

# MANAGERIAL INCENTIVES FOR EARNINGS MANAGEMENT AMONG LISTED FIRMS: EVIDENCE FROM FIJI

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## ABSTRACT

*High profile corporate collapses of the past decade have undermined the integrity of financial reporting. Earnings management has been of growing concern to many academics, practitioners and regulators. Despite an enormous amount of regulation and standards governing the financial reporting process, earnings management practices are accelerating at an alarming rate in organizations today. Fiji, like many other developed countries, has had instances of financial reporting failures. One does not need to look further than the multimillion-dollar saga involving the state owned Bank, the National Bank of Fiji, which was the largest known financial scandal in the history of Fiji and the Pacific Islands. This suggests that even emerging economies like Fiji were long ago, introduced to earnings management practices. However, this has not been apparent. Most studies on managerial incentives for earnings management, have been conducted in the USA, UK, Canada, Australia and New Zealand. Very few studies took place in emerging economies like Fiji. This study uses a questionnaire-based approach to examine managerial incentives for earnings management among listed firms in Fiji, highlighting the most prevalent incentive.*

**JEL:** M41

**KEYWORDS:** Incentives for earnings management, emerging economies

## INTRODUCTION

Recent corporate collapses such as Enron, WorldCom, HIH Insurance and the demise of Arthur Anderson have undermined the integrity of financial reporting. Earnings management also known as creative accounting, income/earnings smoothing, financial engineering and cosmetic accounting has been a growing concern for academics, practitioners and regulators for quite some time. It has also become a central issue to accounting research. In the past, there have been instances of financial reporting failures in Fiji, such as the collapse of the state-owned bank, the National Bank of Fiji (NBF). The NBF's case was the largest known financial scandal in the history of Fiji and the Pacific Islands (Grynberg et al., 2002). The failure of this magnitude resulted from improper accounting practices, corruption and mismanagement. Despite regulations and monitoring by the Reserve Bank of Fiji, the Auditor General and the Ministry of Finance, the National Bank of Fiji collapsed. This collapse emphasizes the need for more policies that require adherence to good accounting practices and financial disclosures, sound corporate governance and robust banking supervision (Singh, 2008). The NBF case suggests that emerging economies, like Fiji, have been introduced to earnings management practices long ago. However, this introduction was not apparent.

Corporate collapses and prior studies (Healy, 1985; McNichols and Wilson, 1988; DeFond and Jiambalvo, 1994; Nelson et al., 2002) have strongly suggested that earnings management is becoming a common business practice in most companies today. This justifies the need to study earnings management practices in our economies. Such practices not only have an adverse impact on financial and investment decisions but also obscure a firm's intrinsic value. More importantly, we must also consider incentives that give rise to such practices.

A large number of studies (DeAngelo, 1986; Cahan, 1992; Beneish, 2001; Singh, 2008) have been conducted to determine the managerial incentives for earnings management, most of which have focused on private sectors in developed economies such as USA, UK, Canada, Australia and New Zealand. In emerging economies, such studies are rare and hardly pursued. Due to the presence of institutional and regulatory differences between developed and emerging economies, it is not only difficult but also futile to generalize research results from studies in developed to emerging economies.

Singh (2008) reveals that accounting standards in Fiji do not have a legal backing and has a weak regulatory environment that permits high levels of manipulation. Our research contributes to earnings management literature by examining provisions in management policies and practices (for example, management compensation policies, forecasts, etc) of listed companies that actually create incentives for earnings management. Additionally, we intend to identify the most prevalent incentive for earnings management amongst listed firms in Fiji.

These findings will provide FIA and other standard setters in emerging economies evidence on the most common driver for earnings management, which should assist them in formulating relevant financial reporting and corporate governance policies to ensure that management makes adequate disclosures. It should also assist users especially investors and financiers while reviewing annual reports to be cautious if the firm concerned displays characteristics that are aligned with the most prevalent incentives for earnings management. Moreover, our findings would compel auditors to be more vigilant in the auditing process if their clients have policies and practices that would allow such incentives to take effect.

The paper comprises of five sections. Section 1 summarizes the literature review on the incentives for earnings management. Section 2 outlines the research methodology adopted in the study and Section 3 analyses and discusses the results of the study. Section 4 outlines the conclusion and limitations.

## **LITERATURE REVIEW**

### What is Earnings Management?

According to Healy and Wahlen (1999), “earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported outcomes.” Levitt (1998) defines “earnings management as a gray area where the accounting is being perverted, where managers are cutting corners; and, where earnings reports reflect the desires of management rather than the underlying financial performance of the company.” Schipper (1989) defines earnings management as a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain. Until today, there is no single universally accepted definition of earnings management. A lack of consensus on the definition of earnings management implies differing interpretations of empirical evidence in studies that seek to detect earnings management, or to provide evidence of earnings management incentives (Beneish, 2001).

With a substantial amount of regulation and standards governing the reporting process, how is it that the practice of aggressive earnings management is accelerating at an alarming rate in organizations today? The financial reporting process governed by GAAP allows managers with some level of flexibility in preparing their reports to ensure that the reports reflect relevant and reliable information. Although, flexibility in financial reporting grants managers with the freedom to choose accounting policies and procedures, managers tend to misuse this freedom in altering the reported earnings in order to receive bonuses, avoid violation of debt covenants and so forth. Leaving GAAP aside, our study attempts to discover if organizations have provisions in their management contracts and firm policies, which give rise

to earnings management practices. We are undertaking an in-depth study of the policies of the firm in respect to earnings management incentives.

### Why does Earnings Management occur?

Academics often use agency theory in describing earnings management behavior. Agency theory is simply the agency relationship that exists between management and shareholders. Jensen and Meckling (1976) define agency relationship as "...a contract relationship where one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent" (p. 6). If both the principal and agent are utility maximisers, it is reasonable to believe the agent will not always act in the best interests of the principal. This divergence in interest of the two parties results in agency problems. It is apparent that such problems arise because of asymmetric information between the agent (management) and the principal (shareholder and other stakeholders). Management possesses a more complete set of organizational information relative to current and potential stakeholders as management not only makes day to day business decisions but also controls daily business operations. Therefore, information asymmetry arises when management does not communicate all information, resulting in conflict between the privileged agents (management) and the remote body of stakeholders.

Richardson (2000) found a positive relationship exists between the levels of information asymmetry and earnings management and hence provided empirical evidence suggesting that information asymmetry is a necessary condition for earnings management. Consequently, increasing levels of information asymmetry makes it difficult for stakeholders to see through earnings manipulation as they lack the necessary resources, incentives or access to relevant information that would ensure effective monitoring of management actions, decisions and choices. Therefore, agency theory provides a solid framework for understanding earnings management as it provides agents with economic incentives to manipulate financial results.

### Managerial Compensation Incentives

One of the most common incentives for managing earnings is the manager's remuneration package. In most businesses, managers are entitled to cash bonuses or share options upon achieving predetermined reported earnings. It is quite common for management employment contracts to include accounting based constraints that determine compensation opportunities, such as annual salary increases, bonus, performance evaluation, and reaching targets set in compensation contracts (Singh, 2008).

Healy (1985), showed how upper and lower bounds on executive bonus packages encourage managers to make discretionary accounting accruals in a strategic manner. Hence, compensation contracts specifying minimum levels of profits to grant bonuses provide incentives for income increasing or income decreasing earnings management depending on the actual level of profits attained in a particular period. Healy (1985) used accruals and changes in accounting procedures and found that managers choose income-increasing accruals as long as profits fall within the minimum and maximum boundaries. However, managers also tend to move towards income decreasing accruals if earnings are above the maximum level. Gaver et al., (1995) extended Healy's study by examining the relationship between discretionary accruals and bonus plan bounds using a sample of 102 firms for the period 1980-1990. They found that when earnings before discretionary accruals are below the lower bound, managers select income increasing discretionary accruals (and vice versa). Gaver et al., (1995) thus believe that their results are more consistent with income smoothing hypothesis than with Healy's bonus hypothesis.

### Borrowing Cost Effects

The firm's closeness to violating its debt covenant provides its management with another incentive to engage in earnings management. Mulford and Comiskey (2002) describe debt covenants as stipulations included in debt agreements designed to monitor corporate performance. For instance, a lender might instruct that a certain value for an accounting ratio be maintained or impose limits to investing and financing activities. If the borrower violates the debt covenant, the lender might increase the interest rate, requiring additional financial security, or calling for immediate repayment. Therefore, debt covenants provide incentives for earnings management either to reduce the restrictiveness of accounting based constraints in debt agreements or to avoid the costs of covenant violations (Beneish, 2001). According to Christie (1990), the closer a firm is to violating its debt covenant restrictions; the more likely it is for its managers to adopt income increasing accounting choices.

Additionally, DeFond and Jiambalvo (1994) suggest that managers of firms reporting debt covenant violations in their annual report adopt income increasing accounting choices in the years prior to the violation. Sweeney (1994) also finds that covenant violators manipulate earnings, but in the year(s) following rather than prior to the violation, indicating that earnings are not managed specifically to avoid violating a lending contract but to reduce the likelihood of violating them in the future. However, Healy and Palepu (1990) find no such evidence of earnings management in their study of firms with binding debt covenants.

Dichev and Skinner (2002) used a database of private lending agreements for USA firms in order to provide large sample tests of the debt covenant hypothesis. They found an unusually small number of loans with financial measures just below covenant thresholds and an unusually large number of loans with financial measures at or just above covenant threshold. Therefore, they provide solid evidence that managers take actions either to reduce the restrictiveness of accounting based constraints in debt agreements or to avoid the costs of covenant violations.

### Equity Offerings

Share issues provide a direct incentive for management to engage in earnings management as higher earnings would result in increased share prices implying an increase in market valuation and a reduction in cost of capital. Dechow and Skinner (2000) suggests that if managers are able to increase reported earnings without detection, they can improve the terms of the public offer. In this way, they are providing direct monetary benefits to themselves as well as their firm. Studies examining equity offerings as an incentive for earnings management usually test whether managers manipulate earnings in periods prior to initial public offers (IPO) and seasoned equity offerings. IPOs are highly susceptible to earnings management because of the existence of asymmetric information between the investors and IPO issuers. As there is no previous market price for shares, management has an opportunity to manipulate earnings to increase its introductory price.

Teoh et al., (1998) examine the relationship between underperformance of IPOs in subsequent periods and earnings management by using a sample of 1649 IPO firms in USA. Their study reveals that issuers with unusually high accruals in the IPO year experience poor stock returns in the three years thereafter. Their study concludes that the underperformance of firms in years after IPO is largely due to earnings management in the year of IPO. Likewise, Rangan (1998) provides evidence of earnings management at the time of seasoned equity offerings. His study disseminates that at the time of the issue, firms report unusually high earnings due to unusually high accruals. However, in subsequent years, firms report poor earnings performance. Both the studies indicate that a strong association exists between the extent of earnings management and subsequent stock returns.

### Management Buyout

In case of a management buyout, there is downwards earnings management. In such a situation, management faces a conflict as they have a fiduciary duty to the shareholders to get the best price for the firm and as buyers, managers would not want to pay a high price. Hence, managers have an incentive to reduce reported earnings prior to the buyout. DeAngelo (1986) claim that the management of buyout firms would understate earnings, as information about the firm's earnings play an important role in the valuation of management buyouts. She uses a sample of 64 New York and American Stock Exchange companies, whose managers proposed to buyout the firm, over the period 1973-1982. However, DeAngelo (1986) finds little evidence that managers of buyout firms systematically select accounting accruals to understate reported income in periods before the buyout. Perry and William (1994) examined discretionary accruals of a sample of 175 management buyouts during 1981- 88. Their findings provide convincing evidence of income decreasing earnings management prior to a buyout.

### Meeting Targets/Expectations

Financial analysts or management usually forecast firms' expected earnings prior to year-end. DeGeorge et al., (1999) tries to find out whether firms manage earnings in order to meet analyst's earnings forecasts. Their study reveals that firms report abnormally high earnings just to meet or exceed the analyst's forecast. Kasznik (1999) examined whether managers who issue annual earnings forecasts practice earnings management to meet their forecasts. His study of 499 firm years (366 firms) with management earnings forecast issued between 1987 and 1991, reveals that positive discretionary accruals was used to manage earnings upwards when earnings were below management forecast.

### Reduce (Increase) Regulatory Cost (Benefits)

Regulatory concerns can also induce management to engage in earnings management. Usually firms that are vulnerable to anti-trust investigations or other adverse political consequences or firms seeking government subsidy have enormous incentives to manage earnings to appear less profitable. Jones (1991) examines whether regulatory scrutiny increases the likelihood of earnings management by firms benefiting from import relief assistance in form of tariff increases or quota reductions. His study provides evidence of firms practicing income decreasing earnings management in order to qualify for import relief assistance.

Additionally, Cahan (1992) uses a sample of 48 firms to investigate the effect of monopoly related antitrust investigations on firms' reported earnings from 1970-1998. His findings suggest that firms under scrutiny reported income-decreasing discretionary accruals in the investigation years.

Finally, we have selected these incentives for our study, as these are strong incentives and well established in literature. While the above practices are important incentives driving earnings management among firms, numerous other factors give rise to the issue that may be unexplored by academics. Factors that deter earnings management practices among firms are the firm's internal governance structure, previous accounting decisions made by the firm that limit future discretionary choices and the costs imposed on the entity should earnings management be revealed (Becker et al., 1998).

## **METHODOLOGY**

In this paper, we examine the practices and policies of firms that give rise to earnings management. In order to obtain information about firm policies and practices that is not publicly available, we emailed questionnaires to CEO's of listed companies. In some cases, where the CEO was unavailable, we requested an interview with the company's CFO. The respondents completed the questionnaire in the

presence of the researcher. Researchers were present in case the respondents needed clarification about any issues.

In the questionnaire, we had closed-ended questions, whereby the researcher provided a suitable list of responses. This type of questionnaires produces quantitative data. Closed questions provide little or no scope for the researcher to misinterpret the meanings of answers. For example, if an answer is restricted to “Yes / No / Don’t Know” it is easy for the researcher to understand the exact intentions of the respondent. However, it also does not give an in-depth picture of the study, as it is possible that respondents had some other answers to the research questions. That is another reason researchers were present before the respondents so they could discuss and note down any other important points that came to attention.

Our intended group of recipients for the questionnaire was the management team from each listed company. This is because we felt that a member of the management team would be the best person to answer the questionnaire as he/she has access to inside company information. Managers are in-charge of the day-to-day operations of the company and therefore possess more knowledge about their management policies and practices.

There are sixteen companies listed on the South Pacific Stock Exchange. This was our initial sample for the study. The sample was reduced to 14 because one of the listed firms was a financial institution and consistent with prior studies financial institutions were excluded due to their unique working capital structures. Another listed company was unavailable for interview and failed to return our questionnaire despite several calls and emails.

## **RESULTS AND DISCUSSIONS**

### **Management Compensation Incentives**

After analyzing information obtained from questionnaires, management compensation is the most common incentive for earnings management in listed companies in Fiji. In order to enhance performance, listed companies have in place performance-based contracts for senior managers. In the entire sample, members of the management team are entitled to other incentives apart from normal salary, for instance, bonuses, annual salary increments, share options etc. These additional incentives are based on certain performance evaluation criteria. Generally, Human Resources Department (HR), Board of Directors (BOD), senior executives or remuneration/compensation committee, set the criteria for rewards or remuneration. BOD and other senior executives set the KPI’s for the management in 86% of the listed companies. In the other 14%, HR sets the criteria for rewards.

The results in Table 1 show all respondents revealed that performance evaluation criteria for rewards are present in the management contracts. Sales, gross profit, cost, share price and customer listing are the basis on which management receives additional rewards. The achievement of this is significantly important to managers. Profit and sales was the most common benchmark for rewards in the management compensation policies amongst all listed companies. Therefore, if management remuneration is dependent upon entity profit or sales for the period, managers may manipulate firm earnings so they can reach their sales/profit targets and get additional rewards.

Further, all respondents stated that their respective supervisors monitor management performance on a monthly basis. Criterion such as comparative data, non-financial measures and variance analysis are used when monitoring management performance. According to 21% of respondents, if managers fail to perform, they face severe consequences, such as lay-off, non-renewal of contract and demotion. For the remaining 79% firms, there are no severe consequences, except that they will not receive any additional

benefits. A respondent stated that they have implemented a performance management system in their firm whereby they ensure that those employees who do not meet their KPI's or performance expectations undergo additional training so that they do their tasks well.

Table 1: Summary Statistics for Managerial Compensation Incentive

Managerial compensation incentive issues examined	Number of firms (/14)
<b>WHO SETS THE CRITERIA FOR REWARDS?</b>	
Human Resources	2
Board of Directors	8
Senior executives	4
Remuneration committee	0
<b>FACTORS LIKELY TO HAVE AN IMPACT ON THE ACHIEVEMENT OF REWARDS</b>	
Sales	11
Cost	9
Profit	14
Share price	9
Customer listing	9
Ratios	1
<b>CRITERIA USED FOR MONITORING MANAGEMENT PERFORMANCE</b>	
Comparative Data	14
Nonfinancial Measures	7
Variance Analysis	7
<b>CONSEQUENCES FOR UNFAVORABLE PERFORMANCE</b>	
Non renewal of contract	1
Demotion	1
Non entitlement of benefits	0
Decline in work responsibility	1

*The figures represent the frequency of responses for each option under the respective criterion.*

### Borrowing Cost Effects

Table 2 presents the results on borrowing cost effects. Banks and other financial institutions impose debt covenants on the firm's loan agreements. From our analysis, it is evident that debt financiers have imposed some form of debt covenant on 57% of the listed firm's loan agreements. The stipulations presented in the loan agreement of these firms are in the form of: restrictions on levels of financing and investing activities that the firm can undertake; maintaining debt ratios at a specific level; and restrictions on future loan approvals. To avoid violation of debt covenants, managers have an incentive to increase reported earnings. Results disseminate that 43% of the listed firms did not have a loan agreement with anyone.

None of the respondents admitted to violating any debt covenants. If any of these firms were on the verge of violating their debt covenants, they would discuss the issue with their debt financiers to identify other possible means of making up for the violation. If in the future, if firms violate their debt covenants, the likely penalties would be immediate repayment, a chance to improve performance or additional cost incurred to restructure a loan.

### Equity Offerings and Management Buyouts

Equity offerings are probably the least common incentive for earnings management in Fiji. This is because of the highly inactive share market in Fiji. There is little share trading taking place. There has not been an instance of management buyout in any of the listed Fiji firms. However, we cannot rule out

the possibility as an incentive in the near future. Usually, management buyout is a method for privatizing state owned entities. A management buyout attempt example in Fiji is the case of Rewa Rice Limited in 1999 when the government was planning to sell off its shares. However, management's offer was declined.

Table 2: Summary Statistics for Borrowing Cost Incentive

Borrowing cost incentive issues examined	Number of firms (/14)
HAVE DEBT FINANCIERS IMPOSED ANY DEBT COVENANTS?	8
STIPULATION PRESENT IN THE LOAN AGREEMENT	
Restrictions on level of financing and investing activities	1
Debt ratios to be maintained at a specific level	6
Restrictions on future loan approvals	1
IF FIRM IS ON THE VERGE OF VIOLATING DEBT COVENANT	
Discuss with debt financier	8
Do anything to not violate covenant	0
Do nothing	0
PENALTIES IN THE CASE OF DEBT COVENANT VIOLATION	
Immediate repayment	1
Cease of loan	0
Chance to improve performance	6
Negotiations to make it work for both parties	1

*The figures represent the frequency of responses for each option under the respective criterion.*

### Meet/Beat Targets/Expectations

Fiji, does not have analysts who forecast or make predictions about firm performance. Therefore, our results solely focus on internal forecasts. In all the listed firms, Board of Directors, CEO's and managers set targets for various divisions in the company. Various factors such as past trends, non-financial measures, competition levels, demand for products/services and current economic conditions are all considered when setting company targets. "Economic conditions such as devaluation and political upheavals in Fiji in the past have led to non-achievement of management forecasts," commented one of the respondents. With the presence of unpredictable events such as these, managers may not be able to meet their targeted expectations and this may lead to managing earnings upwards.

Except for one firm, all other firms experienced significant variances when actual performance was compared with forecasted trends. Most respondents said the variances were due to economic conditions in Fiji such as the military coup, devaluation and so forth. There could be dire consequences for non-achievement of forecasts by companies such as a reduction in management remuneration and a decline in share price if a particular company continually does not meet their targeted company expectations.

One respondent also stated that if management does not meet their forecasted earnings, and they do not have a valid reason, their employment is at risk in the company. This means that to save their employment, the managers might have to engage in earnings management.

### Reduce (Increase) Regulatory Costs (Benefits)

A number of firms receive some form of assistance from the government such as grants or subsidies. One respondent stated that they receive concessionary rates of duty on capital investments. Another stated they receive tax exemptions on local production of wood chips. One respondent stated that they had tax exemptions upon listing in 2000, however this has expired and they no longer receive any assistance from the government. The results show 79% of listed firms did not receive any form of assistance. This

indicates that only a few listed firms would be inclined to report conservative earnings so that they can qualify for subsidies and other grants from government.

Table 3: Summary Statistics for Meet/Beat Targets Incentive

Meet/Beat targets incentive issues examined	Number of firms (/14)
WHO SETS TARGETS FOR VARIOUS COMPANY DIVISIONS	
Managers themselves	12
BOD	6
CEO	4
Analyst	0
WHAT FACTORS TO CONSIDER WHEN SETTING COMPANY TARGETS	
Past trends	14
Nonfinancial measures	11
Competition levels	14
Demand for products	11
Current economic conditions	14
DO PAST TRENDS INDICATE SIGNIFICANT ACTUAL/FORECAST VARIANCE	13
CONSEQUENCE FOR NON ACHIEVEMENT OF FORECASTS	
Decline in share price	5
Reduction in management remuneration	1
Reduction in market share	6
Damage to reputation	2

*The figures represent the frequency of responses for each option under the respective criterion.*

Apart from major incentives discussed in the literature, there could be other incentives driving earnings management amongst listed firms. One of these could be for the purposes of *job security*. Managers are under pressure to perform; otherwise, they are at risk of losing their jobs. For example, in Fiji, the management of Airports Fiji Limited and Fiji Electricity Authority were once fired because of poor performance. In order to retain their jobs, managers have the incentive to manipulate earnings.

## CONCLUSION

Recent corporate collapses and prior studies have indicated that earnings management is a pervasive phenomenon. Fiji's weak regulatory environment makes it subject to high level of earnings manipulation therefore it becomes important to study earnings management practices in emerging economies like Fiji.

The paper contributes to literature by examining provisions in management policies and practices that drive earnings management. Our analysis revealed that common incentives for earnings management in Fiji are management compensation incentive, borrowing cost incentive, incentive to meet/beat targets/expectations and increase (decrease) regulatory benefits (costs). Management compensation is the most prevalent incentive for earnings management in Fiji. The least common incentives were equity offerings due to highly inactive share market; and management buyout as this situation is rare among listed firms to date.

There could be other incentives for earnings management that has not been addressed in this research. We have attempted to examine all the strong incentives that drive earnings management and were prevalent in prior literature. Moreover, the sample size of 14 would be quite small to generalize these research findings to all emerging economies. Further research could focus on private and public sector companies in Fiji.

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