagged Total Assets. 6REV equals change in total sales and PPE represents Property Plant and Equipment

deflated by  $TA_{t-1}$ , to fix heteroskedasticity problems. They are featured to capture manipulations of accrual based on depreciations/amortization and credit sales.  $\epsilon$  is the residual, which captures the discretionary accrual.  $\beta$ s are the coefficients of the variables.

Therefore, from the above model, the normal discretionary accruals can be predicted thus:

$$\frac{\Delta NDACC_t}{TA_{t-1}} = \alpha_0 \frac{1}{TA_{t-1}} + \alpha_1 \frac{\Delta REV}{TA_{t-1}^2} + \alpha_2 \frac{PPE}{\Delta TA_{t-1}} \dots \dots \dots 2$$

$\alpha_0$ ,  $\alpha_1$  and  $\alpha_2$  are predictors of  $\beta_0$ ,  $\beta_1$  and  $\beta_2$  from equation 1. NDACC equals non-discretionary accrual. The discretionary accrual is then determined by substituting the non-discretionary accruals from the total accruals for the target year using the coefficients from equation 2 above and the company specific data for the suspected year or event year. Therefore, the discretionary accrual is the difference between  $TA$  and  $NDACC$ . Since the emergence of Jones models, several studies particularly Dechow et al (1995), Ramzi (2009) Kothari et al (2005), Raman and Shahrur (2008) have modified it to permit the presence of other variables that can also affect accrual management. However, from this fundamental we apply logistic regression thus:

$$\text{Log} [P(\frac{\Delta TACC_t}{TA_{t-1}}=1)] = \beta_0 \frac{1}{TA_{t-1}} + \beta_1 \frac{\Delta REV - \Delta REC}{TA_{t-1}} + \beta_2 \frac{PPE}{\Delta TA_{t-1}} + O_t + \epsilon \dots \dots 3$$

$\text{Log}[P(\frac{\Delta TACC_t}{TA_{t-1}}=1)]$  is the probability that earnings management occurs due to the variables in the right hand side of the equation.  $\Delta REC$  is the change in receivables introduced by Dechow et al (1995) to remove the possibility of bias due to increase in sales that is not a function of accrual management, which the traditional Jones model omitted.  $O_t$  represents other factors that can drive earnings management behavior of managers apart from the fundamentals of the Jones model. The two fundamental variables Revenues (REV) and PPE naturally will have positive and negative effects on accruals respectively. Therefore, we do not need to test them in our study. Our emphasis will be on  $O_t$ . Since we are specifically using survey, we denote  $\frac{\Delta TACC_t}{TA_{t-1}}$  to be EM, which equals Y, and the drivers of Y to be  $O_{it}$ , i takes values from 1 to n. N equals the number of variables to be considered.  $O_{it}$  is categorized into 1 and 0 for high and low quoted firms. In a logistic expression, the probability that  $O_{it}$  drives EM (Y) is written thus:

$$\text{Log} [\frac{P(Y=1)}{1-P(Y=1)}] = \alpha_0 + \beta_{it} O_{it} + \delta_1 \sum_{2001}^{2014} Y_{t1} + \epsilon \dots \dots \dots 4$$

The ratio  $\text{Log}[\frac{P(Y=1)}{1-P(Y=1)}]$ , which also equals  $e^{\alpha+X}$  is the odd and defines how many times success is likely than not that market in this case influences managers' accrual management. The symbol  $\alpha_0$  is the constant while  $\beta_{it}$ ,  $i=1,2,3..n$  is the vector of independent variable  $O_{it}$ .  $\delta_1$  is the coefficient of time invariant dummy variable which takes value 1 for period share prices or market is insensitive and 0 otherwise. Note however that although the expression looks like multiple linear regression, yet the method of determining the gradients of the variables in the equation is not the same with that of linear multiple regression. In a multiple logit (short term for logistic regression), the coefficients to be derived from the model show the change in the expected log odds in relation to a one-unit change in the independent variable controlling for other predictors. With this known and given the specific objectives of this study, our multiple logistic regression model holding all other fundamental drivers of Jones Model constant is specified thus:

$$\text{Log} [\frac{P(EM=1)}{1-P(EM=1)}] = \alpha_{it} + \beta_1 MCap_{it}^{in} + \beta_2 Ccshareop_{it}^{in} + \beta_3 Ccshop_{it}^{in} + \beta_4 Debtc_{it}^{in} + \beta_5 Lossc_{it}^{in} + \beta_6 Reg_{it}^{in} + \sum_{2001}^{2014} \beta_7 Y_{tK} + e_{it} \dots \dots \dots 6$$

Where

$\alpha_{it}$  is the constant, to be set at zero.  $\beta_1$  is the gradient of market capitalization at the period of market sensitivity.  $\beta_2$  is the coefficient of compensation contract at insensitive period.  $\beta_3$  denotes the coefficient of cash option when market is insensitive.  $\beta_4$  is the coefficient of Debt covenant variable.  $\beta_5$  represents the coefficient for loss cover.  $\beta_6$  equals the gradient of the variable Reg.  $\beta_7$  is the year (yr) dummy variable coefficient that takes value 1 for an insensitive period otherwise 0.  $e$  is stochastic error.

EM equal Earnings Management defined by discretionary accrual. It is a dependent variable. Although we did not make use of secondary data, the nature of the study permits that we should show how the dependent variable

(*EM*) is measured and communicated to the respondents to be sure they understand the concept very well as shown in both equation 1 and 2 above.

$MCap_{it}^n$  is an independent variable that captures the effect of insensitive market capitalization on earnings management.

$CCshareop_{it}^n$  is a compensating contract based on share options in an insensitive market.

$Cccashop^n$  represents compensation contract based on cash option payments in an insensitive capital market.

$Debt^n$  is a variable that represents debt covenant. This variable is featured to capture the likelihood of firms' embarking on earnings management in order to impress lenders or creditors, who may file for their repayment.

$Loss^n$  is an explanatory variable representing loss cover-the probability of firms' engaging in earnings management in order to avoid reporting loss that could damage their reputation.

$Reg^n$  is a variable for regulation. Some firms could engage in book cooking in order to circumvent some government regulations such as taxation affecting them. We consider the reality of this in an insensitive market.

#### 4.1 Results and Discussions

Six questions were raised based on the main objective of this research. First, we shall examine the responses with references to the questions. Secondly, we shall afterwards carry out the full real analysis based on the logistic regression output as shown in table 7. All the responses based on the questions are presented in table 1 constituting sections 1 to 6. Subsequently, we would be referring to the table. We begin with the first question, which was asked thus: market-capitalization influence management desire to engage in discretion accounting in an insensitive capital market. Table 1 section 1 shows the responses to this question. Please kindly refer to the table. The result as shown in table below revealed that out of 147 questionnaires distributed, only 103 were returned. Out of these, 39 respondents (37.1% of the respondents) believed that market capitalization has no impact on earnings management of banking firms in an insensitive market. 51.4% constituting 54 respondents indicated that market value of shares has effect but on low scale. Respondents totaling 10 believe that market capitalization affects earnings management of corporate firms moderately or largely. This constitutes about 9.5% of the respondents. Judging from above, there could be poor presence of market stock prices in the creative accounting dispositions in an insensitive market. At extreme side of table 1 above, these responses are recoded into 'yes'(1) and 'no'(0) iteration. The table shows that 93 respondents believed that market capitalization measured by share prices has no bearing on earnings management in an insensitive market, while 10 were consenting to the presence of market capitalization on earnings management behavior of firms.

The next research question was raised about the reality of earnings management and compensation contract based on share options. In this case the probing question was: compensation contracting based on share options influences earnings management in a market that is no longer sensitive. The responses to the above were presented in table 1 section 2 below. It appears it took similar dimension with outcome of question 1. This implies that market insensitive is negatively affecting earnings management of banking firm as the result displayed in table below shows that 43 respondents (41%) believe that share options based on targeted performance has no impact on earnings management of banking firms in an insensitive market. Respondents totaling 48 (46.6) indicated that share option although has effect on earnings market in a market insensitively yet on a low scale. Only 6 respondents believed that share options drive earnings management in an insensitive market on a moderate scale. Likewise, 6 respondents agreed that share options still drive earnings management largely as capital market goes stiff, but anyway is a very insignificant opinion. When these responses are recoded into 'yes'(1) and 'no'(0) iteration, 91 persons believed that compensation contract based on share options has no link with earnings management in an insensitive market, while 12 were saying yes to the presence of compensation contract based on shares. The full analysis of this result would be based on the regression analysis to be able to determine the maximum likelihood.

The responses to question 3 as well gave us some clues regarding the reality of compensating contracting based on cash options and its presence in earnings management in an insensitive market. The question we specifically raised was that cash compensation based on earnings target-contracting influences banking firms' earnings management where capital market is insensitive to performance. In response to the above question, 56 (54.4%) of our target respondents as presented in table 1 section 3, believed that cash compensation earnings target contract drives their earnings management in an sensitive market. Likewise, 19 respondents indicated that cash

compensation based on targeted earnings drives creative accounting in insensitive market. However, 4 and 24 respondents believed that cash compensation options have no and low effect on creative accounting in an insensitive market respectively. Recoding these responses into ‘yes’ and ‘no’ iteration, 28 persons believed that cash compensation contracting option has no link with earnings management in an insensitive market, while 75 were saying yes to the presence of cash compensation performance contracting in earnings management.

As it affects debt covenant and the likelihood of earnings management, we raised question 4 thus; debt covenant by corporate firms affect their propensity to manage earning in inefficient market. We analyzed the responses by both the quoted and unquoted firms below in table 1 section 4. The responses show that 1 and 7 persons responded that the debt covenant drove earnings management to no extent and low extent respectively. 26 respondents believed debt covenant drove earnings management to a moderate extent while 67% of the respondents (69 respondents) believed debt covenant greatly determined earnings management in an insensitive market. Recoding these responses into on and off iteration, 8 persons believed that debt covenant has no bearing on earnings management in an insensitive market, while 95 were saying yes to the presence of debt covenant in earnings management.

Question was also raised regarding the extent desire to avoid loss report motivates managers of banks to engage in earnings management. Here, the question was thus: loss possibility drives banks’ earnings management in an inefficiently insensitive capital market. Responses to this question are presented in table 1 section 5 below. The table shows that 63 constituting 60% responded that loss deletion is a driver of earnings management of banking firms in an insensitive market. Respondents totaling 23 believed that the loss variable although has influence on firms’ earnings management but on a moderate scale in an insensitive market. 16.5% indicated that loss deletion either has no or low effect on firms’ earnings management in an insensitive market.

The final question we raised was: regulation drives earnings management when the market goes insensitive. The summary of the responses to this question are summarized in table 1 section 6 below.

The responses from the table show that 66 respondents believed that regulation greatly drives earnings management. On a moderate scale, 22 respondents vote for the presence of regulation on earnings management among banking firm in an insensitive market. No respondent believes that regulation cannot drive earnings management. However, 15 still see regulation as having a low influence on earnings management. At extreme right-hand side of table 1 section 6, these responses are recoded into ‘yes’(1) and ‘no’(0) iteration. The table shows that 88 respondents said ‘Yes’ that regulation has a bearing on earnings management in an insensitive market, while 15 were saying ‘No’ to the presence of regulation in earnings management behavior of banking firms.

**Table 1: Survey of the Effects of the Presence Market Capitalization, Share options, Cash Options, Debt Covenant, Loss Covering and Regulation on Earnings Management in an Insensitive Capital Market**

Research Questions		Responses	Frequency	Percent	Cumulative Percent	Recoded Responses	Binary
<b>Section 1</b>	Market-capitalization influences management desire to engage in discretion accounting in an insensitive capital market	1	39	37.9	37.9	NO=0	93
		2	54	52.4	90.3		
		3	4	3.9	94.2	Yes=1	10
		4	6	5.8	100.0		
		Total	103	100.0			
<b>Section 2</b>	Compensation contracting based on share price or options influences earnings management in a market that is no longer sensitive	1	43	41.7	41.7	NO=0	91
		2	48	46.6	88.3		
		3	6	5.8	94.2	Yes=1	12
		4	6	5.8	100.0		
		Total	103	100.0			103
<b>Section 3</b>	Cash compensation based on earnings target contracting influences banking firms’ earnings management where capital market is insensitive to performance	1	4	3.9	3.9	NO=0	28
		2	24	23.3	27.2		
		3	19	18.4	45.6	Yes=1	75
		4	56	54.4	100.0		
		Total	103	100.0			103
Section 4	Debt covenant by corporate firms affects their propensity to manage earning in inefficient market.	1	1	1.0	1.0	NO=0	8
		2	7	6.8	7.8		
		3	26	25.2	33.0	Yes=1	95
		4	69	67.0	100.0		
		Total	103	100.0			103

Source: Author

**Table 1 Continues: Survey of the Effects of the Presence Market Capitalization, Share options, Cash Options, Debt Covenant, Loss Covering and Regulation on Earnings Management in an Insensitive Capital Market**

<b>Section 5</b>	Loss possibility drives banks' earnings management in an inefficiently insensitive capital market	1	3	2.9	2.9	NO=0	17
		2	14	13.6	16.5		
		3	23	22.3	38.8	Yes=1	86
		4	63	61.2	100.0		
		Total	103	100.0			103
<b>Section 6</b>	Regulation drives earnings management when the market goes insensitive	1	15	14.6	14.6	NO=0	15
		2	22	21.4	36.0		
		3	66	64.0	100.0	Yes=1	88
		Total	103	100.0			

Source: Author Using PASW

#### 4.1.2 Binary Logistic Regression Results

We use the logistic regression result to test our hypotheses based on maximum likelihood ratio, direction of the impact, and significance of the effects as measured by Wald statistic. The result of the analysis is presented in table 7 below. We would be interpreting, discussing and testing the hypotheses at the same time. The logistic regression shows that the probability that market capitalization has influences on earnings management in an insensitive market is very low.  $P(EM=1)$  for Mcap, is 0.107. This is very low, and suggests that market capitalization in an insensitive capital market has little or no influence on banking firms' creative accounting. This is also as proved by the negative sign of the impact. The negativity of the relationship shows that as market insensitivity increases, earnings management rate falls. We hypothesized that Market capitalization does not negatively influence management's desire to engage in discretion accounting in an insensitive capital market and the maximum likelihood of the presence of market capitalization in earnings management is not low. From the result, the maximum likelihood or the probability  $(P(EM=1)/(1+P(EM=1))=0.107)$  is substantially less than 0.5 benchmark. Moreover, the direction is negative. Therefore, the null hypothesis is rejected. We conclude that Market capitalization negatively influenced management's desire to engage in discretion accounting in an insensitive capital market and the maximum likelihood of the presence of market capitalization in earnings management is low. This finding is not consistent with the findings of Ramzi (2009), that size (market capitalization) has a positive relationship with earnings management. According to him, the larger the company, the more the corporate managers tend to adjust earnings upwards. In addition, the present study is inconsistent with the work of (Lanouar et al, 2013). This is since they found size or market capitalization to be positive, although significant. The divergence could stem from the fact that they investigated theirs under the framework of market sensitivity. Investors and bank directors should bear this in mind. First, they should rethink the drivers of earnings management especially as markets transits from sensitivity to insensitivity. Secondly, they should realize that this behavior has implication on the containment strategies. Obviously, many containment strategies were hinged on the fact that market capitalization has positive link with earnings management. Now that the relationship has changed, there is need to reevaluate the effectiveness of these containment factors in an insensitive market. Of course, in so doing, the likelihood of investors' resource misallocation would be significantly minimized. Likewise, looking at compensation contracting based on share option and its relationship with earnings in an insensitive market, we can see that the effect is negative and the maximum likelihood is very low. The probability is 0.064. This shows that share options may not provide explanation for banking firms' engaging in earnings management. Once more, this result is a negation of our hypothesis that compensation contracting based on share options does not negatively influence earnings management in a market that is no longer sensitive and its maximum likelihood is not low. We reject this null hypothesis and alternatively, accept the reality that compensation contracting based on share options negatively influences earnings management in a market that is no longer sensitive and its maximum likelihood is low. This result is inconsistent with the work of Toeh et al (1998) that the most significant motivations for earnings management for capital reasons is to encourage investment in a firm through offerings or options of stock. Our research lacks such evidence in an insensitive capital market, despite their claim that firms report positive unexpected accruals, which increase income before initial public offer, seasoned equity offers and stock-financed acquisitions. Our finding is also inconsistent with the work of Yermack (1997) that managers influence their compensation contracts by positively influencing earnings to include more options. Likewise, inconsistent with the findings of Bergstresser and Philippon (2006) that there is a positive correlation between earnings management and compensation contract based on shares and options, we discover negative relationship in an insensitive dummy market. This no doubt is good contribution to literature. However, the result also shows that compensation contracting Cash payment options significantly and positively influenced banks' earnings management in an insensitive market. Cash contract performance payment increases even with market insensitivity. The reason is since investors would not like to tie their rewards down in shares that are not increasing in value with

performance reports. The maximum likelihood ratio is high leading to high probability ( $P=0.714$ ) that cash based compensation contracting has a significant influence on banking firms' earnings management. The outcome of the analysis therefore shows high probability function for the success of earnings management due to cash payment options. The null hypothesis that cash compensation based on earnings target contracting does not significantly influence banking firms' earnings management where capital market is insensitive to performance and its maximum likelihood is not low is rejected. We accept the alternative that cash compensation based on earnings target contracting significantly influence banking firms' earnings management where capital market is insensitive to performance and its maximum likelihood is high.

In table 7 below, Loss cover is found to be a significant factor affecting earnings management in an insensitive capital market. The coefficient is positive and significant ( $\beta=1.526$ , sig.val.<0.05). The result shows that loss covering is a driver of earnings management. We can infer that banks although are aware that loss report may not decrease their market influence, yet they would rather review earnings upwards rather than reporting loss. This could be to meet an analysts' report and maintain a consistent reputation before investors and other stakeholders. As it affects the null hypothesis that the Extent to which loss possibility drives banks' earnings management in an inefficiently insensitive capital market is not significant, positive and the likelihood ratio is not high is rejected. Since, the effect is significant, positive and the probability is high (0.82), we accept the alternative that the extent to which loss possibility drives firms' earnings management in an inefficiently insensitive capital market is significant, positive, and the likelihood ratio is high. This is consistent with the findings of Roychowdhury (2006) that whenever result is close to zero, managers are motivated to manage earnings in order to prevent loss. Therefore, the findings of Lanouar et al (2013) based on Tunisian context that weak performance can motivate managers to manage earnings in order to make the weakness less visible is consistent with Nigerian context in an insensitive market. Moreover, debt covenant is found to be a positive and significant driver of banking firms' earnings management in an insensitive market ( $\beta=2.128$ , sig. val.<0.05). The maximum likelihood is 0.89, which is very high. The result implies that in order to impress creditors and then shift their desire to demand debt repayment, they can reengineer earnings positively. Therefore, the null hypothesis that debt covenant by banking firms does not significantly constitute an earnings management driver, the influence is not positive and the maximum likelihood of the debt covenant presence in earnings management is not high in inefficient market is rejected. The fact that debt covenant by banking firms significantly constitutes an earnings management driver the influence of which is positive and its maximum likelihood is high in inefficient market is accepted. This is consistent with the finding of Xiong (2006), that firms who have a lot of debt have an incentive to manage earnings so that they do not breach their debt covenant. It also agrees with (Watts and Zimmerman, 1986) that creditors often impose restrictions on the payment of dividends, share buybacks and the issuing of additional debt in terms of reported accounting figures and ratios, in order to ensure the repayment of the firms, borrowing. However, in terms of direction the present study is inconsistent with Ramzi (2009) that discovered the debt covenant has a negative although significant effect on earnings. Regulation has also been revealed as having significant positive effect on earnings management in an insensitive market. The coefficient is positive and maximum likelihood that there is the presence of regulation in earnings management is high ( $\beta=1.006$ ; sig.Val.<0.05;  $P(EM=1)=\frac{\text{Exp}(B)}{1+\text{Exp}(B)}=0.73$ ). The log odds of success is 2.733 times likely than not. This result contradict the null hypothesis that the extent regulation drives earnings management when the market goes insensitive is not significant, positive and the maximum likelihood of the presence of regulation as an earnings management driver in an insensitive capital market is low. We therefore accept otherwise. This conclusion is consistent with the findings of Collins et al (1995) that half of the banks sampled for study employed at least five out of seven methods of managing regulatory capital. The regulatory capital is adjusted through capitalization of expendable expenses, which in turn would result in profit and reserve increment. Hence, in both sensitive and insensitive market, banking firms, which are always under strict monitoring, try to evade some requirements by reviewing upwards their earnings. However, regulation such taxation can result in downward review of banking firms' profitability.

**Table 7: Binary Logistic Regression Table**

	B	S.E.	Wald	Df	Sig.	Exp(B)	-2log Likelihood	P(EM=1) Exp(B)/(1+ Exp(B))
Step 1 <sup>a</sup>								
MCap	-2.120	.432	24.083	1	.000	.120	103.292	10.7% or 0.107
Ccshareop	-2.686	.597	20.256	1	.000	.068	99.946	6.4% or 0.064
Cccashop	.916	.296	9.595	1	.002	2.500	132.162 <sup>a</sup>	71.4% or 0.714
	B	S.E.	Wald	Df	Sig.	Exp(B)	-2log Likelihood	P(EM=1) Exp(B)/(1+ Exp(B))
Lossc	1.526	.349	19.130	1	.000	4.600	117.709 <sup>a</sup>	82.% or 0.81
Reg	1.006	.302	11.104	1	.001	2.733	130.241 <sup>a</sup>	73
Debtc	2.128	.473	20.238	1	.000	8.400	109.488	89.4% or 0.894

Source: Author with the Aid of PASW. Data Used From Survey

MCap= Market Capitalization; Ccshareop= Compensation contract share options; CcASHCOMP= Cash Compensation Options

### 5.1 Conclusion and Recommendations

The study of earnings management has indeed been very essential and relevant to earnings quality and investors' resource management. From all ramifications, good knowledge of earnings management behavior of managers could help in enhancing earnings quality and standard setting. Based on the positive accounting theory, postulated with an underlying assumption of market efficiency and sensitivity, market capitalization and share options are seen as key and positive market-based drivers of earnings management among the corporate entities. Interestingly, various empirical findings seem to agree with this theory. Therefore, recommendations especially on its containment strategies were made with this theory and empirical studies in mind. However, it could boggle minds that in an insensitive market, these factors negatively relate with earnings management projecting low likelihood that they have any presence in earnings management. This sounds quite bizarre. However, that is the fact. Since this knowledge did not follow the popular discourse, we recommend that the earnings-management containment strategies of corporate firms be reviewed to ascertain and reconfirm the degree of their effectiveness in an insensitive capital market. Compensation contracting based on cash options, debt covenant, regulation and loss cover appeared with high odd ratios with probabilities function at upper ends implying that in an insensitive market the strength of managers to engage in the act of earnings management lies on these factors. They should be intercepted directly or indirectly to minimize or if possible to remove earnings management for optimal earnings quality and as a panacea for investors' resource misallocation.

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