

Firms Characteristics and Financial Statements Fraud in Nigeria

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Abstract

This study investigates the relationship between firm characteristics and financial statement fraud in Nigerian manufacturing firms. Using a sample of all 57 manufacturing companies that have the potential to exhibit the firm characteristics and financial statement fraud being investigated. As of 2022, using Lusha database business leads from manufacturing companies in Nigeria., we examine the impact of firm size, profitability, fictitious revenue, financial reporting quality, and corporate governance on the likelihood of financial statement fraud. Our results show that firms with weaker corporate governance, lower profitability, and higher leverage are more likely to engage in financial statement fraud. Additionally, we find that financial reporting quality have no significant effect on financial statement fraud. The study contributes to the literature by providing evidence on the factors that influence financial statement fraud in Nigerian manufacturing firms. This study adopted a quasi-experimental research design which helps to examine the impact of firm characteristics on fraudulent financial statement fraud in Nigeria. The findings have implications for regulators, auditors, and investors seeking to mitigate financial statement fraud in Nigeria.

Keywords: Firms characteristics, Financial statement fraud, Profitability, Firms size, Leverage, Nigerian Manufacturing Firms

1 INTRODUCTION

Deliberately falsifying a company's financial status, or financial statement fraud, has dire repercussions for all parties involved, including creditors, employees, and investors. This danger does not exempt Nigeria's industrial sector, which makes a substantial economic contribution to the nation (Central Bank of Nigeria, 2020). Financial statement fraud can be prevented in large part by a company's attributes, including CEO duality, audit committee effectiveness, and board composition (Akanni, 2018). Nonetheless, the association between firm characteristics and financial statement fraud may be influenced by the distinct cultural, economic, and regulatory environment of Nigeria's manufacturing sector (Olowe, 2018). Research has indicated that corporate attributes, such the experience of the audit committee, can influence the probability of financial statement fraud (Akanni, 2018).

Certainly. In Nigeria, manufacturing firms often face challenges related to weak corporate governance structures, which include factors such as ineffective board oversight, lack of transparency, and insufficient checks and balances within the organization. These weaknesses provide opportunities for fraudulent activities, including financial statement fraud. For instance, when there's inadequate oversight from the board of directors, management may feel less accountable for their actions, increasing the likelihood of manipulation or misrepresentation of financial statements to meet certain targets or hide financial problems. Moreover, without robust internal controls and audit mechanisms in place, there's less likelihood of detecting and preventing fraudulent activities. To address these issues effectively, Nigerian manufacturing firms need to prioritize enhancing their corporate governance practices by strengthening board independence, implementing stringent internal control systems, and fostering a culture of transparency and accountability throughout the organization. This would help mitigate the risk of financial statement fraud and enhance investor confidence in the integrity of financial reporting. One significant issue surrounding firm characteristics and financial statement fraud in Nigeria's manufacturing firms is the lack of strong corporate governance mechanisms. According to Adeyemo, Adeyemo, and Arogundade (2020), weak corporate governance practices contribute to increased opportunities for financial statement fraud in Nigerian manufacturing firms. Additionally, inadequate internal controls and audit oversight exacerbate the problem (Olamide & Nzewi, 2017).

Businesses that are more profitable may feel pressure to match analyst expectations or hold onto their market position, which may lead them to commit financial statement fraud in an effort to preserve or grow their profitability. Quality of Financial Reporting: The qualities of thoroughness, accuracy, and transparency define excellent financial reporting. Because they place a high value on accountability and stakeholder trust, companies with high quality financial reporting are less likely to commit financial statement fraud. The relationship between financial reporting quality and profitability is critical for manufacturing companies in Nigeria since this industry faces particular problems, including: High levels of competition; Uncertain economic conditions; Strict regulations; and Limited financing options. Strong firm traits and high-quality financial reporting enable businesses to better handle these difficulties and continue to be profitable without turning to financial statement fraud. Fictitious revenue refers to the fraudulent reporting of revenue that does not exist or has not been earned. This is a common type of financial statement fraud, and it can have severe consequences for investors, creditors, and other stakeholders. Fictitious income is commonly associated with other forms of deception, including the falsification of outstanding invoices and the misrepresentation of possessions. (Beneish, 2018).

In Nigeria's manufacturing sector, firm size plays a crucial role in determining the likelihood of financial statement fraud. Larger firms tend to have more robust internal controls and auditing practices, which serve as a deterrent to fraudulent activities. On the other hand, smaller firms with limited resources may be more susceptible to financial statement fraud due to weaker internal controls. The size of a firm has a significant influence on its financial performance, profitability, and the quality of financial reporting. Larger firms typically have more resources to allocate towards maintaining effective internal controls and auditing procedures, reducing the risk of financial statement fraud. In contrast, smaller firms may struggle to implement robust systems, making them more exposed to fraudulent activities. Research conducted by Egbunike and Okerekeoti in 2018 highlighted firm size as a key determinant of financial performance in Nigerian manufacturing firms. The study underscored the importance of firm size in understanding the prevalence and impact of financial statement fraud in the industry.

In conclusion, the relationship between firm characteristics and financial statement fraud in Nigeria's manufacturing firms is complex and multifaceted. By examining the various firm characteristics, including firm size, leverage, profitability, corporate governance, auditor independence, industry-specific risks, financial distress, and cultural factors, we can better understand the factors that contribute to financial statement fraud is essential for stakeholders, including investors, regulators, and auditors, to be aware of these factors and to take steps to prevent and detect financial statement fraud. This includes promoting transparency and accountability, improving corporate governance, and enhancing auditing and oversight practices.

2 LITERATURE AND HYPOTHESES DEVELOPMENT

2.1.1 Profitability profitability of selected Nigerian manufacturing firms focus on ascertaining the effect of variables of financial statement fraud on return on assets (ROA).

The findings of the analysis revealed that there is a significant relationship between financial statement fraud and profitability in Nigerian manufacturing industry. It was found that increase in fictitious revenue in manufacturing industry would lead to low profitability. The implication of this is that increase in fictitious revenue would lead to decrease in performance.

Agbomah and Agbagbara (2019) found out that audit committee size, board independence, board members financial expertise and fraudulent financial reporting is positively and significantly related while board size has positive and insignificant impact on fraudulent financial reporting likelihood while firm size as a control variable impacted positively and significantly on financial statement fraud likelihood and firm performance measured by return on assets is not significantly related to financial statement fraud likelihood and Agbaje and Dare (2018) documented that financial statement fraud and profitability was negatively and significantly related

A firm's profitability is used to indicate the health of a firm's business performance and measures a firm's efficiency in the deployment of its assets and capital resources to generate positive returns -Ibrahim & Mustapha (2019). Adewale and Ibukun-Falayi (2018) also claimed that most Nigerian companies are still lacking in some financial reporting quality dimensions though they have adopted IFRS. One observable point of note from these submissions is that the IFRS affects some financial

reporting quality constructs (such as timeliness), in different jurisdictions, remains a lingering question yet to be sufficiently and perfectly answered.

Managers of companies have expressed concerns about the concept of profitability due to the current performance and future uncertainty. While profit and profitability are sometimes used interchangeably, there are distinct differences between the two terms. Profit represents the total income or sales generated minus total expenses incurred by the company over a specific period, whereas profitability reflects the efficiency of the company's operations in generating profit. Profitability is the ability of a company to earn a satisfactory return on the capital, land, and labor invested in its operations. Three common measures of profitability include Return on Investment (ROI), Return on Assets (ROA), and Return on Equity (ROE) as outlined by Chowdhury et al. (2018). **H01: Profitably have a significant effect on the financial statements fraud of Nigeria manufacturing firms.**

2.1.2 Financial Statement Fraud(FSF)

In order to deceive stakeholders, including creditors, investors, and regulators, financial statement fraud entails the deliberate modification or distortion of financial information (American Institute of Certified Public Accountants [AICPA], 2019). Effective audit committees reduce financial statement fraud (Oseni & Dada, 2017), smaller and younger firms are more vulnerable to financial statement fraud (Adeyemi 2019), and firms with more independent directors are less likely to engage in financial statement fraud (Udiale & Fagbemi, 2017). These findings are specific to Nigerian manufacturing firms. It can be identified by having strong corporate governance, regular audits and reviews, effective internal control, unusual or unexplained changes in financial performance, lack of transparency, unusual transactions, and changes in accounting policies or procedures.

H02: Financial statements fraud have a significant effect in Nigeria manufacturing firms

2.1.2.1 Leverage

The degree of a firm's indebtedness or financial commitments is referred to as leverage in the context of firm characteristics and financial statement fraud. According to Kohlbeck and Magilke (2017), leverage is the ratio of a company's total debt to its total equity (TD/TE) or total assets (TD/TA). Included are operational leverage (fixed cost / total cost) and financial leverage (debt-to-debt ratio). Research focusing on Nigerian manufacturing companies has revealed that high debt-to-equity ratios are associated with a higher likelihood of earnings management (Oseni & Dada, 2017) and that excessive leverage is positively correlated with financial statement fraud (Adeyemi 2019).

H03: Leverage have a significant effect on financial statements fraud in Nigeria manufacturing firms

2.1.2.2 Firm size(FS)

Firm size, often measured by the number of employees or total assets, is a characteristic of a firm that has been shown to impact financial performance, profitability, and financial reporting quality. Larger firms are generally associated with lower levels of financial statement fraud, attributed to their stronger internal controls and auditing practices. In Nigeria's manufacturing sector, firm size plays a crucial role in determining the likelihood of financial statement fraud. Larger firms tend to have more robust internal controls and auditing practices, which serve as a deterrent to fraudulent activities. On the other hand, smaller firms with limited resources may be more susceptible to financial statement fraud due to weaker internal controls.

The size of a firm has a significant influence on its financial performance, profitability, and the quality of financial reporting. Larger firms typically have more resources to allocate towards maintaining effective internal controls and auditing procedures, reducing the risk of financial statement fraud. In contrast, smaller firms may struggle to implement robust systems, making them more exposed to fraudulent activities.

Research conducted by Egbunike and Okerekeoti in 2018 highlighted firm size as a key determinant of financial performance in Nigerian manufacturing firms. The study underscored the importance of firm size in understanding the prevalence and impact of financial statement fraud in the industry.

H02: Firm size have a significant effect on financial statements fraud in Nigeria manufacturing firms

2.2 Theoretical Foundation

Theoretical reviews can provide valuable insights into understanding the factors that may contribute to financial statement fraud. It also provide a foundation for understanding the relationship between firm characteristics and financial statement fraud in Nigeria manufacturing firms.which includes: Legitimacy theory, Opportunistic behavioral theory and Fraud triangle theory

3 RESEARCH DESIGN AND DATA

This study adopted a quasi-experimental research design which helps to examine the impact of firm characteristics on fraudulent financial statement fraud in Nigeria. The justification for using this retrospectively is that they permit the observing by comparing groups of firms with different characteristics without random assignment. This design allows researchers to observe relationships between variables in real-world settings, despite the lack of full experimental control. The data for the study is obtained from the annual financial reports and the Nigeria Exchange Group. The data used were collected from secondary sources through the annual financial reports of manufacturing firms in Nigeria. The secondary source of data was chosen because the information needed on the variables can be found in the annual report of listed manufacturing firms in Nigeria. The study covers a period of twelve (10) years spanning from 2014 to 2023.

4 RESULTS AND DISCUSSION

This study examines the impact of firm characteristics on financial statement fraud using samples from listed manufacturing firms in Nigeria from 2014 to 2023. The explanatory variables of the study include profitability (measured in terms of return on assets - RETA), leverage (measured as debt to assets - DETA), and firm size (FSIZ). This chapter presents the preliminary regression analysis, including descriptive statistics and data normality tests. Additionally, the chapter provides correlation analysis and details on the multivariate regression technique employed in the study. This study examines the impact of firm characteristics on financial statement fraud using samples from listed manufacturing firms in Nigeria from 2014 to 2023. The explanatory variables of the study include profitability (measured in terms of return on assets - RETA), leverage (measured as debt to assets - DETA), and firm size (FSIZ). This chapter presents the preliminary regression analysis, including descriptive statistics and data normality tests. Additionally, the chapter provides correlation analysis and details on the multivariate regression technique employed in the study.

4.1.1 Descriptive Analysis

The study examines the descriptive statistics for both the explanatory and dependent variables of interest. Basically, each variable is examined in terms of the mean, standard deviation, maximum and minimum. Table 1 displays the descriptive statistics for the study. **Table 4.1:**

Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
msco	430	-2.368	3.453	-13.510	30.800
reta	430	2.390	21.857	-256.980	108.900
deta	430	60.447	24.498	2.010	222.970
fsiz	430	7.316	0.893	5.120	9.520

Source: Authors (2024)

The descriptive statistics in Table 4.1 provide an overview of the key variables used in the study, offering insights into their distribution, central tendencies, and variability. The dependent variable, Benish M-score (MSCO), which represents financial statement fraud, has a mean value of -2.368 with a standard deviation of 3.453. The negative mean indicates that, on average, firms in the sample are not engaging in fraudulent activities according to the Benish M-score; however, the high standard deviation suggests a wide variation in the financial statement manipulation scores across the firms, with values ranging from a minimum of -13.510 to a maximum of 30.800. This large range implies that while most firms might not be involved in fraud, there are extreme cases where firms significantly deviate from the norm. In the case of the independent variables, the result shows that return on assets (RETA), which measures profitability, has a mean value of 2.390, but with a substantial standard deviation of 21.857. The wide standard deviation and the extreme range from 256.980 to 108.900

suggest significant variability in profitability among the sampled firms. Some firms have experienced considerable losses, as indicated by the negative minimum value, while others have seen very high profitability. This wide dispersion could reflect the varying operational efficiencies, market conditions, or financial strategies across the firms during the study period. Furthermore, debt-to-asset ratio (DETA), representing leverage, shows a mean of 60.447 with a standard deviation of 24.498. The mean indicates that, on average, firms in the sample have a moderate to high level of debt relative to their assets, with some firms having relatively low leverage (minimum of 2.010) while others are highly leveraged (maximum of 222.970). This significant range suggests differing financial structures and risk profiles within the sample, where some firms might be heavily reliant on debt financing, potentially increasing their financial vulnerability. Finally, firm size (FSIZ), which measures the size of the firm, has a mean value of 7.316 and a standard deviation of 0.893, with a range from 5.120 to 9.520. The relatively smaller standard deviation compared to other variables indicates that firm size is more consistent across the sampled firms. The narrow range suggests that the firms are generally comparable in size, which may help reduce variability in the analysis related to the firm size factor.

Table 4.2: Shapiro-Wilk Test for Normal Data

Variable	Obs	W	V	z	Prob>z
msco	430	0.611	114.320	11.314	0.000
reta	430	0.519	141.154	11.817	0.000
deta	430	0.912	25.857	7.765	0.000
fsiz	430	0.982	5.370	4.013	0.000

Source: Authors (2024)

From Table 4.2, the study finds that the dependent variable of Benish M-score (MSCO) ($\text{prob} > z = 0.000$) is not normally distributed, as the probability of the z-statistic, as revealed by the Shapiro-Wilk test, is significant at the 1% significance level. Similarly, the independent variables of return on assets (RETA) ($\text{prob} > z = 0.000$), debt-to-asset ratio (DETA) ($\text{prob} > z = 0.000$), and firm size (FSIZ) ($\text{prob} > z = 0.000$) are also not normally distributed, as indicated by the significant probabilities of their zstatistics at the 1% significance level. Given that all variables are not normally distributed, the study employs the Spearman Rank Correlation to examine the relationships between the variables under investigation.

Table 4.3: Spearman's Rank Correlation

Variables	(1)	(2)	(3)	(4)
(1) msco	1.000			
(2) reta	0.194	1.000		
(3) deta	-0.009	-0.300	1.000	
(4) fsiz	0.044	0.253	0.081	1.000

Source: Authors (2024)

The results of the Spearman Rank Correlation analysis in Table 4.3 show that there is a positive association between the independent variable of return on assets (RETA) (0.194) and the dependent variable of Benish M-score (MSCO) during the period under study. This indicates that as the return on assets increases, there is a tendency for the Benish M-score to increase as well, suggesting a potential relationship between profitability and financial statement fraud. Additionally, the table shows a negative association between the independent variable of debt-to-asset ratio (DETA) (-0.009) and the dependent variable of Benish M-score (MSCO), although the association is very weak. This suggests that changes in the debt-to-asset ratio have a minimal inverse relationship with the Benish M-score. The results also indicate a positive association between firm size (FSIZ) (0.044) and the dependent variable of Benish M-score (MSCO), although this association is also quite weak. This implies that larger firms may have

a slightly higher Benish M-score compared to smaller firms. For the correlations among the independent variables, there is a negative association between return on assets (RETA) and debt-to-asset ratio (DETA) (-0.300), suggesting that firms with higher profitability tend to have lower levels of leverage. There is a positive association between return on assets (RETA) and firm size (FSIZ) (0.253), indicating that larger firms may tend to be more profitable. Additionally, there is a positive but weak association between debt-to-asset ratio (DETA) and firm size (FSIZ) (0.081). The results indicate the absence of multicollinearity among the variables since all associations are either weak or moderate. However, to further confirm the absence of multicollinearity, a more robust check using the Variance Inflation Factor (VIF) test will be employed, and the results will be presented in the next sections.

4.2.2 Regression Analyses

Specifically, to examine the cause-effect relationships between the dependent variables and independent variables as well as to test the formulated hypotheses, the study used a robust regression since the result reveal the presence of heteroscedasticity. The pool OLS and Robust Regression results obtained is presented and discussed below.

Table 4.4: Regression Results

Variables	(1) OLS	(2) Robust
reta	0.031*** (0.000)	0.039*** (0.000)
deta	0.000 (0.991)	0.004** (0.044)
fsiz	0.206 (0.280)	-0.087 (0.152)
Intercept	-3.954*** (0.006)	- 2.486*** (0.000)
Observations	430.000	430.000
R2	0.047	0.373
Year Dummy	No	No
Hettest	17.99{0.000}	
VIF	1.11	

Notes: p-values are in parentheses. *** p<.01, ** p<.05

Table 4.4 represents the results obtained from the estimation of the models using the OLS regression method. The results indicate that the dependent variable, as captured by the regression model, has an R-Square value of 0.47. This suggests that the independent and control variables in the study account for approximately 4.7% of the systematic variation in the dependent variable during the period under study. The remaining 95.3% of the variation is explained by other factors not included in the model, as indicated by the error term. However, to further validate the estimates of the pool OLS results, this study also tests for multicollinearity and heteroscedasticity.

4.3 Discussions of Findings

The finding that profitability (RETA) has a significant positive effect on the financial performance of listed manufacturing firms in Nigeria aligns with the existing literature, which underscores profitability as a key determinant of firm performance. This result suggests that as profitability increases, the overall performance of these firms also improves, indicating that effective management practices and operational efficiencies are crucial for enhancing financial outcomes. The positive correlation between profitability and performance is consistent with the findings of Oyedokun et al. (2020), who noted that ownership structure significantly influences firm value, thereby reinforcing the notion that higher profitability leads to better financial performance. Furthermore, this finding resonates with research by Nanda and Panda (2019), which highlighted that factors such as leverage and current assets can negatively impact profitability, suggesting that the relationship between profitability and performance is not always straightforward. This underscores the complexity of financial performance dynamics within the manufacturing sector, where multiple variables interact to shape

outcomes. Conversely, some studies offer a more nuanced perspective on the relationship between profitability and performance. For instance, research by Diana (2020) found that financial performance, as measured by return on assets, did not significantly affect firm value, suggesting that other factors may play a more critical role in determining performance outcomes.

Furthermore, the finding that the debt-to-asset ratio (DETA) has a significant positive effect on the financial performance of listed manufacturing firms in Nigeria suggests that increased leverage can enhance the operational effectiveness of these firms. This result indicates that as firms utilize more debt relative to their assets, they may be able to invest in growth opportunities that lead to improved financial outcomes. This aligns with the perspective of Akinrinola et al. (2023), who argue that the ratio of long-term debt to total assets is a key determinant of financial success for manufacturing firms, emphasizing the potential benefits of leveraging debt to enhance performance. Moreover, this finding resonates with the work of Olaoye and Adesina (2022), who highlighted that debt financing can positively impact the performance of manufacturing companies. They suggest that firms can effectively utilize borrowed funds to finance operations and expansion, thereby boosting profitability. The implication here is that manufacturing firms in Nigeria may benefit from strategic debt management, enabling them to optimize their capital structure to enhance performance metrics. However, this finding contrasts with some studies that advocate a more cautious approach to leveraging debt. For instance, research by Adeoye and Olojede (2022) found that capital structure negatively affects the financial performance of deposit money banks in Nigeria, suggesting that excessive debt can lead to financial distress and operational inefficiencies. This highlights the complexity of the relationship between debt and performance, as the impact of leverage may vary significantly across different sectors and economic contexts. Additionally, the findings of Ibrahim et al. (2021) support the notion that while debt can enhance financial performance, it must be managed judiciously to avoid the pitfalls of over-leverage, which can lead to increased financial risk and potential distress. This perspective underscores the importance of a balanced approach to capital structure, where firms must carefully weigh the benefits of debt against the risks associated with high leverage.

Finally, the finding that firm size (FSIZ) does not have a significant effect on the financial performance of listed manufacturing firms in Nigeria suggests that being a larger firm does not inherently lead to better financial outcomes. This result indicates that the advantages typically associated with larger firms, such as economies of scale and greater market power, may not be sufficient to translate into improved financial performance in this context. This aligns with the observations made by Omenyo (2019), who noted that despite the expectation that larger firms would leverage their capital base for increased profits, many have experienced a decline in financial performance over time, suggesting that size alone is not a reliable predictor of success. Furthermore, this finding resonates with the work of Roni (2017), who argued that while larger firms often have more resources, they may also face bureaucratic inefficiencies that can hinder performance. The implication here is that the operational dynamics within larger firms can sometimes negate the potential benefits of size, leading to situations where smaller firms may outperform their larger counterparts due to greater agility and efficiency. This perspective is further supported by Dogan et al. (2016), who emphasized that organizational capabilities, rather than sheer size, are crucial in driving innovation and performance. Contrarily, some studies suggest that firm size does play a significant role in determining financial performance. For instance, Ghani et al. (2022) found that larger firms are more likely to diversify their markets and achieve economies of scale, which can enhance their overall performance. This suggests that while size may not directly correlate with performance in the Nigerian manufacturing context, it could still provide advantages in specific scenarios, particularly when firms effectively leverage their resources. Additionally, the findings of Yulianto (2023) highlight that firm size can have asymmetric information content, which may influence capital structure decisions but does not necessarily translate into improved financial performance. This underscores the complexity of the relationship between size and performance, indicating that while larger firms may possess certain advantages, these do not always result in superior financial outcomes.

5 CONCLUSION AND RECOMMENDATION

The main problem of this study centers on the issue of financial statement fraud among listed manufacturing firms in Nigeria, which poses significant risks to stakeholders, including investors, creditors, and regulators. The primary aim of the study was to examine the effects of specific firm characteristics—profitability, leverage, and firm size—on the likelihood of financial statement fraud, as

measured by the Benish M-score, within the context of listed manufacturing firms in Nigeria over the period from 2014 to 2023. The study's key findings reveal that profitability, as indicated by return on assets, and leverage, as represented by the debt-to-asset ratio, both have a significant positive effect on financial statement fraud. This suggests that firms with higher profitability and greater leverage may be more inclined to manipulate financial statements. Conversely, the study finds that firm size does not have a statistically significant effect on financial statement fraud. These findings underscore the complexity of factors that influence financial misconduct, highlighting the need for stakeholders to focus on profitability and leverage when assessing the risk of financial statement fraud. The key takeaways from this study are that firm characteristics, particularly profitability and leverage, play a crucial role in determining the likelihood of financial statement fraud in the Nigerian manufacturing sector. The positive association between these variables and the Benish M-score suggests that firms with higher profitability and higher levels of debt may be under greater pressure to meet financial expectations, potentially leading to manipulative practices. On the other hand, the non-significant relationship between firm size and financial statement fraud indicates that being a larger firm does not necessarily correlate with a higher or lower likelihood of fraud. These insights contribute to the broader understanding of financial statement fraud dynamics, particularly in the context of emerging markets like Nigeria.

Based on the findings of this study, a general recommendation is for all stakeholders, including corporate managers, directors, policymakers, regulators, analysts, and investors, to pay closer attention to the financial characteristics of firms when assessing the risk of financial statement fraud. Monitoring profitability, leverage, and other critical indicators can help in detecting potential fraud and ensuring the integrity of financial reporting.

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