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### **BOARD CHARACTERISTICS AND EARNINGS MANAGEMENT OF LISTED OIL AND GAS FIRMS IN NIGERIA**

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#### **Abstract**

*This paper investigates the relationship between board characteristics and earnings management of listed oil and gas firms in Nigeria for the period 2007 to 2014. Data was obtained from a sample of seven firms out of the population of nine firms through their annual report and accounts. Board characteristics as an independent variable was proxied by board size, board composition, foreign directors and women directors, while the residuals from the modified Jones Model by Dechow et al (1995) was used to represent earnings management. The study adopted ordinary least square multiple regression technique in analyzing data. The findings revealed that board size and board composition have insignificant impact on earnings management, while foreign directors and women directors have negative significant impact on earnings management of Nigerian listed oil and gas firms. It is recommended that Nigerian listed oil and gas Firms should have more proportion of foreign and women directors in their board of directors'*

*membership and the proportion of non-executive directors in their firms' board of directors membership should be reduce in order to control the level of earnings management practice by managers.*

**Keywords:** Board Size and Composition, Foreign and Women Directors, and Earnings Management

### **1.1 Introduction**

Financial Statements are a means through which companies communicate to its users its financial information as well as its position for a particular accounting period. Information provided in the financial statements is associated with manipulation by management which reduces the quality of earnings and usefulness of decision making process. As a result of separation of ownership from control of business entity, there is tendency for managers of these companies to engage in fraudulent financial reporting to protect their interest at the detriment of the interests of users of financial information (Dabor & Adeyemi, 2009).

Corporate entities are associated with an unethical accounting practice by the management with the aim of satisfying their personal interest at the expense of the companies they are managing which may eventually lead to the collapse of those firms (Roodposhti & Chashmi, 2011). These unethical accounting practices are viewed as earnings management (Roodposhti & Chashmi, 2011). Earnings management involves alteration of financial information to mislead some stakeholders about the underlying economic performance of business organizations or to influence contractual outcomes that depend on reported earnings (Zhu & Tian, 2009).

Corporate governance mechanism is the system by which companies are directed and controlled through the board of directors (Nigerian Security and Exchange Commission Code of Corporate Governance, 2011). Board of directors determines the company's strategic goals and ensures that its human and financial resources are effectively deployed towards attaining those organizational goals (Nigerian SEC Code of Corporate Governance, 2011). Board of directors is attributable to the composition of non-executive, foreign and female directors who serve as board members in the company's board of directors whose functions is to monitor the activities of a firm's management (Roodoshti & Chashmi, 2011). Board size represents the numbers of directors sitting on the board of directors of a company as board members are saddled with the responsibility of overseeing the effective performance of the management in order to protect and enhance

shareholders values and to meet company's obligations to its stakeholders (Shen & Chih, 2007).

Board compositions of a firm constituted the proportion of the non-executive directors in the company board of directors' membership who would bring independent judgment as well as necessary scrutiny to the proposals and actions of the management and executive directors especially on issues of strategy, performance evaluation and key appointments (Nigerian SEC Code of Corporate Governance, 2011). Some companies' board of directors consist of foreign directors who are non-citizens of the country where the company is operating, but because of their experience, integrity and credibility they are appointed by the company's shareholders to serve as members in the board of directors so as to make their contribution for the growth and development of their company (Zhan & Uchida, 2012). Therefore, the study generally seeks to examine the impact of board characteristics on earnings management of listed oil and gas companies in Nigeria. It was also hypothesized that board characteristics proxied by board size, board composition, foreign directors and women directors has no significant impact on earnings management of listed oil and gas companies in Nigeria.

The existing empirical studies on board characteristics and earnings management of companies in developed nations and emerging economies for example the work of Dabor and Adeyemi (2009), Bermig and Frick (2010), Abdul Rauf et al (2012), and Zhang and Uchida (2012) provide mix results. Hence, the natures of their relationships remain controversial which create a gap for further studies. In Nigeria, the areas of corporate governance and its effect on earnings management have attracted a lot of interest by researchers such as Nugroho and Eko, (2011). Many researchers have attempted to examine the effect of board characteristics on earnings management of firms using difference proxies of corporate governance. The studies however suffered two limitations. First, as the case with other foreign-based studies in this area, the Nigerian-based studies ignored the importance of inclusion of foreign and female directors as corporate governance proxies in one study in examining earnings management of firms. Second, the studies seemed to have focused on financial sector and some subsectors of the manufacturing sector in exclusion of downstream oil and gas sector despite its strategic importance to the Nigerian economy. The quest for individuals and corporate organizations to use petroleum products for transportation of goods and services as well as other industrial operations in Nigerian economy has made oil and gas firms an important sector to be study in the country. Therefore, this seeks to examine the relationship between board characteristics and earnings management of listed oil and gas firms in Nigeria.

This paper is organized as follows: the next section describes the review of empirical studies and theoretical framework. The third section explains the research method, data collecting process and model specification. The descriptive statistics, correlation matrix and regression results are presented and discussed in section four, followed by conclusion and recommendations in section five.

## **2. Literature Review and Theoretical Framework**

### **2.1 Board Size and Earnings Management**

Zhu and Tian, (2009) examined the impact of chief executive officers pay-performance and board independence on earnings management of listed firms in China using the sample size of 341 firms for the period of 2004 to 2008. Multiple regression was used as statistical tools of analysis and found a significant negative association between board size and earnings management. Abdul Rauf, Johari, Buniamin and Abd Rahman (2012) explored the impact of companies and board characteristics on earnings management of listed firms in Malaysia for the year 2008 using a sample size of 214 companies, multiple regression was adopted as tool of analysis. They found evidence of significant positive relationship between board size and earnings management. Further, Ishak, Haron, Salleh and Abdul Rashid (2011) studied the impact of family control on earnings management of listed firms in Malaysia for the year 2009 using a sample size of 236 firms. Cross-sectional data was collected and analyzed using pooled ordinary least square regression and the result reveals an insignificant positive relationship between board size and earnings management of the selected firms. However, Nugroho and Eko, (2011) studied the effect of board characteristics on earnings management of listed firms on the Indonesian Stock Exchange for the period of 2004 to 2008 using ordinary least square regression as tool of analysis and found insignificant positive relationship between board size and earnings management. Moradi, Salehi, Bighi, and Najari, (2012) investigated the influence of board characteristics and earnings management of listed firms on the Tehran Stock Exchange for the period of 2006 to 2009. Multiple regression was used for analysis and the result reveals an insignificant negative relationship between board size and earnings management of the selected firms. Most of these studies covered insufficient time period to establish a good relationship between board size and earnings management of the selected firms. Board size represents the total members of the firms' board of directors while earnings management refers

to the unethical accounting practice by managers which can affect the firm's profit negatively.

## **2.2 Board Compositions and Earnings Management**

Empirical studies were conducted by various researchers in both developed and developing countries on the relationship between board of directors compositions and earnings management of listed firms and reported mixed of results. For example Qin and Liwen, (2006) examined the influence of board independence on earnings management of listed firms in China using a sample size of 45 firms. Multiple regression was used for data analysis and the result reveals a significant negative relationship between board composition and earnings management of the firms selected. However, Wang Chuang and Lee, (2010) studied the impact of board of directors' compositions on earnings management of listed firms in China and found evidence of insignificant positive relationship between board compositions and earnings management of firms.

Also, Nugroho and Eko, (2011) studied the effect of board characteristics on earnings management of listed firms on Indonesian Stock Exchange for the period of 2004 to 2008 and found insignificant negative relationship between board composition and earnings management. Similarly, Ishak, Haron, Salleh and Abdul Rashid, (2011) found an insignificant positive relationship between board composition and earnings management of the selected firms. However, Zhu and Tian, (2009) found significant negative association between board composition and earnings management. These studies focused more attention on other sectors of the economies while ignoring the strategic importance of oil and gas companies. Board composition is the proportion of non-executive directors in the company's board of directors membership whereas earnings management is the income smoothening of firm's earnings by the management.

## **2.3 Foreign Directorship and Earnings Management**

Several studies were conducted in different countries of the world on the relationship between foreign directors and earnings management of listed firms. Some studies found positive and negative significant relationship between foreign directors on the board and earnings management while others found no evidence of insignificant relationship. Zhang and Uchida, (2012) studied the impact of corporate governance and investors' protection on earnings management of listed firms. Their study is cross-border as they collected data from the sample size of 18, 491 firms from 42 countries worldwide and adopted multiple regression as statistical tool of analysis. Their findings revealed a significant negative relationship between proportions of foreign directorship and earnings management. Gulamhussen and Guerrero, (2009) examined the effect of foreign

directorship on earnings management and found significant negative relationship between foreign directors and earnings management of the sampled firms. Oxelheim and Randoy, (2003) studied the relationship of foreign board membership on earnings management and found no evidence of significant relationship among the variables of the study.

Hooghiemstra, Hermes, Oxelheim and Randoy, (2014) examined the impact of board internationalization on earnings management of listed firms using a sample size of 3,249 firms for the period 2001 to 2008. They used ordinary least square regression for data analysis and found evidence of significant positive relationship between foreign directorship and earnings management of firms. Further, Oxelheim, Gregoric, Randoy and Thomsen, (2013) investigated the impact of internationalization of corporate board on earnings management and found evidence of significant negative relationship between presence of foreign directors on corporate boards and earnings management. Also these studies focused more attention on other sectors of the economies while ignoring the oil and gas companies and most of the results were found significant negative relationship. Foreign directors represent the proportion of foreign directors in the firms' board of directors' membership while earnings management is act of maneuvering accounting information by the management in order to mislead the users of company's accounting information.

#### **2.4 Women Directorship and Earnings Management**

Extant empirical works have established relationships between women directorship and earnings management, however the results are diverse. For example Sun, Liu and Lan, (2011) investigated the impact of female directorship on earnings management of 525 sample firms for a period of 2003 to 2005 using multiple regression as a statistical tools of analysis. Their result reveals evidence of an insignificant positive relationship between the percentage of female directors on the board membership and earnings management. In contrast, Bermig and Frick (2010) studied the effect of female board of directors on earnings management in 294 German companies for the period 1998 to 2007 using ordinary least square regression. Their result shows evidence of significant negative relationship between female directors and earnings management of the firms. Furthermore, Hooghiemstra, Hermes, Oxelheim and Randoy, (2014) on the impact of board internationalization on earnings management of listed firms using a sample size of 3,249 firms for a period of 2001 to 2008. They used ordinary least square regression for data analysis and found an evidence of significant positive relationship between women directors and earnings management of firms.

Also, Damagum, Oba, Chima and Ibikunle, (2014) investigated the influence of women in corporate boards on financial reporting credibility in Nigeria. They studied 20 firms listed on the Nigerian Stock Exchange and using panel data regression analysis. They reported a significant negative association between female directors and earnings management. Lakhali, Aguir, Lakhali and Malek, (2015) evaluated the effect of women directors on earnings management of 170 listed firms in France for a period of 4 years (2011 to 2014). Data was collected and analyzed using ordinary least square regression and they found evidence of significant negative correlation among the variables of the study, an indication that the percentage of female directors on the companies' board membership mitigated the earnings management of the selected firms in France. Furthermore, Peni and Vahamaa (2010) studied the influence of female directors on earnings management of firms and found evidence of insignificant negative relationship between female directors and earnings management of the sampled firms. Most of these studies failed to mention the sampling techniques used to arrive at the sample size of their studies. Women directors is the proportion of women directors in the firms' board of directors membership while earnings management is act of violating the accounting standard by the management for their personal gain.

The theory that anchored this work is agency theory. An agency relationship exists when one or more principal (shareholders) engage another person as their agent (managers) to perform a service on their behalf (Fama & Jensen, 1983). Performance of this service results in delegation of some decision-making authority to the managers. Jensen and Meckling, (1976) argue that where ownership and management are separated, the accounting function is affected by the agency problem. This delegation of responsibility by the owners and the resulting division of labour are helpful in promoting an efficient and productive economy. However, such delegation means that the principal needs to place trust in an agent to act in the principal's best interest. As a result of information asymmetries and personal interest of manager, shareholders lack reasons to trust their agents and will seek to resolve these concerns by putting in place mechanisms to align the interests of managers with shareholders and to reduce the extent for information asymmetries and opportunistic behavior Donaldson and Davis, (1991).

Managers may have different motives to shareholders. Brennan, (1995) view that managers can be influenced by some factors such as financial rewards, labour market opportunities and relationship with other parties that are not directly relevant to the interest of the shareholders. This can result to a tendency for

managers to be more optimistic about economic performance of an entity than the reality. As a result of these different interests, managers may have incentives to bias information flows Agrawal and Knoeber, (1996). Shareholders may also express concerns about information asymmetries where managers are in possession of information to which shareholders do not have access to it.

Different motivation and information asymmetries lead to concern about the quality and reliability of information, which impact on the level of trust that shareholders will have in their managers Fama, (1980). There are various mechanisms that can be used to align the interest of managers with shareholders and to allow shareholders to measure and control the behavior of their managers and reinforce trust in them. Board of directors provides an independent check on the activities of managers and of the information provided by the managers, which helps to maintain confidence and trust on them.

### 3.1 Methodology

Correlation research design was adopted because the study attempts to measure the relationship between board characteristics and earnings management of listed oil and gas firms in Nigeria. The population of the study consists of all the 9 listed oil and gas companies on the Nigerian Stock Exchange for the period of 8 years (2007 - 2014). In view of the non-availability of comprehensive data for two of the firms, the study covered only seven firms by using convenience sampling method. The annual reports and accounts of the firms were used to obtain required data for the study. Pooled ordinary least square multiple regression was adopted for data analysis in order to establish the relationship among the variables of the study.

The independent variables of the study are board size, board composition, foreign directors and women directors, while earnings management is the dependent variable. The dependent and independent variables used in the model are explained as follows:

<b>Variables</b>	<b>Variables Name</b>	<b>Variables Measurement</b>
<b>EM</b>	Earnings Management	Measured by absolute values of the residuals (discretionary accruals) using Modified Jones model by Dechow <i>et al.</i> (1995).
<b>BS</b>	Board Size	Measured as the total numbers of directors in the firms' board of

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		directors' membership (Nugroho & Eko, 2011).
<b>BC</b>	Board Compositions	Measured as percentage of non-executive directors in the firms' board of directors' membership (Zhang & Uchida, 2012).
<b>FD</b>	Foreign Directors	Measured as the proportion of foreign directors in the firms' board of directors' membership (Hooghiemstra <i>et al</i> , 2014).
<b>WD</b>	Women Directors	Measured as ratio of female directors in the firms' board of directors' membership (Lakhal <i>et al</i> , 2015).

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Source: By the Author, 2015.

Two steps regression was used in determining the earnings management of listed oil and gas firms in Nigeria, by adopting modified Jones Model by Dechow *et al*. (1995). The study adopted the modified Jones model by Dechow *et al* 1995, which estimates discretionary accruals as proxy of earnings management, the residual of the model given below is used as data for earnings management.

$$DAC_{it} = \frac{TAC_{it}}{TA_{it}} - (1/TA_{it} + \beta_{it} [\frac{\Delta REV_{it} - \Delta REC_{it}}{TA_{it}} + \frac{PPE_{it}}{TA_{it}}]) + \varepsilon_{it}$$

The model used to empirically test the hypotheses formulated is as follows:

$$EM_{it} = \beta_{0it} + \beta_1 BS_{it} + \beta_2 BC_{it} + \beta_3 FD_{it} + \beta_4 WD_{it} + \varepsilon_{it}$$

Where:

EM = Earnings Management

BS= Board Size

BC= Board Composition

FD = Foreign Directors

FD = Women Directors

$\beta_o$  = Beta Coefficient

$\varepsilon$ = Error Term

i = Firm

t = Time/ period

#### **4.1 Results and Discussion**

This section presents the descriptive statistics, correlation matrix and summary of multiple regression results.

**Table 4.1 Descriptive Statistics**

<b>Variables</b>	<b>Obs.</b>	<b>Min.</b>	<b>Max.</b>	<b>Mean</b>	<b>Std. Dev.</b>
<b>EM</b>	56	0.001	0.649	0.114	0.163
BS	56	5	12	8.589	2.138
BC	56	0.285	0.7	0.521	0.115
FD	56	0.090	0.555	0.220	0.145
WD	56	0.083	0.333	0.169	0.070

*Source: STATA Output*

From Table 4.1, the minimum and maximum values of discretionary accrual are 0.001 and 0.649 respectively. Higher discretionary accrual signifies higher earnings management, while lower discretionary accrual indicates lower earnings management. The average value of discretionary accrual is 0.114 while the standard deviation is 0.163. The minimum and maximum values of board size of listed oil and gas firms in Nigeria are 5 and 12 members. The average value of board size is approximately 9 members with a standard deviation of 2.138. The firms' board composition shows minimum and maximum values of 0.285 and 0.7 respectively. Also, the average board composition of listed oil and gas firms in Nigeria revealed a value of 0.521 and standard deviation of 0.115. The foreign director has a minimum and maximum of 0.90 and 0.555 respectively. The mean of foreign director stood at 0.220 while the standard deviation was 0.145.

Finally, the firms' women directors revealed minimum and maximum values of 0.0834 and 0.333 respectively. Also, the mean value of firms' women directors shows a value of 0.169. It is however observed that the women directors has the lowest standard deviation value of 0.070 among the proxies of independent variables and therefore it shows that the women directors has the highest contribution to the earnings management as proxy of dependent variable of the study.

**Table 4.2 Correlation Matrix**

<b>Variables</b>	<b>EM</b>	<b>BS</b>	<b>BC</b>	<b>FD</b>	<b>WD</b>
EM	1				
BS	0.159 (0.240)	1			
BC	0.042 (0.755)	0.567* (0.000)	1		
FD	-0.214 (0.113)	-0.187 (0.166)	0.128 (0.347)	1	

WD	-0.295*	-0.078	-0.138	-0.201	1
	(0.027)	(0.565)	(0.307)	(0.136)	

*Source: STATA Output*

Table 4.2 reveals that foreign directors and women directors of the firms are negatively correlated with earnings management. The coefficient values of -0.214 and -0.295 of the variables with p-values of 0.113 and 0.027 which is insignificant and significant at 5% level of significant respectively. In contrast, board size and board composition are positively correlated with earnings management with the coefficient of 0.159 and 0.042 respectively. The p-values of 0.240 for board size and 0.755 for board composition indicate that the relationships are not significant at any level of significance.

The relationship of the independent variables among themselves shows that board composition and board size, foreign directors and board composition are positively correlated among themselves. On the other hand, the relationship between foreign directors and board size, women directors and board size, women directors and board composition, women directors and foreign directors are negatively related among themselves.

#### **4.2 Regression Results and Discussion of Findings**

In view of the nature of the data, robustness test like multicollinearity and hetroskedasticity tests were conducted in order to see their existence or otherwise. The multicollinearity test revealed a variance inflation factor and tolerance values of less than 10 and 1 respectively, meaning that the data used in the study does not have any multicollinearity problems. The hetroskedasticity test revealed a Chi<sup>2</sup> value of 1.31 with a p-value of 0.251 which is not significant at any level of significance. This means there is complete absence of hetroskedasticity problem associated with the data of the study. Therefore, the study adopted ordinary least square regression model.

Table 4.3 presents the summary of the pooled ordinary least square regression results obtained from the analysis of data.

**Table 4.3 Regression Results**

<b>Variables</b>	<b>Coefficient</b>	<b>T-Value</b>	<b>P-Value</b>	<b>Tolerance</b>	<b>VIF</b>
<b>Constant</b>	0.270	2.08	0.043		
<b>BS</b>	0.007	0.61	0.545	0.607	1.65
<b>BC</b>	-0.040	-0.17	0.862	0.619	1.61
<b>FD</b>	-0.294	-1.89	0.065	0.849	1.18
<b>WD</b>	-0.801	-2.62	0.012	0.942	1.06

<b>R2</b>	0.172	
<b>Wald Chi<sup>2</sup></b>	2.65	
<b>Prob. Chi<sup>2</sup></b>		0.043

*Source: STATA Output*

Table 4.3 shows the functional relationship between dependent and independent variables as follows: **EM= 0.270 + 0.007BS - 0.040BC – 0.294FD – 0.801WD**

The table 4.3 shows that board size has insignificant positive impact on earnings management of listed oil and gas firms in Nigeria. This can be observed from the computed value of beta coefficient of 0.007 with p-value of 0.545 which is statistically insignificant at any level of significance. This finding is in line with that of Abdul Rauf *et al* (2012) but inconsistent with Zhu and Tian (2009) who found significant negative relationship between board size and earnings management.

Table 4.3 reveals that board composition is negatively and insignificantly correlated with earnings management of listed oil and gas firms in Nigeria. The beta coefficient of the variable is -0.040 with p-value of 0.862 which is not statistically significant at any level of significance. The finding is in consistent with the study of Nugroho and Eko (2011) but contradicted the findings of Qin and Liwen (2006) who found evidence of insignificant positive relationship among the variables of the study.

Furthermore, the result provides evidence of a significant negative association between foreign directors and earnings management of listed oil and gas firms in Nigeria. The result shows a beta coefficient of -0.294 with p-value of 0.065 which is significant at 10% level of significance. The result is in line with the findings of Zhang and Uchida (2012) who found evidence of negative significant relationship between foreign directors and earnings management, but contradicts Rashid, Hooghiemstra (2014) who found significant positive association between foreign directors and earnings management of companies.

Table 4.3 shows that women directorship has significant negative influence on earnings management of listed oil and gas firms in Nigeria. The value of beta coefficient is -0.801 while the corresponding p-value is 0.012 which is significant at 5% level of significance. It means that as women directors rises earnings management decreases, an indication that presence of more women directors enhances the accounting quality of the firms. This result is consisted with the findings of Bermig and Frick (2010), but contradicts Sun, Liu and Lan (2011)

who found evidence of positive insignificant relationship between women directors and earnings management.

The combined and overall effect of the predictor variables on the explained variable showed that the model is adequate and free from misspecification. The Wald Chi<sup>2</sup> value of 2.65 with p-value of 0.043 which is significant at 5% level of significant shows that the model is well fitted with the variables of the study. Also the coefficient of determination of adjusted R<sup>2</sup> which stands at 11% indicate the proportion of the total variations in dependent variable that is explained by the independent variables. This signifies that 11% of the total variation in earnings management of listed oil and gas firms in Nigeria is caused by the combined effect of board size, board composition, foreign directors, and women directors; while the remaining 89% is caused by other factors outside the model of this study.

### **5.1 Conclusion and Recommendations**

The study investigates the impact of board characteristics on earnings management of listed oil and gas companies in Nigeria. Data were sourced and collected from the annual report and account of seven oil and gas firms in Nigeria, the data were analyzed using multiple regression. It was found that foreign directors and women directors are negatively and significantly influencing the earnings management of listed oil and gas firms in Nigeria, while board size and board composition were found to have positive and negative insignificant influence on earnings management of listed oil and gas firms in Nigeria. It is recommended that the listed oil and gas firms in Nigeria should reduce the board of directors' size, since it was found to have positive relationship with the firms' earnings management which may eventually increase their earnings management thereby distorting the quality of their accounting information. Also a precautionary measure should be taken on the proportion of non-executive directors in the firms' board of director membership, since the result shows a negative insignificant association of board composition and earnings management. Finally, the listed oil and gas firms in Nigeria should increase the percentage of foreign and women directors in their firms' board of director membership, since the result is found to have negative significant influence on earnings management.

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