



# FAIR VALUE ACCOUNTING AND EARNINGS MANAGEMENT: AN ANALYSIS OF LISTED INVESTMENT FIRMS IN NIGERIA

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## -----ABSTRACT-----

*This research explores the association among fair value accounting and earnings management in listed investment firms in Nigeria, using the framework of signaling theory. Fair value accounting purposes is to deliver timely and relevant information about asset and liability values, while earnings management involves the strategic manipulation of financial statements. Signal theory suggests that fair value accounting serves as a signal to stakeholders, conveying information about an enterprise's financial condition and prospects. The study utilizes a quantitative research design, analyzing data collected from financial reports and disclosures of selected investment firms. Net asset value (NAV), abnormal performance, and discretionary expenses are used as proxies for fair value accounting and earnings management. Descriptive statistics, correlation coefficients, and regression analysis are employed to examine the relationships between these variables. The findings reveal a weak negative correlation between NAV and abnormal performance, indicating a negligible relationship. However, a strong positive correlation is observed between NAV and discretionary expenses, indicating a significant association. Regression analysis confirms the impact of discretionary expenses on NAV, while abnormal performance shows no significant relationship. Based on the results, recommendations are made for investment firms to focus on managing discretionary expenses, monitor abnormal performance, and establish robust controls to ensure transparency in financial reporting.*

**KEYWORDS:** *Fair Value Accounting, Earnings Management, Signaling Theory*-----

## 1. INTRODUCTION

Fair value accounting has gained significant prominence in financial reporting and has become an important tool for measuring and presenting financial information. The process entails ascertaining the present market values of assets and liabilities, thereby precisely capturing their authentic economic worth. While fair value accounting provides benefits such as improved transparency and relevance of financial statements, concerns have been raised regarding its potential impact on earnings management by quoted companies in Nigeria.

Earnings management refers to the deliberate manipulation of financial statements to achieve desired financial results. It involves various strategies, such as income smoothing, to create an illusion of stability or manage reported earnings to meet specific targets. Earnings management can occur through various mechanisms under fair value accounting. For instance, firms may opportunistically classify certain assets or liabilities as fair value items to enhance reported earnings or decrease reported losses. Additionally, firms can selectively use fair value estimates that are favorable to their desired financial results. Such practices can distort the reliability and comparability of financial information, potentially misleading investors and stakeholders.

The adoption of fair value accounting may provide prospects for firms to participate in earnings management practices, thereby undermining the reliability and comparability of financial information. According to Akinlo (2015), earnings management practices have been a concern in Nigeria's financial reporting landscape, raising doubts about the reliability of financial statements. Furthermore, Adegbite et al. (2019) found evidence of income smoothing practices among Nigerian listed firms, indicating the potential existence of earnings management activities.



Fair value accounting has gained traction globally due to its potential to enhance financial reporting quality and decision-making. However, the influence of fair value accounting on earnings management in Nigeria is an area that necessitates additional research. A number of studies have examined the association among fair value accounting and earnings management in developed economies, yielding mixed findings. Therefore, exploring this issue within the Nigerian context is essential to shed light on the specific challenges and implications faced by Nigeria listed firms. The study by Olayinka et al. (2018) provides insights into the influence of fair value accounting on earnings management in emerging nations, but there is a need for specific research focusing on Nigeria's listed firms. One concern regarding fair value accounting is that it introduces subjectivity into financial reporting. Unlike historical cost accounting, fair value accounting relies on market-based valuations, which can be influenced by market conditions, management's judgment, and estimation errors. This subjectivity may provide opportunities for firms to manipulate fair value measurements to achieve specific financial reporting outcomes, including managing earnings.

In their study, Adelopo et al. (2017) emphasized the potential influence of management judgment in fair value accounting, highlighting the need for empirical examination of the association among fair value accounting and earnings management in Nigeria. This study aims to contribute to filling this gap in the literature.

## 2. MATERIALS

### Net Asset Value

Net Asset Value (NAV) is a commonly used metric in the investment industry to assess the value of a mutual fund, exchange-traded fund (ETF), or other investment vehicles. While NAV is not explicitly designed as a proxy for fair value accounting, it does provide some insights into the fair value of the underlying assets held by the investment vehicle.

Fair value accounting is a methodology that endeavours to accurately represent the present market valuation of an asset or liability. As per the Financial Accounting Standards Board (FASB), the term fair value is characterised as "the monetary value that would be obtained upon the sale of an asset or the compensation for the transfer of a liability in a systematic transaction among market players at the time of evaluation" (FASB, 2018).

NAV is calculated by subtracting the liabilities of an investment vehicle from the market value of its assets and dividing the result by the amount of shares outstanding. The resulting figure represents the per-share fair value of the investment vehicle's underlying assets. While NAV is not determined solely based on fair value accounting, it incorporates fair value principles to a certain extent. The assets held by investment vehicles are often valued using fair value methodologies such as market prices, pricing models, or other valuation techniques. These fair value estimates contribute to determining the market value of the assets used in the NAV calculation.

The use of fair value estimates in the valuation of assets within investment vehicles is consistent with the principles of fair value accounting. In fact, the International Accounting Standards Board (IASB) notes that fair value measurement techniques used for financial reporting can also be employed in estimating the fair value of assets and liabilities held by investment vehicles (IASB, 2018).

Moreover, NAV serves as a useful indicator for investors to evaluate the performance and value of their investments. Investors can compare the NAV per share to the market price per share to determine if the investment is trading at a premium or a discount. If the market price per share is higher than the NAV per share, it suggests the investment is trading at a premium, indicating a potential overvaluation. Conversely, if the market price per share is lower than the NAV per share, it indicates a discount and a possible undervaluation.

### Abnormal Performance

Abnormal performance refers to a company's financial results that deviate significantly from what would be expected based on its historical performance or industry norms. Earnings management may be utilised to amplify unnaturally or deflate a company's reported earnings in order to portray a more favorable financial picture. This manipulation can lead to abnormal performance, where the reported financial results deviate from what would be considered normal or expected.



Numerous research has looked at the relationship among earnings management and abnormal performance. For example, a study by Dechow, Sloan, and Sweeney (1995) found that companies engaged in earnings management tend to have higher abnormal accruals, which are considered indicators of manipulated earnings. These abnormal accruals can lead to a distortion in reported earnings and contribute to abnormal performance.

Moreover, earnings management has been linked to abnormal stock price performance. A study by Burgstahler and Dichev (1997) found that companies with higher levels of earnings management experience abnormal stock returns following the release of earnings announcements. This abnormal stock price performance suggests that investors react to the manipulation of earnings, which can ultimately impact the company's overall performance.

It is important to note that not all abnormal performance is necessarily indicative of earnings management. Factors such as changes in the industry landscape, macroeconomic conditions, or company-specific events can also contribute to abnormal performance. However, earnings management can be a potential explanation for abnormal performance when financial results deviate significantly from expectations or industry norms and there is evidence of manipulation in the financial statements.

### **Discretionary Expenses**

Discretionary expenses are expenses that a company has control over and can adjust based on its financial objectives. These expenses include items such as advertising and marketing, research and development, and discretionary bonuses. The manipulation of discretionary expenses may serve as a technique for managing earnings, allowing companies to manipulate their reported earnings.

One common strategy used in earnings management is the management of discretionary expenses. By either increasing or decreasing discretionary expenses, companies can impact their reported earnings and present a more favorable financial performance. Numerous research have looked at the connection among discretionary expenses and earnings management. For instance, Healy and Wahlen's (1999) research discovered evidence that corporations with higher levels of discretionary expenses are prone to participate in earnings management activities. They argued that discretionary expenses provide firms with opportunities to manipulate reported earnings and achieve their desired financial outcomes.

Moreover, another study by Roychowdhury (2006) explored the role of discretionary expenses in earnings management through actual operations manipulation. Real activities handling refers to the manipulation of non-financial activities to affect reported earnings. The investigation has revealed that companies that engage in earnings management by means of real activities manipulation frequently alter other costs, such as promotion and development, and research, in order to attain their intended earnings objectives.

It is important to note that not all adjustments to discretionary expenses are indicative of earnings management. Companies may legitimately adjust their discretionary expenses based on changing business conditions or strategic objectives. However, when discretionary expenses are systematically manipulated to achieve specific earnings targets or to smooth earnings over time, it raises concerns about earnings management practices.

### **Signaling Theory**

Signal theory is a valuable framework for understanding the association among fair value accounting and earnings management. Fair value accounting aims to deliver relevant and timely data regarding the financial position of a company. On the other hand, earnings management refers to the strategic manipulating financial reports to change how investors see the financial status of a business. In this context, signal theory suggests that fair value accounting can serve as a signal to stakeholders, conveying information about the firm's financial condition and prospects.

According to Dechow et al. (2012), fair value accounting can act as a credible signal of a firm's intrinsic value and future prospects. The transparency and objectivity related with fair value measurements enhance the credibility of financial information. Stakeholders, such as investors and creditors, rely on these signals to assess a company's financial health and make informed decisions. By reflecting the market value of assets and liabilities, fair value accounting provides stakeholders with facts relating to the business's economic resources and potential risks.



However, the potential for earnings management complicates the signaling role of fair value accounting. Managers may be tempted to manipulate fair value estimates to meet certain financial targets or hide unfavorable information. This raises concerns about the dependability and usefulness of fair value measurements. Scholars have found evidence of earnings management around fair value estimates, particularly during periods of economic uncertainty (Laux & Leuz, 2010). Such earnings management practices can undermine the credibility of fair value signals and mislead stakeholders.

Nevertheless, the signaling benefits of fair value accounting can still be significant. Information asymmetry between managers and external stakeholders is a key driver of the need for signals (Verrecchia, 2001). Fair value measurements, when accompanied by robust disclosures and independent audit oversight, can help mitigate information asymmetry by providing transparent and verifiable information. This can improve the accuracy of stakeholders' assessments of a firm's financial condition, reducing the need for costly information acquisition and processing.

### **Empirical Review and Hypotheses**

Chen, Kim, and Lee's (2022) investigation focuses on the association among the fair value hierarchy and earnings management following the adoption of International Financial Reporting Standards (IFRS). The scholars centre their attention on the ramifications of the application of IFRS on the fair value assessment of companies, as well as its correlation with the utilisation of techniques for manipulating earnings. The categorization of financial instruments based on the reliability of their valuation inputs is known as the fair value hierarchy. It is noteworthy that Level 1 is considered the most reliable, while Level 3 is deemed the least reliable. The researchers conduct an analysis of a subset of enterprises hailing from nations that have implemented the IFRS, scrutinising their financial disclosure methodologies pre- and post-IFRS adoption. The study's results indicate a noteworthy connection among the fair value structure and the practise of earnings management. It is a common practise for corporations to exercise discretion in the classification of financial instruments into varying tiers of the hierarchy of fair value as a means of earnings management.

The scholarly work of De George and Reis (2021) delves into the intricate interplay between fair value accounting and earnings management in the banking sector. To scrutinise this correlation, the scholars conduct an analysis of a subset of financial institutions and scrutinise the interplay among fair value accounting and the manipulation of earnings. Diverse metrics are employed to apprehend the extent of earnings management, which encompasses the manipulation of accruals and the utilisation of discretionary loan loss provisions. The study's results indicate a correlation between fair value accounting and increased instances of earnings management within the banking sector. It has been observed that financial institutions that opt for fair value accounting exhibit a greater proclivity towards the manipulation of earnings as opposed to those that adhere to historical cost accounting. The results of the research indicate that the interplay between fair value accounting and earnings management is contingent upon the distinctive attributes of banks. It has been observed that financial institutions with greater asset magnitudes and elevated risk profiles are inclined towards indulging in earnings management practises, particularly in the context of fair value accounting.

The scholarly work of D'Souza, Jacob, and Jorgensen (2022) delves into the intricate interplay among fair value accounting, financial analysts' earnings forecasts, and firms' disclosure strategies. By utilising a dataset of publicly traded corporations, the researchers delved into the ramifications of fair value accounting on the earnings prognostications of financial analysts. The research findings indicate that the implementation of fair value accounting has a notable impact on the earnings forecasts of financial analysts. It has been observed that the precision and uniformity of analysts' predictions tend to diminish in the case of companies that utilise fair value measurements relative to those that rely on historical cost accounting.

The scholarly work conducted by Elrazaz and Hussainey (2021) delves into the intricate interplay between fair value accounting and earnings management, specifically within the European banking sector. The researchers obtained empirical evidence from a cohort of 190 European financial institutions spanning the timeframe of 2009 to 2018. The researchers utilised a diverse range of statistical methodologies, such as regression analysis, to scrutinise the effect of fair value accounting on the practise of earnings management. The study's results demonstrate a favourable association



between fair value accounting and earnings management within the European banking sector. The proposition posits that financial institutions that utilise fair value accounting techniques are prone to partaking in manipulative manoeuvres concerning their earnings. The findings align with the notion that fair value accounting affords banks greater leeway and adaptability in disclosing their fiscal standing, a capability that may be leveraged for strategic ends. Enyi (2016) explores the effect of fair value accounting on earnings management in emerging economies. However, a specific investigation into Nigeria's listed firms is necessary to comprehend the extent and nature of earnings management practices under fair value accounting in the Nigerian context.

Adegbite et al. (2019) found evidence of income smoothing practices among Nigerian listed firms, indicating the potential existence of earnings management activities. Given the rising adoption of fair value accounting in Nigeria, it is crucial to assess its impact on earnings management to safeguard the integrity of financial reporting.

Jiang, Li, and Lin (2022) investigate the association among fair value accounting and earnings management during the COVID-19 pandemic. The study utilizes a portion of firms quoted on major stock exchanges in the United States and focuses on the period from January to December 2020 when the COVID-19 crisis had a substantial influence on financial markets and economic activities. The research's results indicate that fair value accounting is indeed associated with increased earnings management in the time of corona virus. Companies that report more assets at fair value incline to partake in greater of earnings management to manipulate their financial results. This relationship is particularly evident for companies with lower financial reporting quality, suggesting that the potential risks associated with fair value accounting are more pronounced when financial reporting is less reliable.

**Hypotheses**

**Ho1.** There is a significant relationship between net asset value and abnormal performance among listed investment firms in Nigeria.

**Ho2.** There is a significant relationship between net asset value and discretionary expenses among listed investment firms in Nigeria.

**3. METHOD**

The study will utilize a quantitative research design. The data were collected at a single point in time, capturing the fair value accounting and earnings management activities of listed investment firms in Nigeria. Data on net asset value, abnormal performance, and discretionary expenses were collected from the financial reports and disclosures of the selected investment firms. The net asset value was used as a proxy for fair value accounting, while abnormal performance and discretionary expenses were used as proxies for earnings management. Descriptive statistics was used to briefly outline the sample's properties and the elements of interest, while correlation coefficient was employed to explore the bivariate link among fair value accounting (net asset value) and earnings management (abnormal performance, discretionary expenses). Also, multiple regression analysis was conducted to define the extent of the connotation among fair value accounting and earnings management.

Earnings Management =  $\beta_0 + \beta_1 * \text{Fair Value Accounting} + \epsilon$ .....(Equ 1)

- Earnings Management represents the dependent variable, which can be measured using abnormal performance and discretionary expenses as proxies.
- Fair Value Accounting represents the independent variable of interest, proxied by net asset value, which captures the degree to which investment firms employ fair value accounting practices.
- $\beta_0$  and  $\beta_1$  represent the coefficients to be estimated, indicating the direction and magnitude of the association among fair value accounting, and earnings management.
- $\epsilon$  represents the error term, accounting for any unexplained variation in the dependent variable.



#### 4. RESULTS AND RECOMMENDATION

##### Descriptive Result

	NET_ASSET_VALUE	ABNORMAL_PERFOR MANCE	DISCRETIONARY_EX PENSES
Mean	2.02E+09	0.027778	8.00E+08
Median	1.80E+09	0.050000	7.50E+08
Maximum	4.00E+09	0.250000	1.50E+09
Minimum	6.00E+08	-0.200000	3.00E+08
Std. Dev.	1.22E+09	0.160295	3.86E+08
Skewness	0.406803	-0.054644	0.446098
Kurtosis	1.793973	1.610906	2.285333
Jarque-Bera	0.793671	0.728073	0.490036
Probability	0.672445	0.694866	0.782690
Sum	1.82E+10	0.250000	7.20E+09
Sum Sq. Dev.	1.18E+19	0.205556	1.20E+18
Observations	9	9	9

The descriptive results provide insights into the study on fair value accounting and earnings management in listed investment firms in Nigeria. Net asset value (NAV) is used as a proxy for fair value accounting, while abnormal performance and discretionary expenses serve as proxies for earnings management. The mean NAV is approximately 2.02 billion Naira, with a median of 1.80 billion Naira. The maximum and minimum NAV values are 4.00 billion Naira and 600 million Naira, respectively. The standard deviation of NAV is 1.22 billion Naira, indicating a significant variation in values. The skewness for NAV is positive, suggesting a slightly right-skewed distribution. The kurtosis value of 1.79 indicates a moderately peaked distribution for NAV. The Jarque-Bera test results for all variables are relatively low, indicating a normal distribution. The sums of NAV, abnormal performance, and discretionary expenses are 18.2 billion Naira, 0.25, and 7.2 billion Naira, respectively. Overall, the findings provide statistical information on the variables studied.

##### Correlation Result

	NET_ASSET_VALUE	ABNORMAL_PERFORMA NCE	DISCRETIONARY_EXPEN SES
NET_ASSET_VALUE	1	-0.0019602281908418	0.8986538946226003
ABNORMAL_PERFORMANCE	-0.0019602281908418	1	0.2320327451964032
DISCRETIONARY_EXPENSES	0.8986538946226003	0.2320327451964032	1

Net asset value (NAV), serving as a proxy for fair value accounting, shows a weak negative correlation (-0.002) with abnormal performance, a proxy for earnings management. This suggests a negligible link among NAV and abnormal performance. However, NAV exhibits a strong positive correlation (0.899) with discretionary expenses, which are also proxies for earnings management. This indicates a substantial favourable association among NAV and discretionary expenses, implying that as NAV increases, discretionary expenses tend to increase as well. Additionally, abnormal performance and discretionary expenses display a relatively weak positive correlation (0.232), suggesting a mild association between these two variables.



**Regression Result**

Dependent Variable: NET\_ASSET\_VALUE

Method: Least Squares

Date: 05/27/23 Time: 05:17

Sample (adjusted): 19

Included observations: 9 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-3.22E+08	4.35E+08	-0.740259	0.4871
ABNORMAL_PERFORMANCE	-1.69E+09	1.21E+09	-1.389052	0.2142
DISCRETIONARY_EXPENSES	2.988700	0.503683	5.933695	0.0010
R-squared	0.854400	Mean dependent var		2.02E+09
Adjusted R-squared	0.805867	S.D. dependent var		1.22E+09
S.E. of regression	5.36E+08	Akaike info criterion		43.29680
Sum squared resid	1.72E+18	Schwarz criterion		43.36254
Log likelihood	-191.8356	Hannan-Quinn criter.		43.15493
F-statistic	17.60445	Durbin-Watson stat		1.597045
Prob(F-statistic)	0.003087			

The regression equation shows that the constant term (C) has a coefficient of -3.22E+08, but it is not substantial (p-value = 0.4871), indicating non-substantial effect on the net asset value. The variable "abnormal performance," another proxy for earnings management, has a coefficient of -1.69E+09, but it is also not statistically significant (p-value = 0.2142), suggesting that there is no discernible connection between it and net asset value. On the other hand, the variable "discretionary expenses," which represents earnings management, has a coefficient of 2.988700 and is highly substantial (p-value = 0.0010). This indicates that discretionary expenses have a substantial favourable effect on the net asset value. The R-squared value of 0.854400 suggests that the model explains 85.44% of the variation in the net asset value.

**Recommendations**

Based on the three analyses conducted in the study on fair value accounting and earnings management in listed investment firms in Nigeria, the following recommendations can be made:

- i. Fair Value Accounting and Discretionary Expenses: The study found a strong positive correlation between net asset value (NAV), as a proxy for fair value accounting, and discretionary expenses, which are proxies for earnings management. This suggests that firms engaging in fair value accounting should pay close attention to their discretionary expenses. It is recommended that listed investment firms implement robust internal controls and monitoring mechanisms to ensure that discretionary expenses are appropriately managed and aligned with fair value accounting principles. This can help enhance transparency and reliability in financial reporting.
- ii. Abnormal Performance and Fair Value Accounting: The analysis revealed a weak and statistically insignificant relationship between abnormal performance and NAV, indicating a lack of association between earnings management and fair value accounting. However, it is important for investment firms to continue monitoring and evaluating abnormal performance to ensure that it remains aligned with fair value accounting practices. This can involve regular reviews of financial statements and performance metrics to detect any potential deviations or irregularities that may warrant further investigation.
- iii. Robustness of Discretionary Expenses: The regression analysis demonstrated that discretionary expenses significantly influence the net asset value. As discretionary expenses can be prone to manipulation, it is crucial for investment firms to establish strong governance structures and internal controls to prevent any potential abuse or misrepresentation. Implementing comprehensive policies and procedures for the approval, monitoring, and reporting of discretionary expenses can help mitigate the risk of earnings management and ensure the integrity of financial statements.



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