



Ownership Structure and Real Earnings Management: Evidence from Nigeria

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Received: 8th October 2020

Accepted: 25th October 2020

Published: 1st November 2020

Abstract

Financial statements are expected to assist users in decision making by reporting the true and fair value of companies. However, there always exists the potential risks of manipulations of the reported results if the numbers were intentionally prepared to misrepresent the actual performance or conditions of the companies. Manipulating the reported earnings to achieve pre-set objectives is an art known as earnings management which can be classified into real or accrual manipulations. This study examines the effects of ownership structures (managerial, institutional, and foreign) on real earnings management in Nigeria. The analyses involve a sample of 72 non-financial firms with 360 firm-year observations for a period 2014-2018. Data was collected from the financial reports of these companies, Thompson Reuters, and Bloomberg databases. The multiple regression technique was employed for panel data analysis. The results show that managerial ownership increase management's desire to manipulate the reported earnings, while institutional ownership have insignificant relationship with real earnings management. Also, the findings reveal that foreign ownership prevent managers' from manipulating the financial statement. Thus, the study recommends that listed companies in Nigeria should consider higher percentage of foreign ownership to improve their monitoring and have quality financial statement.

Keywords: Earnings Management, Managerial, Institutional, Foreign, Nigeria.



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INTRODUCTION

For most users of financial information earnings represent one of the key results of the accounting function. Investors rely heavily on the accounting and earnings numbers when evaluating the investment worthiness of firms. Thus, the reliability and quality of earnings in the published financial statement contribute significantly to the users (Samaila, 2014). In general, every capital market operator demands high-quality financial reports (Mansor & Rahman, 2019). Financial statement is the responsibility of management and prepared to report to the various stakeholders how the resources of the companies have been used and their effectiveness in achieving the organisational goals (Hassan, 2011). These statements also provide the means of informing shareholders about the current financial positions of the firms (Alzoubi, 2012). Thus, financial report is expected to report the real economic positions of companies. However, in preparing the financial reports, there are potential of risk of manipulations of the reported earnings such that the reported results of operations do not reflect the actual conditions of the companies (Obigbemi, Omolehinwa, Mukoro, Ben-Caleb, & Olusanmi, 2016).

In Nigeria, several high-profile corporate accounting scandals has been witnessed at the end of the 20th century which lead to the collapse of well-established companies across the globe (Elhaj & Mansor, 2019). The business environment in this country is also plagued with ethical problems associated with corporate scandals involving large companies (Enobong, 2017). Thus, it was indicated that there were about 1,639 cases with losses of 18.5 million USD in 2012, 314.5 million USD with 3,380 cases in 2013, and the highest number of cases 3,756 with losses of 254.5 million USD were recorded in 2014 (Enofe, Omagbon, & Ehigiator, 2015). For example, the case of Oando oil Plc and Arik airline are the recent corporate frauds recorded in 2017. These cases have raised doubts of the integrity and credibility of accounting earnings in Nigeria (Umobong & Ibanichuka, 2017; Nwanyanwu, 2017).

Earnings management means intentionally manipulating the reported financial statement numbers by managers to deceive information users to attain the managers' own gains or pre-set objectives Healy & Wahlen (1999). Zang (2012) categorises earnings management based on Accruals Earnings Management (AEM) and Real Earnings Management (REM). AEM involves deliberate attempt by management to change

the accounting procedures when treating a given transaction in the financial statement (Dechow & Schrand, 2010). In contrast, REM reflect management departure from routine operational procedures, intentionally to misinform shareholders that the financial report has been achieved using regular operating procedure (Enomoto, Kimura, & Yamaguchi, 2015). However, firm cash flow is not affected under AEM as compared with the activities of REM (Mansor & Rahman, 2019).

Studies have documented that managers prefer REM when engaging in earnings management since AEM is possible to be uncovered by auditors than AEM (Barber & Hollie, 2020; Baatour, Othman, & Hussainey, 2017; Kassamany, Ibrahim, & Archbold, 2017; Karbhari, Sitangang, & Matemilola, 2019; Alhadab, 2018; Amoah, Anderson, Bonaparte, & Tang, 2017; Farooqi, Ngo, & Jory, 2017; Al-Amri, Al Shidi, Al Busaidi, & Akguc, 2017; Chandren, 2016). Agency theory also argues that ownership structure mitigates the management and shareholders conflict (Jensen & Meckling, 1976). Specifically, managers with significant holdings in the equity of a firm lessen the propensity of earnings manipulation (Alves, 2012; Alzoubi, 2016). On the other hand, higher management ownership may lead to information asymmetric and give management the opportunity to dwell in earnings management (Aygun, Ic, & Sayim, 2014). Moreover, institutional investors are believed to exhibit extra effort to aid compliance with the provision of corporate governance and ensure that managers' actions are not entrenched (Uwuigbe & Olusanmi, 2012). Agency theory has suggested that institutional shareholders serve as monitoring mechanism against the activities of opportunist management. Institutional investors made it difficult for managers to involve in real earnings management since their activities would be closely monitored by active institutional investors (Zang, 2012).

Extant literature has also reported the importance of foreign shareholders in reducing earnings management (Adebiyi & Olowookere, 2016; Ben-Nasr, Boubakri, & Cosset, 2015; Korczak & Korczak, 2009). Foreign investors have cross country experience and good knowledge of investment compared to other investors; therefore, their knowledge could be used to restrain the effect of earnings management (Guo, Huang, Zhang, & Zhou, 2015). From the above-mentioned facts, the study investigates the impacts of ownership structure (managerial, institutional, and foreign) on earnings management. Thus, the findings enlighten policymakers, shareholders, and regulators on the importance of effective internal control mechanisms such as risk management committee to help in restraining earnings manipulations and improving the financial reporting quality.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Managerial Ownership and Real Earnings Management

Agency theory explains that conflict of interests occurs because of the ownership and control separation that gives management the privilege to oversee the affairs of the firms (Jones & Butler, 1992). Managers are expected to serve the interest of the principal. The impact of managerial share ownership and earnings management is based on two views.

The alignment of interest argues that the presence of greater managerial ownership mitigates the impacts of earnings management through aligning the interests of insiders with those of outsiders (Jensen & Meckling, 1976). Hence, it is

believed that higher ownership by managers is likely to serve as an incentive for them to reduce agency conflicts. Empirically, studies on earnings management and managerial ownership provide inconclusive results. In Nigeria, Hassan (2013) studied a sample of 32 firms for six years and documented that managerial ownership, among other things, helped in lessening the impact of earnings management. Their finding is similar with the alignment hypothesis, where presence of insider's ownership aligned the interest of all stakeholders and decreases the possibility of earnings management practices. Likewise, Kantudu and Samaila (2015) reported that earnings management has a negative association with managerial ownership and lends their support to the alignment hypothesis.

On the contrary, the existence of high managerial ownership may give management the opportunity to influence firm's decisions, and hence influence the reported earnings. This view is in accordance with the entrenchment hypothesis which states that managers with large shareholdings are more likely to expropriate the resources of the shareholders. Based on this, Al-Fayoumi, Abuzayed and Alexander (2010) established that managerial shareholders possess a solid incentive to involve in earnings management.

H₁: *There is a significant relationship between managerial ownership and earnings management of listed companies in Nigeria.*

Institutional Ownership and Real Earnings Management

Institutional investors are perceived as more professional in terms of knowledge and skills to effectively monitor compliance and necessary disclosure (Emamgholipour et al., 2013). Institutional investors with a larger percentage of stock are expected to exercise monitoring and prevent manager's manipulative behaviors (Roodposhti & Chashmi, 2011).

In Nigeria, Hassan, and Ahmed (2012) used a sample of 15 listed food and beverages companies from 2006-2010 and employed multiple regression techniques. The authors reported significant negative influence of institutional shareholders on the earnings management practice. Also, Al-dhamari and Ku Ismail (2014) urged that companies having large presence of institutional shareholders, among others, showed improved earnings predictability and less agency problems. Similarly, Alzoubi (2016) indicated negative significant association between earnings management practice and institutional ownership in Jordan. More recently, Abousamak and Shahwan (2018) suggested that institutional ownership was negatively associated with earnings manipulation in Egypt.

Contrarily, some researches have documented positive impact of institutional shareholders and earnings management activities. For example, Koh (2003) conducted an analysis of institutional shareholders and aggressive earnings practice of listed Austrian firms. The result indicates a positive significant influence of institutional investors on earnings aggressiveness, even enormous when the percentage of ownership is relatively low. Likewise, in China, Hsu and Wen (2015) employed accrual and real earnings management and conclude that institutional investors give managers the opportunities to manipulate the discretionary accruals.

H₂: *There is a significant relationship between institutional ownership and real earnings management of listed companies in Nigeria.*

Foreign ownership and Real Earnings Management

The existence of foreign shareholders improves the corporate government practice due to their experience in global operations and investment (Lskavyan & Spatareanu, 2011). In addition, foreign investors can be a good external monitoring mechanism expected to utilize their external knowledge in resolving the agency conflicts (Guo et al., 2015). Prior findings on foreign ownership and earnings management have presented inconclusive and mixed findings. For example, Ben-Nasr, Boubakri and Cosset (2015) explored the association between foreign ownership and earnings management of 350 listed companies from 45 countries for 2002-2012. The result showed that foreign investors reduce earnings manipulation. Consistent with Ben-Nasr findings, Guo, Huang, Zhang, and Zhou (2015) and Swai (2016) documented a negative effect of foreign investors in restraining the propensity of REM.

There are also studies that document positive impact of foreign ownership and earnings management. Klai and Omri (2011) examined the importance of foreign investors and earnings management in Tunisia. It was found that firms with foreign investors experienced higher earnings management practice. Similarly, in China, Guo, and Ma (2015) showed there was a positive linked between foreign shareholders and earnings management practice.

H₂: *There is a significant relationship between foreign ownership and real earnings management of listed companies Nigeria.*

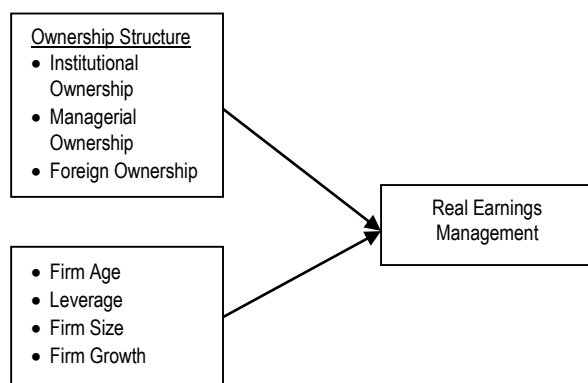


Figure 1: Research Framework

RESEARCH METHOD

The population covered 169 listed firms in Nigeria Stock Exchange starting from 2014-2018. Table 1 show the procedure for sample selection. From the total of 169 companies, 57 banks and other financial service institution were removed, additionally, the Nigerian stock exchange delisted 25 companies. Finally, to attain the final sample of 72 companies, 15 firms were removed because of inadequate information bringing a complete of 360 observation. The study data were obtained from financial statements using Thompson Reuters DataStream, Bloomberg DataStream, and financial reports of the listed firms.

Table 1: Sample selection procedure

	No	No
Firm listed on Nigerian stock exchange as at 31/12/2018		169
Less		
Financial service companies	57	
Delisted	25	

Firm with incomplete data	15
Sample	72
Years	5
Observation	360

Dependent Variable

Consistent with Roychowdury (2006), the REM was computed using abnormal cash flow, abnormal discretionary expenses, and abnormal production.

Abnormal Cash flow (Ab_CFO)

we run the following cross-sectional regression for every firm-year for normal cash flow.

$$\text{CFO}_{it}/\text{Assets}_{it-1} = a_0 + a_1(1/\text{Assets}_{it-1}) + \beta_1(\text{Sales}_{it}/\text{Assets}_{it-1}) + \beta_2(\Delta\text{Sales}_{it}/\text{Assets}_{it-1}) + \epsilon_{it} \quad (1)$$

CFO_{it} signifies operating cash flow for firm *i* and in year *t*. Asset_{it-1} signifies lagged total assets. Sales_{it} is existing year sales and ΔSales_{it} represents changes in total sales i.e existing year sales less previous year's sales. While ε_{it} signifies error term. Abnormal cash flow from operation (Ab_CFO) is obtained as the disparity between the actual cash flow (ACFO) and normal cash flow (NCFO), and same with Cohen and Zarowin (2010) the abnormal CFO residual is multiplied by -1, as lower cash flow from operation indicate real earnings manipulation.

Abnormal Discretionary Expenses (Ab_DISEXP)

DISEXP is the sum of selling, general and administration expenses, research and development and advertisement expenses. The disparity between the actual discretionary expenses and normal discretionary is the abnormal ISEXP. The unusual discretionary spending is computed by lagging with the total assets and is regressed against current year sales scaled by lagged total assets; Similar with Cohen, Dey, and Lys (2008), Ab_DEXP is multiply with a negative one (-1) to get the final Ab_DEXP.

$$\text{DISEXP}_{it}/\text{Assets}_{it-1} = a_0 + a_1(1/\text{Assets}_{it-1}) + \beta_1(\text{Sales}_{it-1}/\text{Assets}_{it-1}) + \epsilon_{it} \quad (2)$$

Abnormal Production (Ab_PROD)

Production cost is the total of cost of goods sold (COGS) and changes in inventory (Δ Inv) for the year. The difference between actual and the normal production costs is known as abnormal production cost (Ab_PROD). The regression residuals saved stand as real earnings' management.

$$\text{PROD}_{it}/\text{Assets}_{it-1} = a_0 + a_1(1/\text{Assets}_{it-1}) + \beta_1(\text{Sales}_{it}/\text{Assets}_{it-1}) + \beta_2(\Delta\text{Sales}_{it}/\text{Assets}_{it-1}) + \beta_3(\Delta\text{Sales}_{it-1}/\text{Assets}_{it-1}) + \epsilon_{it} \quad (3)$$

Real Earnings Management Matric

Similar with Braam, Nandy, Weitzel, and Lodh (2015) and Baatour, Othman, and Hussainey (2017) equation 1, 2, and 3 were aggregated to obtain a single variable (REM). REM= Ab_PROD + Ab_CFO+ Ab_DEXP.

Independent Variables

Managerial ownership (MSO) was defined as the proportion of shares own by insider shareholder to the total number of issued shares of a firm (Alves, 2012). Institutional ownership (ISO) is the proportion of shares own by institutional shareholders to the total number of issued shares (Al-Fayoumi

et al., 2010; Aygun et al., 2014). And foreign ownership (FSO) is the Proportion of foreign investors to the total issued shares (Shayan-Nia et al., 2017; Lel, 2019).

Control Variables

Firm's age is regarded as one of the attributes that perform a key role in the firm's earnings management. Prior literatures indicated that older companies have the motivation to disclose quality earnings information and less likely to manage their earnings (Alexander, 2017; Johl, Johl, Subramaniam, & Cooper, 2013). Olowokure, Tanko, and Nyor (2016) point out that old listed firms are negatively related to financial misappropriation in Nigeria. On the other hand, some scholars such as Bassiouny (2016) present an insignificant correlation between firms age and earnings management in Egypt. Based on this there is no relationship between the period firms's been in the market and the level of earnings management.

Also, firm size could influence a firm's possibility to manipulate earnings (Ali, Noor, Khurshid, & Mahmood, 2015). Studies have shown larger firms are less probable to involve in aggressive earnings management (Ben-Nasr, Boubakri, & Cosset, 2015; Guidara & Boujelbene, 2014). On the other hand, some scholars such as Omoye and Eriki (2014), and Swastika, (2013) find that big firms manipulate the reporting earnings to maintain their status in the market. Uwuigbe, Uwuigbe, & Bernard (2015) advocated that firm size has a significant positive impact over earnings management.

Firm growth was widely utilized by prior studies as one of the variables that affects the earnings management of the firms (Debnath, 2017; Fodio, Ibikunle, & Oba, 2013). Chau and Gray (2002) indicate that firms with growth potential have the motivations to disclose good information to justify their corporate decisions and minimize information asymmetric. Gorganli and Vakili (2014) discover that firm's growth is negatively related to earnings management. In Contrast, Razzaque, Ali, & Mather (2016) find an insignificant association between firm growth and real earnings management.

Prior researches indicated that leverage have influence on earnings management (Klein, 2002; Othman & Zhegal, 2006). Defond and Jambalvo (1994) stated that when a company have high leverage, the earnings management practice will be high, because the company tries to improve its bargaining position for negotiating the debt. While Januarsi, Badina, & Febrianti (2014) states companies that have leverage may be at the control of creditors, making it difficult for managers to manipulate the earnings.

Model Specification and Variable Measurement

The models used for the study based on the reviewed literature were formulated as follows:

$$REM = \alpha_0 + \beta_1 MSO_{it} + \beta_2 ISO_{it} + \beta_3 FSO_{it} + \beta_4 FAGE_{it} + \beta_5 LEV_{it} + \beta_6 FSIZE_{it} + \beta_7 FGRT_{it} + \epsilon$$

Where: REM = Real earnings management, α_0 = Constant, MSO= Managerial ownership, ISO = Institutional ownership, FSO = Foreign ownership, FAGE = Firm age, LEV = Leverage, FSIZE = Firm size, FGRT = Firm growth, and ϵ_{it} = Error term.

Results and Findings

Descriptive statistics

Considering REM, the result from Table 3 reveals an average mean of 0.029, minimum of -0.228 and a maximum value of

0.323. The mean of 0.029 indicates the presence of earnings manipulation among companies in Nigeria. The value is relatively higher than 2.6% reported by Chi et al., (2011), and lower than 3.0% reported Razzaque et al., (2016). However, the mean value of managerial ownership shows the mean value of 0.193, indicating that MSO held about 19% of the total shareholdings in the Nigerian capital market. The maximum value of 0.713 shows that MSO has the highest of 71% in some listed companies. Additionally, the result indicate that institutional shareholders have an average of 0.491, a minimum of 0 and a maximum of 0.880, respectively. This reconfirms the findings provide by Miko and Kamardin (2015) and Usman and Yero (2012). Regarding foreign shareholders, the result indicates a mean of 0.271, minimum of 0 and a maximum of 0.750 of FSO in Nigerian listed firms. This indicate that foreign shareholders accounts for 27% of the total shareholdings. The maximum value shows that some firms are highly dominated by foreign shareholders.

Table 2: Descriptive Statistics

Variables	Obs	Mean	Std. Dev.	Min	Max
REM	360	0.029	0.168	-0.228	0.232
MSO	360	0.193	0.220	0.000	0.713
ISO	360	0.491	0.249	0	0.880
FSO	360	0.271	0.281	0	0.750
AGE	360	24.31	13.273	6	43
LEV	360	0.540	0.249	0.047	0.960
FSIZE	360	7.208	0.702	6.031	8.543
FGRT	360	0.172	0.188	-0.990	0.614

Note. REM = Real earnings management; MSO= Managerial Ownership; ISO = Institutional Ownership; Foreign Ownership = FSO; Firm Age = FAGE; Leverage= LEV; Firm Size = FSIZE; Firm growth = FGRT *** significant at 0.01 level, ** significant at 0.05 and * at 0.1 level

Multicollinearity Assumption

The test of multicollinearity for the explanatory variables is show in Table 4. The test results indicate that the variables do not go beyond the acceptable limit. According to Gujarati (2004), the acceptable range of variance inflation factors (VIF) values should not be more than 10 as this may pose a problem of multicollinearity. In other words, multicollinearity happens when the tolerance value is less than 0.01 (Pallant, 2011).

Table 3: Multicollinearity Diagnostic Test

Variable	VIF	Tolerance
REM	1.07	0.9307
MSO	1.33	0.7541
ISO	1.32	0.7565
FSO	1.55	0.6434
AGE	1.32	0.7563
LEV	1.06	0.9443
FSIZE	1.36	0.7375
FGRT	1.04	0.9622
Mean VIF	1.26	

Correlation Matrix

Table 4 shown the outcome of the correlation as none of the coefficients is greater than 0.9 as indicated by Hair et al., (2010). The highest correlation is 0.4519 between ISO and FSO. Table 4 also shows that ISO, FSO, AGE, LEV and FGRT has a negative correlation with REM. While MSO has

insignificant correlation with REM while FSIZE have a positive significant association with REM.

Table 4: Correlation

Variable	REM	MSO	ISO	FSO	AGE	LEV	FSIZE	FGRT
REM	1							
MSO	0.2121*	1						
ISO	-0.0172	-0.1211*	1					
FSO	-0.0719	-0.1773*	0.4519*	1				
AGE	-0.0197	-0.3261*	0.0731	0.3525*	1			
LEV	-0.0374	-0.1040*	0.0011	0.1395*	0.2046*	1		
FSIZE	0.0274	-0.3240	0.3038*	0.3400*	0.0773	0.0901	1	
FGRT	-0.0274	-0.0574	-0.0316	-0.0139	-0.0076	0.0384	0.1626*	1

Note. REM = Real earnings management; MSO= Managerial Ownership; ISO = Institutional Ownership; FSO = Foreign Ownership; AGE = Firm age; LEV= Leverage; FSIZE = Firm Size; FGRT = Firm Growth *** significant at 0.01 level, ** significant at 0.05 and * at 0.1 level

Regression Results

This part presents the result of linear regression carried out to check the assumption of the relationship that arise between the dependent, independent and control variable. Table 5 show the linear regression model analysis.

Table 5: Result of the Estimated Regression

REM	Coefficient	Std. Err.	Z	P> Z
MSO	0.2120625	0.043264	4.90	0.000
ISO	0.0216945	0.0403923	0.54	0.592
FSO	-0.0774176	0.0388368	-1.99	0.047
AGE	0.0021326	0.0008096	2.63	0.009
LEV	-0.0723642	0.0376443	-1.92	0.055
FSIZE	0.0433537	0.0159484	2.72	0.007
FGRT	-0.0281473	0.0509809	-0.55	0.581
CONS	-0.3118965	0.1261862	-2.47	0.014
Firm Effect	yes			
Fixed Effect				
Year Effect	yes			
R Square	0.127			
Prob>F	0.0000			
Obs	360			

Note. REM = Real earnings management; MSO= Managerial Ownership; ISO = Institutional Ownership; FSO = Foreign Ownership; AGE = Firm Age; LEV = Leverage; FSIZE = Firm Size; FGRT = Firm Growth

Table 5 show the result of the relationship between the MSO, ISO, FSO, AGE, LEV, FSIZE, FGRT and REM. The result reveals that MSO has significant positive (Coeff 0.2120, P=0.000) with REM. This is an indication that MSO provoke managers to involve in REM. This view is in accordance with the entrenchment hypothesis which states that managers with large shareholdings are more likely to expropriate the resources of the shareholders. This is also consistent with Salehi, Mahmoudabadi and Adibian (2018) that documented a positive link between managerial entrenchment and earnings management.

Also, the regression outcome indicate that ISO has an insignificant positive relationship (Coeff 0.0217, P=0.592) with REM. This means that ISO do not influence the managers to involve in REM. This is similar to the findings of Abata and

Migiro (2016) that establish an insignificant linked between earnings management and institutional shareholders in Nigerian listed companies. Additionally, the findings indicate that FSO has negative significant relationship (Coeff -0.0774, P=0.047) with REM. The result is in accordance with the agency theory proposition that foreign share ownership serves as external mechanism of managing opportunistic behaviour (Jensen & Meckling, 1976). Also, consistent with Swai (2016), that documented a negative effect of foreign investors in restraining the propensity of REM.

The result reveal that the FAGE has a positive significant link (Coeff 0.0021, P=0.009) with REM. This suggest that older firms tend to engage in earnings manipulation than younger firms. This support the results of Khanh and Nguyen (2018), and Bala et al., (2019) that established a positive significant correlation between FAGE and earnings management. LEV have negatively significantly relationship (Coeff-0.0724, P=0.055) with REM. The findings is consistent with the assumption of agency theory that higher debt will put the firm on the scrutiny of borrowers and restrict them from unnecessary spending (Jensen, 1986). FSIZE have positive significant relationship (Coeff 0.0433, P=0.007) with REM. This Shows that larger firms based on their total asset engage in earnings manipulation. FGRT was negatively but insignificantly (Coeff-0.0281, P=0.55) related with REM.

Furthermore, the R2 of 0.12 shows the degree of variability of the independent variables (MSO, ISO, FSO, FAGE, LEV, FSIZE and FGRT) on the dependent variable (REM). This means 13% of changes in REM of listed firms is discussed by the combined influence of independent variables. The R2 is similar to the result of (Gao et al., 2017; Bukit & Nasution, 2015).

CONCLUSION

The study examines the effect of ownership structure (managerial, institutional, and foreign) on real earnings management. The results reveal that managerial ownership provoke managers to involve in earnings management and institutional ownership does not affect managers to involve in earnings manipulation. Also, the findings indicate that foreign shareholders prevent managers from engaging in earnings manipulation. Equally, the negative association between foreign investors and real earnings management contributes to agency theory that foreign shareholders provide knowledge and expertise, thereby strengthen the monitoring mechanism. The study suggests that listed companies in Nigeria should consider higher percentage of foreign ownership in order to improve their monitoring and have quality financial statement. The study also assists regulators such as Financial Reporting Council of Nigeria, Nigerian Securities and Exchange Commission to know that presence of foreign shareholders plays a significant role in mitigating the effect of earnings management.

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