EARNINGS QUALITY AND FINANCIAL PERFORMANCE OF LISTED SERVICE COMPANIES IN NIGERIA

Maimuna Jafaru Musa[1], Zakariyau Gurama[2], & Ahmed Ishiaku[3]
[1]Gombe Local Education Authority, Gombe State, Nigeria
[2&3] Department of Accounting Gombe State University, Gombe State, Nigeria
maimunajafarumusa@gmail.com[1]
zakariyaugurama@gmail.com[2]
ahmed12659@yahoo.com[3]

Abstract
The study investigates the impact of earnings quality on the financial performance of listed Service Companies in Nigeria. It highlights the global importance of financial reporting quality, the significance of Nigeria's service sector, and the unique features of Nigeria's regulatory environment as justification for the research. The study used correlational research and data from annual reports of sampled companies from 2011 to 2020, employing various statistical analyses. The results indicate that earnings persistence significantly positively influences financial performance (ROA), while earnings predictability has a positive but not significant effect. Additionally, earnings smoothness significantly enhances financial performance. The study emphasizes the importance of maintaining earnings quality in financial reports, as stakeholders rely on this data for decision-making. It also suggests that policymakers enforce strict compliance with financial reporting regulations for listed service companies, given the significant impact of earnings quality on investment decisions. In summary, the study underscores the necessity of upholding and improving earnings quality for the success of the service sector in Nigeria and wealth maximization for shareholders.

Key Words: Earnings Quality, Persistence, Smoothness, Predictability, Return on Asset

Introduction

Accounting information holds immense importance for the public and plays a pivotal role in decision-making. Stakeholders rely on accounting information that is unbiased, timely, relevant, accurate, transparent, comparable, predictive, understandable, verifiable, and unambiguous (International Accounting Standard Board IASB, 2019). Reliability, in particular, focuses on the quality of reported earnings, which should be free from errors and bias, faithfully representing the intended financial situation. Accounting information quality and earnings quality are closely intertwined, with the former directly influencing the latter.

Evaluating a company's performance involves a comprehensive assessment of its financial health, value, and operational results to make informed decisions (Bhakti, Nila, and Damayanti, 2019). A company's financial success is also heavily influenced by its performance relative to its competitors. This relative performance is significant for investors and creditors making capital allocation decisions and can impact the compensation of the financial accounting standard board (Dang, 2020).

Extensive research has explored the relationship between earnings quality and firm financial performance, encompassing both developed and developing countries. These studies have yielded intriguing insights, with some concluding that earnings quality can indeed impact financial performance (Warfield, Wild & Wild, 1995; Klein, 2002; Duarte, Lisboa, & Carreira, 2020). Furthermore, the time period covered by some of the previous studies in Nigeria leaves a gap. Saidu, et al., (2017) covered the period of 2011 to 2015, and Huynh (2019) covered the period of 2012-2015. These periods can be regarded as not too current as a lot of activities that have taken place, which include changes in the current corporate governance code of 2011 by the Nigeria Securities and Exchange Commission. Some of the findings of these studies may not be relied upon in view of the fact that the studies have been taken over by the changes. Similarly, the work of Huynh (2019) covered only four years, this could be considered too short to enable the generalization of findings.

However, in Nigeria, there are some studies such as Umoren, Ikpantan, & Ededeh (2018), Mohammad & Bassam, (2017) who studied earnings quality and financial performance from other sectors not listed service companies. This situation motivates this study to see how earnings quality affects financial performance of service companies in Nigeria. Furthermore, previous studies on the relation between earnings quality and financial performance revealed conflicting findings as in Radziah, Kamil & Pok (2017) who established that earnings quality has a positive effect on the financial performance of firms. However, Shehu (2011), Akintoye, et al., (2019) reported a negative effect of earnings quality on the financial performance of firms. Therefore, this study examined the effect of earnings quality and financial performance of service companies in Nigeria

However, prior studies in Nigeria have left a gap, with limited coverage of recent years and major regulatory changes. Some studies covered only a short timeframe, making it challenging to generalize their findings. Additionally, while there are global studies on earnings quality and financial performance, they often exclude listed service companies, which are a significant part of the Nigerian economy. In Nigeria, some studies have examined earnings quality and financial performance in various sectors, but there's a lack of research focusing on listed service companies. This knowledge gap motivates the present study to investigate how earnings quality influences the financial performance of service companies in Nigeria.

Moreover, existing studies on the relationship between earnings quality and financial performance have yielded conflicting results. While some studies found a positive effect of earnings quality, others reported a negative impact on financial performance.

This study seeks to bridge these gaps by examining the effect of earnings quality on the financial performance of service companies in Nigeria. Its findings will be invaluable for stakeholders seeking to understand the opportunities presented by listed service companies in Nigeria, influencing their decision-making. The primary objective is to investigate how earnings quality affects return on assets (ROA) for listed service companies in Nigeria, with specific objectives:

1. Assess the impact of earnings persistence on the return on assets (ROA) of listed service companies in Nigeria.
2. Investigate the effect of earnings predictability on the return on assets (ROA) of listed service companies in Nigeria.
3. Examine the influence of earnings smoothness on the return on assets (ROA) of listed service companies in Nigeria.

Literature Review

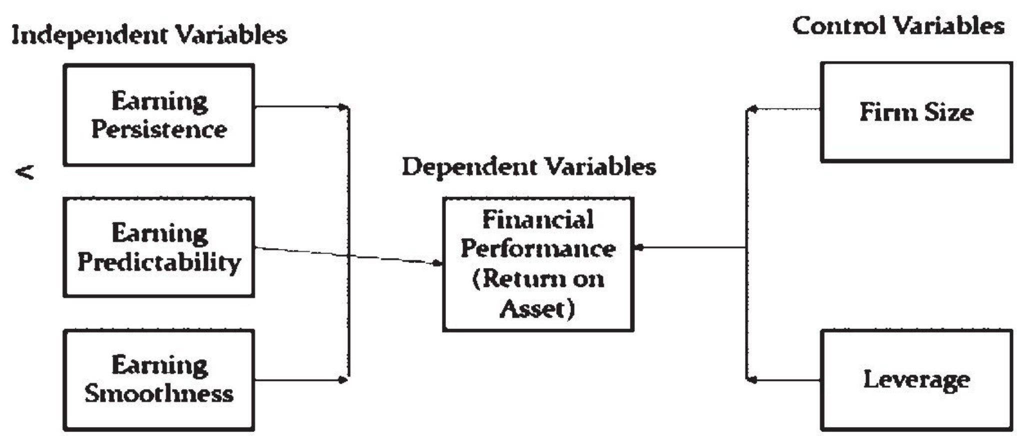
Concept of Earnings Quality

According to Aguguom, Dada & Nwaobia (2019) earnings quality can be referred to the degree to which reported earnings capture a firm's economic reality. Dechow & Dichev (2002) assert that earnings quality should be a reflection of the underlying economic realities of a firm's overall performance. In this regard, earnings have the features of quality if they can be sustained in the future because investors desire repeatability or stability of performance and earnings. Dechow & Schrand (2004) viewed earnings quality as that should reflect the firm's current operating performance and a good indicator of future operating performance. It should also be a useful summary measure for assessing firm value. Earnings quality can be referred to the degree to which reported earnings capture a firm's economic reality, Umoren, Ikpantan, & Ededeh, (2018) state that earnings quality is the extent to which reported earnings faithfully represent high income, where representational faithfulness means correspondence or agreement between a measure on description and the phenomenon that it purports to represent. However, in this study, earnings quality is defined as the extent to which reported earnings present a firm's economic reality to assess the financial performance of the company properly. Hence, quality earnings will give investors the ability to predict future earnings which may significantly influence their decision to divest or provide additional funds for investment.

Concept of Financial Performance

The subject of financial performance has received significant attention from scholars in the various areas of business and strategic management. It has also been the primary concern of business practitioners in all types of organizations since financial performance has implications to organization's health and ultimately its survival. High performance reflects management efficiency and effectiveness in making use of the company's resources and this in turn contributes to the country's economy at large (Adegbie, Salawu, & Usifoh, 2019). A well-designed and implemented financial management is expected to contribute positively to the creation of a firm's value. The dilemma in financial management is to achieve desired trade-off between liquidity, solvency, and profitability (Lazaridis & Tryfonidis, 2006). Financial performance (enterprise or corporate performance) is an important concept that relates to the way and manner in which financial resources available to an organization are judiciously used to achieve the overall business objective of an organization, it keeps the organization in business and creates a greater prospect for future opportunities (Bopkin & Abor, 2009). Good financial performance leads to efficient business performance management. Business performance management has three main activities: selection of goals, consolidation of measurement information relevant to an organization's progress against these goals, and interventions made by managers in light of this information with a view to improve future performance against these goals (Dang, 2020). Managing business performance is very important. ICAEW (2013) states that there are ten ways of business performance management, these are: planning and control, key performance indicators, balanced scorecard, benchmarking, business excellence model, enterprise risk management, Six Sigma, performance dashboard, customer relationship management, and performance appraisal.

The Conceptual Framework of this Study is Presented below in Figure 1



Empirical Review

Aguguom, et al., (2019) examined the potency and value relevance of earnings persistence (EPERS) and its effect on firm performance and the implications of the analysts' accurate forecast ability from the emerging market of Nigeria. The study adopted the expo facto research design and sampled 51 companies listed on the Nigerian Stock Exchange using stratified random sampling techniques for all the sectors from the 2000-2016 periods. Descriptive and Panel data regression statistics were employed in the analyzing the effect of earnings persistence on firm performance. The study revealed that earnings persistence had a negative and no significant effect on firm performance (Tobin's Q). Leverage exhibited a positive relationship whereas firm size revealed a negative relationship with Tobin's Q. Also based on findings, a weak growth trend was established between EPERS and Tobin's Q. Earnings persistence resulting from discretionary and opportunistic earnings could give inaccurate forecasting ability.

However, Akintoye, Adegbie, Nwaobia, & Kwarbai (2019) examined earnings quality and growth of listed firms in Nigeria. The variables for the study were accrual quality business growth, conservatism, e predictability and value relevance. The study used ex-post factor research design. The findings revealed that the quality of earnings had a significant effect on turnover growth. The study concludes that earnings quality is useful in determining the growth of firms.

Furthermore, Saleh, Abu Afif, & Alsufy, (2020) investigated the importance of earnings quality as a determinant of companies' performance. The study developed an econometric model for the effect of earnings quality on the companies' performance using empirical evidence. A panel data analysis method was employed with a Jordanian industrial public shareholding companies listed on the Amman Stock Exchange from 2010 to 2018. The results reveal that return on assets (ROA), return on equity (ROE), and earnings per share (EPS) as proxies of a company's performance are affected by the earnings quality.

This provides the importance of positive earnings quality that eventually influences the companies' performance. The results also show high relevance of accounting information will improve earnings quality. Cyril, Ogbogu, & Emeka (2020) determined the impact of earnings management on the financial performance of consumer goods firms in Nigeria. The dependent variable is financial performance proxy by total assets, equity, and total liability of the firms while earnings management is the independent variable (proxy by net profit or profit for the year). The findings show that earnings management does not have a significant impact on the financial performance of consumer goods firms in Nigeria.

Duarte, Lisboa, & Carreira (2020) investigated the impact of earnings quality on a company's performance. Findings revealed that high earnings quality has a positive impact on performance since the investment and financing decisions are based on correct information, thus increasing the company's profits and value creation. The study used panel data for 12 years (2008–2019). The study found that Iraqi banks are in a state of financial instability and that the EQ is significantly low. It was evident that managerial and concentration ownership has no effect as moderating variables on an administration's motives towards maintaining a bank's continuity and EQ.

Dang (2020) investigates the impact level of earnings quality on firm value. The results show that earnings quality is positively associated with firm value with statistical significance. In the same vein, Bazrafshan, Makarem, Hesarzadeh, & Salman (2021) investigated the association between managerial ability and earnings quality in firms listed on the Iraq Stock Exchange and how the emergence of the Islamic State of Iraq and Syria (ISIS) influences the association. The findings indicate that managerial ability positively affects the earnings quality of Iraqi firms and that ISIS weakens the relationship between managerial ability and earnings quality. However, none of these previous studies analyzed the influence of earning quality (earnings persistence, earning predictability, and earning smoothness) on financial performance (return on asset, return on equity, and return on capital employed) of listed service companies in Nigeria. Therefore, this study filled this literature gap.

Theoretical Framework

In assessing the effect of earnings quality on financial performance three theories were found to be commonly used to explain the relationship between earning quality and financial performance in the literature. These theories include agency theory, opportunistic theory, and income smoothing theory.

Agency Theory is applied to this study because it explains the relationship that exists between the investor and the managers. The agent (manager) undertakes to perform certain duties for the principal (investors) and the principal undertakes to reward the agent. Also, agency theory is based on the premise that the principal will always be interested in the outcome generated by the agents which is the financial performance of the company.

The Agency Theory examines conflicts between shareholders and managers in a company. Managers may not always act in the best interest of shareholders due to information disparities. Agency theory focuses on reducing these conflicts and costs, aligning manager incentives with shareholder interests, and improving corporate governance. Furthermore, Income Smoothing Theory involves altering financial results intentionally or naturally to create a stable income pattern. The Eckel's model is used to detect income smoothing, looking for artificial profit smoothing when profit coefficients fall below revenue coefficients. Whereas, Opportunist theory suggests that some managers prioritize their short-term self-interest over long-term shareholder wealth. They seek opportunities for personal gain, even if it means making decisions that harm shareholders in the long run. This theory distinguishes between efficient earnings management, which communicates future cash flows to investors, and opportunistic earnings management, which aims to mislead investors.

Methodology

This study is a quantitative study that used a correlational research design. Data were extracted from the annual reports and accounts of the sampled service companies listed on the Nigerian stock exchange for the period of 10 years (2011 to 2020). The study population is all the 14 service companies listed on the Nigerian Stock Exchange from January 2011 to 31 December 2020. The data were analyzed using descriptive statistics, correlation; and OLS regression analysis, robustness tests namely multicollinearity, heteroscedacity and Hausman specification were conducted to validate the results. Variables measured as Return on assets (ROA) = profit before tax divided by total assets, Earnings persistence = NIBEitoi + 1i $NIBE_{it}$ -1 + U_{it} Equation, Earnings predictability = as earnings persistence, Earnings smoothness = the percentage of the firm-level standard deviation of earnings and the standard deviation of the operating cash flow, Firm size = log of total assets, Leverage = total liabilities divided by the total assets.

Results and Findings

Descriptive Statistics

Table 1 provides a summary of statistics for the study variables. The statistics include measures of central tendency, such as mean, measures of dispersion, standard deviation, minimum, and maximum of the dependent variable, explanatory variables and control variables to effectively appreciate the nature of the results.

Table 1: Descriptive Statistics of the Variables

Variables	Obs	Mean	Std. Dev.	Min	Max
ROA	130	0.0292	0.1365	-0.8245	0.4413
EPERS	130	-0.0826	0.1735	-0.8263	0.6589
EPRED	130	1.5870	22.686	-190.08	119.84
ESM	130	0.1220	0.2570	-1.2728	0.8522
FS	130	9.5185	0.5232	8.3613	10.587
LEV	130	0.3547	0.2101	0.0039	0.7211

Source: STATA Output, (2023)

The descriptive statistics on Table 1 revealed that return on assets has a mean of 0.0292, and the standard deviation of 1.3659, with a minimum and maximum of -0.8245 and 0.441 respectively; the standard deviation of 1.3659 signifies high variation in return on assets of the companies within the period under study. Earnings persistence has a mean of -0.0826 with a minimum and maximum of -0.8263 and 0.6589 respectively and a standard deviation of 0.1735 shows that the earnings persistence of the companies under study deviated significantly. Earnings predictability has a mean of 1.5873, and a standard deviation of 22.686 with a minimum and maximum of -190.08 and 119.84 respectively. The standard deviation confirmed the absence of significant deviation within the period under study.

Earnings smoothness has a mean of 0.1220, and a standard deviation of 0.2570 with a minimum and maximum of -1.2728 and 0.8522 respectively. On average the companies under study have an average size of 9.5185, a standard deviation of 0.5232 with the minimum and maximum of 8.3613 and 10.587 respectively. Leverage has a mean of 0.3547, meaning, on average, the companies listed in the Nigerian service sector is approximately 35% with a minimum and maximum of 0.0039 and 0.7211 respectively, however, a standard deviation of 0.2101 signifies no variation in the use of debt within the period under study.

Correlation Matrix

The correlation coefficient shows the relationship between the dependent variable (financial performance), explanatory variables (earnings persistence, earnings predictability, and earnings smoothness), and control variables (firm size leverage). The values of the correlation coefficient range from -1 to 1 which indicates the direction of the relationship (positive or negative), the absolute values of the correlation coefficient indicate the strength, with larger values indicating stronger relationships.

Table 2: Correlation Matrix

	ROA	EPERS	EPRED	ESM	FS	LEV	VIF
ROA	1.0000						
EPERS	0.3432	1.0000					1.20
EPRED	0.0341	-0.0517	1.0000				1.02
ESM	0.7751	-0.2893	0.0662	1.0000			1.13
FS	0.1391	-0.0983	-0.0504	0.1772	1.0000		1.15
LEV	-0.1287	-0.2836	-0.1148	0.0401	0.3179	1.0000	1.23

Source: STATA Output, (2023)

It can be seen from Table 4.2 that earnings persistence, earnings predictability, earnings smoothness, and firm size have a positive correlation with all the measures of financial performance (ROA). This suggests that the variable increases financial performance (ROA). Hence, as earnings persistence, earnings predictability, earnings smoothness, and firm size increase, financial performance increases. However, leverage is negatively correlated with financial performance (ROA) with a correlation coefficient of -0.1287. This means that an increase in leverage decreases financial performance. The variance inflation factor (VIF) of all the variables revealed the absence of multicollinearity as the VIF test result ranges between 1.02 to 1.23.

Multicollinearity Test

Multicollinearity is a statistical phenomenon in which two or more predictor variables in a multiple regression model are highly correlated. In this situation, the coefficient estimates may change in response to small changes in the model or the data (Samaila, 2014). This study used VIF to check for the presence of multicollinearity between the explanatory variables in the models. According to Gujarati (2003), VIF above 10 is an indication of multicollinearity. The result from the VIF test is less than 5 for all the study variables which is an indication of the absence of multicollinearity. This gives concrete evidence that the regression data is free of regression errors capable of invalidating the research's regression assumptions. This makes the regression estimates reliable and enhances its accuracy.

Heteroskedasticity Test

The test is conducted to check whether the variability of error terms is constant or not. The presence of heteroskedasticity signifies that the variation of the residuals or term errors is not constant which would affect inferences on respect to the beta coefficient, coefficient of determination (R^2), t-statistics, and F-statistics of the study. Test of heteroskedasticity ensures that the regression fits all the values of the independent variables and this is possible only if the residuals do not vary with the independent variable and therefore are random. The result of the heteroskedasticity test reveals the absence of heteroskedasticity in the model (0.0709). However, this was corrected through the OLS robust test.

Hausman Specification Test

Hausman test reveals a p-value of less than 5% in the model suggesting that the fixed effect regression model fits the data. The fixed effects regression represents a common, unbiased way of controlling for omitted variables in a panel set. An important assumption of the fixed effect model is that those time-invariant characteristics are unique to the individual firms and should not be correlated with other firms' characteristics (Saidu, Ibrahim, & Muktar 2017). It removes the effect of those time-invariant characteristics from the predictor variables to assess the predictors' net effect.

Table 3 Diagnostic Test

Model	Variance Inflation Factor (VIF)	Heteroskedasticity	Hausman Test	Lagrange Multiplier (LM)
One	1.15	0.0709	0.0030	0.6561

Source: STATA Output, (2023)

Regression Analysis

Table 4: GLS (Fixed Effect) Regression Results for ROA

Variables	Coefficient	Std. error	Z-statistics	P-value
EPERS	0.4824	0.0166	29.15	0.000
EPRED	8.5806	0.0001	0.07	0.942
ESM	0.5111	0.0121	42.41	0.000
FS	-0.0175	0.0100	-1.75	0.083
LEV	0.0241	0.0213	1.13	0.260
_cons	0.1651	0.0950	1.74	0.085
R-square		0.9443		
P-Value		0.0000		
F-statistics		4.62		
Mean VIF		1.23		
Hettest		0.0709		

Source: STATA Output, (2023)

Table 4 shows the value of R^2 as 0.9443 which is the multiple coefficients of determination that gives the proportion of the total variation in the dependent variable explained by the explanatory variables jointly. Hence, it signifies that approximately 94.43% of the total variation in return on assets of sample companies is caused by earnings persistence, earnings predictability, earnings smoothness, firm size, and leverage. The F-statistics value is 4.62 with the corresponding P-value of 0.0000. This implies that the relationship among the variables was not due to mere chance and as such the results from the regression can be relied upon. The results show that earnings persistence has a positive and significant impact on return on assets. This is because the investment and financing decisions are based on correct information, thus increasing the company's profits and value creation. This finding is consistent with the findings of Akintoye, et al., (2019) who reported that the quality of earnings had a significant effect on turnover growth.

Earnings predictability has a positive and insignificant effect on return on assets implying that more predictable future earnings will positively influence current earnings. This is consistent with a prior expectation because when earnings are accurately predicted with certainty it will influence current and prospective investors to increase their investment this will increase the capital base and increase firm potentiality in generating returns. This finding is consistent with the findings of Huynh (2019) who found that earnings quality plays an originating role within the vicious linkage where earlier earnings quality is a cause of current financial performance that in turn affects subsequent earnings quality. It is also consistent with Bhakti, et al., (2019) who revealed that earnings quality has a significant effect on the financial performance of banks in Indonesia.

Earnings smoothness showed a positive and significant relationship with return on asset implying that income smoothening increases financial performance. This finding is consistent with the findings of Radziah, Muhd, & Wee (2017) who found that the earnings quality of Malaysian publicly listed firms has a positive association with firm performance. Also, Aguguom & Rufus (2018) found that earnings quality proxies jointly had a positive significant effect on the financial performance of the firms. However, the result reveals that the size of the company has a negative and insignificant effect on return on assets. Thus, ceteris paribus an increase in the size of a company will lead to a decrease in return on assets; this implies that the larger the size of the company without a corresponding increases in earnings the lower the return on assets. This finding is consistent with the findings of Akintoye, et al. (2019) who found that company size is inversely related to stock return and statistically significant at 1%. The leverage revealed a positive but not significant relationship with return on assets indicating that an increase in debt capital to total assets by 1% will lead to an increase in the level of return on assets by 0.4979% and this relationship is statistically insignificant.

Conclusion and Recommendation

This study examined the effect of earnings quality on the financial performance of listed service companies in Nigeria. Therefore, from the findings this study concludes that the need to ensure earnings quality in the financial report by listed service companies is inevitable since all stakeholders rely on it for effective decision-making. The study also, concludes that the significant positive effect of earnings quality on the return on assets of listed service companies in Nigeria is very necessary since the aim of these companies is to maximize shareholders' wealth. In addition, the investment decisions and financing decisions are made based on correct and reliable information, thus increasing the company's profits-generating capacity and value creation for all stakeholders.

Therefore, this study recommends that since earnings predictability has a positive and significant effect on return on assets management of listed service companies in Nigeria should ensure high predictable earnings since lower predictability will be detrimental to investment decisions. Also, policy-makers should ensure strict compliance with policies that guide the preparation and publication of financial reports by listed service companies since investors relied significantly on financial report for their investment decisions.

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