FINANCIAL RISK AND AUDIT FEE ON CORPORATE FINANCIAL DISTRESS OF LISTED INDUSTRIAL GOODS FIRMS IN NIGERIA

MARK DAVID KANTIOK
Department of Accounting, Nuhu Bamalli Polytechnic, Zaria

Abstract

This paper aims to investigate the effect of financial risk and audit fee on opportunistic accounting of listed industrial goods firms in Nigeria. Correlation research design is used in this study, whereas the sample consists of 12 companies listed on the Nigerian Stock Exchange for the period from 2011 to 2015. Multiple regressions is adopted as a technique of a data analysis. The empirical research shows that managers of the companies would engage in opportunistic accounting when the company is financially distress and its profit is low. Therefore the study recommended that the management of listed industrial goods firms in Nigeria should increase their assets and expand the scope of their activities in order to have proper utilization of their free cash flow and reduce the amount use to pay auditors.

Key words: Financial Risk, Opportunistic Accounting, Audit Fee, Industrial Goods

Introduction

Opportunistic accounting is seen as an attempt by managers to induce, influence or manipulates reported earnings by using specific accounting method; recognizing one-time non current items, deferring or increasing expenses or revenue transactions or using other methods designed to influence short term earnings (Hasnan, Rahman, & Mahenthiran, 2013). Opportunistic accounting is to intervene in the management of external financial reporting process in order to favor a particular party destination. In other word, opportunistic accounting bias in the financial statements and may interfere with the users of financial statement trust the figures modified as earnings figures without engineering. Opportunistic accounting is also a controversial and important area in financial accounting. It is not always interpreted as a negative action since it does not profit-oriented management of earnings manipulation. It is not always associated with an attempt to data manipulation, but more inclined to be associated with the selection of accounting methods that are deliberately chosen by the management for specific purposes within the limits of the General Accepted

Accounting Principles (GAAP). If in a condition where the management did not reach the targeted profit, the management will take advantage of the flexibility allowed under the accounting standards in preparing financial statements to modify the reported earnings. Managers are motivated to show good performance in generating value or the maximum profit for the company so that they tend to select and apply accounting methods that can provide better income information.

Managers of the firm modify the financial statements to suit their desired. The preparation of a financial report can be in a different ways depending on how it will meet the expectation of the users being internal or external. The financial statements must comply with standards when it publishes for the purpose of communicating with external users. These standards give managers the room to be flexible in choosing the method of accounting measurement in which the financial statements prepared. It was reported that as a result of the unethical Accounting practices some of the multi-national corporations as well as local firms were collapsed. One of such unethical issues in Accounting is earnings manipulations that come under the umbrella of earnings management and serves as a strategic tool used by managers to maximize firm's value and reduce the financial risks. This is possible by distorting or manipulating the application of Generally Accepted Accounting Principles (GAAP). A lot of corporate failures in recent years were reported in Nigeria, for instance, the Nigerian Cadbury's accounting irregularities. The law suit that follows in the year 2007 is the case that's believed to be the first of its kind in the country, which has been trying to shed its image of corruption to attract foreign investment. The recent cases are of Intercontinental Bank Plc, and Oceanic Bank Plc, found to have had their shareholders' funds eroded without trace even though they have been reporting positively increased earnings, which is obviously non-permanent, throughout the periods. In addition to that, the very recent Nigerian recession which lead great economic difficulties and unfavorable business climate in which so many companies have folded up is evidence that lead to opportunistic behavior. These cases, along with other issues, were also believed to be as a result of poor monitoring system of both internal and external (Eagle, 2009).These have brought about doubt in the minds of investors on the credibility and reliability of financial reports presented by the management of the firms.

In order to protect the investors and shareholders' interest, there is need of proper internal and external monitoring mechanism that could checkmates the activities of the management to reduce the agency cost. Most business entities use debt to finance their operation with the hope of improving their performance. If such firms wish to take out a new loan, the lenders will scrutinize several measures and demand that will clear their doubt on the ability of the firms to pay-back their money. As they are concerned on the debt repayment ability of the companies, lenders will ensure that

the management will fully use of the cash available in the profitable investment. In other words, the monitoring activities will be carried out by the lenders in order to make sure that the company materializes the debt repayment (Waznah, Aima, & Mohd, 2015). If the business is highly indebted to the extent that it could not pay its obligations, it is the first signals for financial distress. Financial distress is the violations of debt payments and failure or reduction of dividends payouts. The pressure from financial distress too has significant adverse effects of the financial system, whereby investors and creditors could possibly suffer substantial financial loss.

In a situation where companies make high cash inflows, Managers may like to choose to invest the cash in an unprofitable project due to its self-interest, which leads the company in the position of low growth. This happens as a result of Ineffective monitoring systems of other independent stakeholders on how the business free cash flows will be managed. In addition, audit fee paid to auditors can either strengthen the economic bond between management and auditors and impair auditor independence resulting in sub-optimal firm performance or increase the level and quality of corporate governance which can enhance the quality of financial statements and increase the efficacy of internal control systems.

The global financial scandals that have exposed many companies of their opportunistic behaviour in a bid to secure larger part of the market has really put the financial statements into question of which the Industrial Goods firms may not be overlooked. It is to this end that the study sought to establish if financial risk variables and audit fee can assist in mitigating the opportunistic accounting of Nigerian listed Industrial Goods firms. The following are objectives to which this study seeks to achieve are;

a. To determine the impact of leverage on opportunistic accounting of Nigerian listed industrial goods firms.
b. To find out the impact of financial distress on opportunistic accounting of Nigerian listed industrial goods firms.
c. To ascertain the impact of free cash flow on opportunistic accounting of Nigerian listed industrial goods firms.
d. To examine the impact of audit fee on opportunistic accounting of Nigerian listed industrial goods firms.

With respect to the specific objectives of the study, the following null hypotheses have been formulated:

H01 Leverage has no significance effect on opportunistic accounting of Nigerian listed Industrial Goods firms.
H02 Financial distress has no significance effect on opportunistic accounting of Nigerian listed Industrial Goods firms.
H03 Free Cash Flows has no significance effect on opportunistic accounting of Nigerian listed Industrial Goods firms.
H04 Audit Fee has no significance effect on opportunistic accounting of Nigerian listed Industrial Goods firms.

This study is aim to add to the existing literature for the potential researchers to build on it and will be of benefit to the Nigerian manufacturing sectors particularly the industrial goods firms to consider external monitoring factors as it will help them in checking earning manipulation. The remaining part of the paper will be as follows; section two literature reviews, section three methodology discussions while section four present and analyses the data and section five conclude the paper.

Literature Reviews

In this section, related literature on financial risks, audit fee and opportunistic accounting are reviewed. Specific attention is paid on the relationship between financial risk variables (leverage, financial distress and free cash flows), audit fee and opportunistic accounting. Earnings manipulation occurs because a managers use the opportunity of their actions to satisfy their self interests (Farhana, Balkish, & Mohd, 2014). Managers are responsible for the provision of the financial statements to show the performance of the company to the shareholders. Managers may alter and manipulate the earnings numbers to obscure the view of investors about the real firm' performance. As a result, managers may use discretion in selecting accounting principles to suit their interest (Farhana et al., 2014; Riahi, Lamiri, & Arab, 2013). According to Chung, Firth and Kim (2005) the provision of General Accepted Accounting Principles (GAAP) gives managers room to select accounting principles to demonstrate the achievement of profit targets that reflect the prospects of the company in the future.

Leverage can be utilized as an efficient control mechanism to avoid the practice of excessive earnings management that would eventually harm the business. According to Leng (2007) the lenders will eventually monitor the management's action because it is the main factors determining repayment. Prior studies found that less long term emoluments are paid to the managers of the highly leveraged firm. The company might consider having a high leverage if the value of debt is more than the debt optimal value. Shubita and Alsawalhah (2012) state that, company with high debt ratio will be in greater risk, which may leads to the higher interest rate. More recent studies have argued that leverage increases the potential for earnings management which responds to avoid debt covenant violations (George, 2006; Zamri, Abdul, Saatila, & Isa, 2013). Leverage increases significantly due to increase in debt capacity (Gombola, Ho, & Huang, 2015; Salloum, Azzi, & Gebrayel, 2014; Sayyar, Basiruddin, Zaleha, Rasid, & Elhabib, n.d.; Zamri et al., 2013). As a result of using debts to finance the business, high leverage impacted significantly to the opportunistic earnings management (Waznah et al., 2015). On the other hand, Jelinek (2007) examines the effects of leverage increases on the magnitude of discretionary

accruals applied and find negative association with discretionary accruals. Abdullahi, Gugong and Bala (2016) find that, debts affect earning manipulation negatively. When lenders are tighten their monitoring on the firms then managers would be less likely to employ earnings management (Fitri, Noor, Mohd, Teck, & Mohd, 2015; Iatridis & Kadorinis, 2009; Ujah & Brusa, 2014). Furthermore, some studies find no significant relation between and earnings management (Amr & Ahmed, 2006; Ali & Reyhaneh, 2015 & Veronica, 2015). Based on the arguments, there are mixed findings on whether leverage may influence the potential of manager to exercise opportunistic behaviour.

When a company is highly indebted, and could not meet the obligations, it may likely bankrupt. Companies that are nearly bankruptcy are in financial distress stage. In general, distressed company means that in the near future, the company would not be able to fulfill its obligations. According to Ignatov (2006) the company may go bankrupt or be reorganized. Md. Zeni & Ameer (2010) see financial distress firms as a term used to designate a situation when agreements or contracts with creditors of a company are not working as expected or at difficult stage. Additionally, Pranowo, Achsani, H.Manurung, & Nuryartono, (2010) and Waznah et al., (2015) define distressed firms as those that have a debt ratio greater than one or interest cover ratio smaller than one. There are mixed opinion on the relationship between financial distress and earnings management, some researchers are in the view of managers engage in earnings management when the company is financially healthy, while others are in the view that earning manipulation can take place when the company is in distress. Managers would engage in earnings management when the company is financially healthy and when the profit of the company is high (Waznah et al., 2015). According to Demirkan & Platt, (2009) managers would exhausted their means of manipulating and managing earnings prior to distress and perhaps they fail to perceive benefit from such manipulation. In the other hand, managers sometimes tend to involved in earnings management in order to hide unlawful transactions (Farhana et al., 2014 & Hasnan et al., 2013). Aff, Rezaei, & Zh, (2016); Agrawal, (2015); Habib, Uddin Bhuiyan, & Islam, (2013) examine that, earnings management occurred in firms which faced financial distress condition and this could provide incentives for managers to manipulate earnings.

Furthermore, cash is one of the important resources that enable firm to ensure their sustainability in the future. Free cash flow can be seen as excess in cash that firms have to invest in project that have positive net present values. According to Ibrahim, Sanusi, & Sulong, (2014) and Sindhu, (2014) free cash flow concept can be defined as managers seek to invest in new project rather than paying dividend to shareholders. The problem that associated with free cash flow is that how to

encourage managers to save the excess cash rather than investing it all in project that have negative net present value because it will wasting it on organization inefficiencies (Hong & Shuting, 2012; Khidmat & Rehman, 2014). Managers are sometime in the view to invest in new project or expanding business operation rather than paying dividend to the shareholders (Bukit & Iskandar, 2009). Prior researchers agree that free cash flow has contribute to the agency problem because managers tend to invest in new project rather than paying dividend to shareholders because it will enhance their power and control over the firm assets. Agency problem also arise in free cash flow (Wang, 2010). Managers choose to invest has negative value and may bring pecuniary benefits or personal benefit to managers. Investing in new projects and expanding business are example of unnecessary investment being done by managers in order to gain personal benefits such as more power in controlling business management and resource (Agrawal, 2015; Fitri et al., 2015). In this case, Managers that invest in negative net present value usually will lead firm's stock price low and earnings and when this happen, shareholders may remove them from their position. To avoid this happen, managers tend to apply earnings management in reporting firm's performance to show positive and strong performance (Agrawal, 2015; Fitri et al., 2015; Ujah & Brusa, 2014; Wang, 2010). Most of the times, managers provided inflate reported earnings to enhance expectation of the investors regarding the future performance of the company and to increase the offer price (Rahman & Abdullah, 2005). Normally, earnings management that occurred in the companies with surplus free cash flow can be connected to discretionary accruals. Bukit & Iskandar, (2009) suggest that surplus free cash flow may create an incentive for the manager to engage in income-increasing management, financial flexibility signal. In other words, Amalendu (2012) and Fitri et al., (2015) find the positive significant association between free cash flow and earnings management.

Prior studies have been dedicated to examine the association between audit fee and earnings management. There are empirical evidences that firms audited by Big audit firms which are well paid, likely to reduce the tendency of opportunistic earnings management (Ding & Jia, 2012). Nuradeen and Hasnah (2015) examine that auditors will performed actively to reduce manipulation of accounts through discretionary accruals, if financially independent. According to Krishnan & Zhang, (2014) discretionary accruals in firms audited by Big-X have a higher positive relationship with future profitability than those of firms audited by non-Big X auditors. High quality auditors are more likely and able to detect questionable accounting practices, report material errors and irregularities than low quality auditors, because of the incentives, expertise, and resources to separate the information component from noise. Krishnan (2003) says that, auditors can enhance the informativeness of

discretionary accruals by constraining aggressive and opportunistic reporting of accruals by managers. These results well show that auditing plays a significant role in constraining opportunistic earnings management. Mouna and Anis (2013) suggest the presence of a negative association between discretionary accruals and the presence of a well-qualified merger auditor. Therefore, managers are less likely to implement their accounting discretion to manage earnings when their firms are audited by Big audit firms. In the other hand, Sandra and Kusuma (2004) investigate and find no significant evidence that audit fee has in moderating effect on the relationship between earnings management. The empirical results suggest that higher audit fees received by auditors may create bonding between client and auditors (Sulong et al., 2013).

Methodology

Correlation research design is adopted to relate financial risk and audit fee and opportunistic accounting of listed industrial goods firms in Nigeria. The study's population is comprised the entire twenty four (24) industrial goods firms listed in the Nigerian stock and exchange as at 31st December, 2015. The sample size consist of 12 firms from a period of 2011 – 2015, which is carefully selected using systematic sampling technique and Taro Yamane adjusted sample size formula (Abbas, Shehu, & Dabo, 2016). The data extracted was analyzed using multiple regression technique.

$$n = N/1 + N(e)^2$$

Where n= sample size
N= total population
e= 0.05 (5%)
n=24/1+24$(0.05)^2$
n=22.6415094
Approximately n=23. Furthermore, the Adjusted Yamane Formula is;
n_0=n/1+(n-1)/N
n_0=23/1+(23-1)/24
n_0=12

Table1 Variables measurement

Variables	Measurement	Sources
Discretionary Accruals	Modified Jones Model (1991) by Dechow et al. (1995)	Shehu and Abubakr (2012)

Leverage	Total Debt to Total Assets	Norhayati, Rahayu & Noor (2013); Nor Farhana et al (2014) & Aziatul et al (2015)
Financial Distress	Using Atman Z-Score (1968) *Z = 0.012X1 + 0.014X2 + 0.033X3+ 0.006X4 + 0.999X5*	Nor Farhana et al (2014)
Free Cash Flows	Net cash flows operation to Total Assets	Jones & Sharma (2001) and Nor Farhana et al (2014)
Audit Fee	Natural log of audit fee	Bashir and Mazadu (2016)

A multiple regression model will be structured using longitudinal panel data. The following regression model is use to captures the hypotheses of this study.

$DAit = \beta0 + \beta1LEVit + \beta2FIDit + \beta3FCFit + \beta4ADFEEit + \mu it$

Where:
DA = Discretionary Accruals, LEV = Leverage, FID = Financial Distress, FCF = Free Cash Flows, ADFEE = Audit Fee, β1 – β4 = Coefficient of explanatory variables, βo = Constant or Intercept and μ = Error Term.

Results and Discussions
This section will present the summary of descriptive statistic and discuss the regression results.

Table2 Descriptive Statistics

Variable	Min	Max	Mean	Std. deviation
DA	-0.18	0.03	-0.0273333	0.0335406
LEV	0.07	0.80	0.4533333	0.1779132
FID	0.04	6.00	1.471	1.422406
FCF	-0.30	0.82	0.1265	0.1806094
ADFEE	5.3	12.16	8.8995	1.607564

Source: Result from STATA 13.

From table2 opportunistic accounting which proxied with discretionary accruals is at minimum and maximum levels of -0.18 and 0.03 respectively, while the average level is -0.027. The standard deviation of leverage is given as 0.178, while the minimum and maximum values maintain 0.07 and 0.80 respectively. This signifies that most of the industrial goods firms' capitals are financed by debt more than equity. The average of financial distress is resulted at 1.453 which is slightly lower than the required value of 1.8 for a company classified as a financial healthy given by (Demirkan & Platt, 2009). The result indicates that free cash flows is ranging between -0.30 to 0.82 as a minimum and maximum values respectively. This shows that the positive result indicates the company is running in the surplus free cash flow which means the business is making excess profit, while the negative result indicates that the company is suffering deficit free cash flow, to fund the net present value project and improving the firms' growth. The value of 0.127 is stand as the average of free cash flow. It is statistically shows the level of disparity of audit quality from discretionary accruals is 1.61, while the minimum and maximum values are 5.3 and 12.16 respectively.

Table3 Correlation Matrix

	DA	LEV	FID	FCF	ADFEE
DA	1				
LEV	-0.1668	1			
FID	-0.3139	-0.1584	1		
FCF	-0.3952	0.1628	0.3168	1	
ADFEE	0.2383	0.1797	-0.4556	0.3002	1

Source: Result from STATA 13.

Table3 discuss the relationship between dependent variable and independent variables. And also look for the relationship among independent variables themselves. It indicates that leverage, financial distress and free cash flow have negative relationship with discretionary accruals, while audit fee has documented negative relationship. Consider the result given in the correlation matrix, it is clear that the relation among leverage, free cash flow and audit fee are positive, while between leverage and financial distress are negatively related. But free cash flow and financial distress show positive correlation, which indicate that companies that have surplus of free cash flow are financially healthy. Finally, financial distress and audit fee provides a negative relation.

Moreover, the multicolinearity test was conducted and it indicates the expected result of VIF and tolerance of less than 10 and 1 respectively. This means the data used in

this study does not have any multicolinearity problems among the independent variables.

Table4 Regression Results

Variable	Co-efficient	t-Statistics	P-values	Tolerance / VIF
(Constant)	-0.0807443	-2.61	0.012	
LEV	-0.0300747	-1.38	0.173	0.924449/1.08
FID	0.0002692	0.08	0.940	0.548397/1.82
FCF	-0.0927718	-3.56	0.001	0.625943/1.60
ADFEE	0.0088077	2.88	0.006	0.572782/1.75
R2			**0.3210**	
Adjusted R2			**0.2717**	
F-Statistic			**6.50**	
F-Significance			**0.0002**	
Root MSE			**0.02862**	

Source: Result from STATA 13.

Table4 reveals the overall association between dependent variable and independent variables is accounted by R-squire as 0.3210. In this study, financial risk and audit fee variables have explained for 32% and the adjusted R-squire value is 0.2717 which is approximately 27% of the variance of opportunistic accounting. This indicates that 27% of the total variation in opportunistic accounting of listed industrial goods firms in Nigeria is caused by the combined effect of the financial risk (leverage, financial distress and free cash flow) and audit fee, remaining 73% is caused by other factors outside the model of this study. The F-Statistic value is 6.50 with F-Significant value of 0.0002 which significant at 1% level of significance. This shows that the model used in this study is well fitted with variables.

From the regression result of table4; leverage has negative significant impact on the opportunistic accounting of listed industrial goods firms in Nigeria. The computation value of beta-coefficient of the regression is -0.0300747 and t-value of -1.38 which shows no statistical significant at any level. This implies that for every change in the proportion of debt maintain by industrial goods firms, it may not necessary affect the opportunistic accounting of the listed industrial goods firms in Nigeria. It is therefore noted that if leverage is improved, it may affect opportunistic accounting negatively and significantly as such fund can be used for other activities that maximize profit. The policy implication is the authorities of the industrial goods firms in Nigeria should improve the system of their debts which may allow lenders to make a proper

monitoring the activities of managers. This result is in line with the findings of (Amr & Ahmed, (2006); Ali & Reyhaneh, (2015) and Veronica, (2015) who reported insignificant association between leverage and earnings management. The result is in contrast with the findings of Iatridis & Kadorinis, (2009); Ujah & Brusa, (2014) and Fitri, Noor, Mohd, Teck, & Mohd, (2015) who documented significant association between leverage and earnings management. Therefore, the result fail to reject the hypothesis one (H1), which stated leverage has no significant impact on opportunistic accounting of listed Nigerian industrial goods firms.

In order to examine the effect of financial distress on opportunistic accounting, a t-value of 0.08 and Beta value of 0.0002692 were given by the regression result, which is also insignificant to checks the opportunistic earnings management of the industries. The positive relationship between financial distress and opportunistic accounting indicate that the managers of the industrial goods firms would practice earnings manipulation when the firms are in distress condition. This is in line with the views of Aff, Rezaei, & Zh, (2016); Agrawal, (2015); Habib, Uddin Bhuiyan, & Islam, (2013) Aff, Rezaei, & Zh, (2016); Agrawal, (2015); Habib, Uddin Bhuiyan, & Islam, (2013). It is contrary to Demirkan & Platt, (2009) and Waznah et al., (2015) which have find that managers will exercise earnings manipulation when the company is in financial healthy. The policy implication of the managements of the industrial goods firms should improve their activities that bring more cash inflows which could cover the debts ratio and enforce the policies that could maintain the financial health of the firms, like proper monitoring financial activities, setting target that could increases profit and motivating the employees. Thus, this result provided the evidence of not to reject the hypothesis two (H2).

In attempt to test hypothesis which states free cash flow has no significant impact on opportunistic accounting of listed Nigerian industrial goods firms. The statistical result shows the Beta-value of free cash flow is -0.0927718 and the t-value is -3.56, which is at 1% significance level. This demonstrates that free cash flow has negatively, strongly, statistically and significantly impacted on opportunistic accounting of industrial goods firms in Nigeria. It explained that managers will practice opportunistic accounting when the flow of the cash is very low for the sake company's survival and continue operation. This signifies that for every 1% increases of free cash flow of the industrial goods firms in Nigeria will leads to the 9% reduction of opportunistic behaviours of the managers. The authorities concerned should be advice when making their policy on free cash flow will consider factors that may lead to maximize the company's profit. The result is in line with the findings of Bukit & Iskandar, (2009). It contrary to the Amalendu (2012) and Fitri et al., (2015) which is find insignificant association between free cash flow and earnings management in his 2010 result. This result provides evidence to reject hypothesis three (H3), therefore the H3 is rejected.

Finally, audit fee documented of Beta-value and t-value as generated from regression result is 0.0088077 and 2.88 respectively, which is significant at 1% level of significance. This indicates that audit fee has positively, strongly, statistically and

significantly influencing on the opportunistic accounting of listed industrial goods firms in Nigeria. It signifies that for every 1% change in audit fee of the industrial goods firms in Nigeria, it will lead to approximately 9% change of opportunistic accounting. However, the policy implication of the industrial goods firms in Nigeria should reduce the amount used to auditors in order to reduce the opportunistic behaviour of mangers of the firms. The result is contrary with the findings of Mouna et al (2013) and Kusuma (2004). Thus, the hypothesis four (H4) is rejected.

Conclusion and Recommendations

This study examined the effect of financial risk and audit fee on opportunistic accounting of listed industrial goods Firms in Nigeria, using a final sample of 12 companies for the period of 2011 – 20015 year of observations. Based on the findings of this study, leverage has statistically negative insignificant influence on the opportunistic accounting, while financial distress has statistically positive insignificant influence on the opportunistic accounting of listed industrial goods firms in Nigeria. Free cash flow has negatively, strongly, statistically and significantly influencing opportunistic accounting. Finally, audit fee has also positively, strongly, statistically and significantly influencing opportunistic accounting of listed industrial goods firms in Nigeria.

Since the empirical results of this study reveals that, earnings manipulation can be employed when the company is in distress, low free cash flow and higher remuneration of audit fee. The employment of earning manipulation reduces the reliability and accuracy of reported earnings information which mislead the investors in making decision. There is need for policy makers and regulators to develop and establish laws and regulations that ensure the accuracy and reliability of reported information in order to protect the interest of stakeholders relying on the information to make their economic decision.

Therefore, it is recommended that the management of the industrial goods firms sub-sector of the Nigerian manufacturing sector should maintain the current leverage in order to have good debt ratio, focus on how to increase their assets and expand the scope of their activities which will help in increase the free cash flow and make proper utilization of the surplus and reduce the amount paid to auditor.

Refereces

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