

**INVESTORS ASSESSMENT OF THE CREDIBILITY OF MANAGEMENT DISCLOSURES****Chinwuba Okafor and Killian Ogiedu,****Dept. of Accounting, Faculty of Management Sciences, University of Benin, Benin City, Nigeria.****E-mail: [chinwubao@yahoo.com](mailto:chinwubao@yahoo.com) , [koogiedu@yahoo.com](mailto:koogiedu@yahoo.com)****Abstract**

*The objective of this study, is to examine the issue of the assessment of the credibility of management disclosures about a company from the perspective of the investors. It presents the results from a questionnaire survey of a sample of financial Analysts, accountants and other investor. The data were analyzed using the one way analysis of variance (ANOVA). The study found that management situational incentives, internal and external assurance and other characteristics of the disclosure itself, were the factors investors considered to affect the credibility of management Disclosures. The study recommends that investors should take these factors into consideration when assessing management disclosures. The study also recommends that management should also take these factors into consideration when preparing their disclosures if they want to improve on their credibility.*

**Keywords:** Investors, Assessment , Disclosures , Management**Introduction**

Management disclosures are valuable source of information for investors. They play an important role in alleviating the problem of information asymmetry between managers and owners (shareholders) of a company. They are the means by which managers communicate information about the company's past and future prospects to present and future investors. Corporate or management disclosures are also an aid to the capital market in the pricing of securities. However for any disclosure to be useful and used, it must be credible or believable. Jennings (1987) notes that investors reactions to a management disclosure are a function of both the new information ("surprise") contained in the disclosure and the credibility (believability) of the disclosure. According to him, a disclosure's credibility may be as important as the amount of new information in explaining investors' reaction.

Managers face a number of institutional penalties for issuing inaccurate disclosure including loss of reputation, possible employment penalties, and potential legal action (Adams, 2002). According to McNichols(1989) and Frankel *et al*(1995) such reasons have, in the past, were sufficient, in general to deter management from issuing intentionally biased disclosures .But according to Adams (2002), the effectiveness of such penalties

is based upon the assumption that firms, investors, financial intermediaries, and security regulators interact on a recurring basis in which market participants and security regulators can punish managers in the future for inaccurate disclosures made in this present. However recent events, like the collapse of Enovn and World com, have shown that penalties as enumerated above have not deterred managers from inaccurate disclosures. This has heightened investors concerns about the credibility of management disclosures (Banet, 2002). This has, also heightened the necessity of having appropriate mechanisms for assessing management disclosures.

The objectiveof this study therefore, is to examine the issue of assessment of the credibility of management disclosures by investors.

**Literature review and hypotheses development**

The credibility of management disclosures is so important that there have been many research into the phenomenon. According to Molly (2004), literature On disclosure credibility is expansive and diverse. Although many existing studies appear unrelated on the surface they, however, address similar theoretical issues . In other words, not many research have directly addressed the issue of

investor assessment of the creditability of management disclosures.

Before looking at the factors that affect the credibility of management disclosures, we will examine the meaning of disclosure credibility. According to Molly (2004), disclosure credibility is investors' perceptions of the believability of a particular disclosure. According to him two elements of this definition should be highlighted. First, disclosure credibility refers a perception held by investors not an objective condition of a disclosure. He stated that the second part of the definition presumes that investors appraise the credibility of the particular management disclosure. According to Jennings (1987), when investors initially receive a disclosure from management, they are unaware of the disclosures actual reliability or quality and will base their reactions on its perceived credibility.

Disclosure credibility is sometimes confused with management credibility. But the concepts are not exactly the same. According to Molly (2004), disclosure credibility is appraised separately for each disclosure and may vary within a firm across different disclosures. On the other hand, management credibility is a more enduring trait of a firm's managers, referring to investors enduring trait of a company's trustworthiness (Molly, 2004). Management credibility is only a factor in the credibility of management disclosures.

According to Molley (2004), empirical studies on disclosure credibility tend to use either archival or experimental data. According to him most archival studies use stock market reactions and/or analysts forecast revisions to asses a disclosure credibility. On the other hand, experimental studies measure disclosure's creditability on a numerical scale or by inferring credibility effects from participants use of management of disclosures in other tasks. Survey of investors opinions on factors affecting disclosure creditability has not been given much attention in the literature and that is why it is considered appropriate now to use the method of this study particularly in a developing country like Nigeria where there is a dearth secondary b of data.

Various factors have been identified in the literature as affecting the creditability of management disclosure. Molly (2004) summarized these factors to include: (1)Situational incentives as at the time of the disclosure;(2) Management credibility;(3)The degree of external assurance;(4)The level of internal assurance;(5)Various characteristics of the disclosure like disclosure precision (6)Time horizon of the disclosure,(7)Availability of support information (8)Inherent plausibility of the disclosure;

### **Situational incentives**

It is generally believed that the situation of a company at the time of disclosure plays a fundamental role in determining the credibility of the disclosure. According to Kelley (1972), people attribute messages consistent with the source's incentives to those incentives, rather than the sources true belief. Conversely, people tend to infer that messages inconsistent with the sources incentives reflect the sources underlying beliefs. These differences suggest that people are less likely to believe messages that are consistent with the source's incentives.

According to Molley (2004), investors are less likely to believe management disclosures when management has high incentives to be misleading or untruthful. Some research have been conducted into the effects of incentive to mislead by comparing the credibility of good news and bad news. According to McNichols (1989), managers tend to have greater incentives to provide overly positive disclosures than overly negative disclosures. In other words bad news disclosures are more credible than good news .This position is supported by other studies. For example, Hassel et al (1988) and William (1996) found that there is a positive relationship between management disclosures containing bad news and larger analysts forecast revisions. In the same vein, Cairney and Richardson (1999) and Hutton *et al* (2003) established a positive relationship between management disclosures containing bad news and larger stock price reactions.

Koch (2002) examines the effectiveness of situational incentives by comparing the disclosure credibility of financially distressed and non – distressed companies and found that management has greater incentives to provide misleading disclosures when a firm is financially distressed. According to him, management earnings forecasts made by financially distressed firm's exhibit greater upward bias than management earnings forecasts made by non-financially distressed firms. (see also Frost, 1997). Thus in summary the credibility of a management disclosure depends on the existing situational incentives at the time of the disclosure. Hence we hypothesize that; H<sub>1</sub> Management disclosure credibility is related to situational incentives existing at the time of the disclosure

#### **Management credibility**

According to Brinbaum and Stegner (1979) the credibility of any message is, in part, a function of its source. However, management credibility is only one of the factors and other variables also have significant effects on message credibility (Petty and Wegener, 1998). According to William (1996), the size of analysts forecasts revisions for subsequent management earnings forecasts are a function of management forecasts prior accuracy using exponential tests, Hirst *et al* (1999) found that investors rely more on management disclosures when management provided accurate forecasts in earlier time periods. The foregoing lead us to the hypothesis that; H<sub>2</sub> Management disclosure credibility is positively related to management credibility.

#### **Level of external assurance**

The credibility of management disclosure increase with the level of external assurance. External assurance can be provided by auditors, financial analysts, regulators and institutional investors, among others. Several studies have found that audited disclosures are more credible than unaudited disclosures Libby (1979) finds that audited disclosure are more credible than unaudited disclosures (see also Hodge, 2001). Leftwich (1983) and Blackwell *et al* (1998) find that external assurance from auditors increases disclosure credibility. These studies find that

bankers believe that audits enhance the credibility of financial statements.

Financial analysts reactions to a management disclosure can also affect investors assessment of the disclosures credibility (Gogoi, 2001; Li, 2002). According to Molley (2004) evidence that analyst reactions to management disclosures affect investors reactions to those disclosures, is as yet, largely anecdotal other factors on external assurance that could affect a disclosure's credibility are the level of regulatory control in the particular industry, size and nature of the company and ownership by large institutional investors and analysts. We therefore hypothesize as follows; H<sub>3</sub>: Management disclosure credibility is positively correlated with the level of external assurance.

#### **Level of internal assurance**

Internal assurance involve essentially the corporate governance mechanisms in place that compel managers adherence to governance principles. Fox (1999) proposes a hitherto unrecognized effect of enforced disclosure policies by arguing that required disclosure helps shareholders enforce manager's fiduciary duties. According to him, other than the direct impact of making managers accountable for their publicly available decisions, enforced disclosures also directly affects corporate governance by affecting the market for corporate control, the cost of capital, and monitoring by external sources of finance.

According to Molley (2004), investors may feel more confidence in the veracity of a firm's disclosures when the firm has a high quality board of directors. Basely (1996) found that firms with more independent boards and audit committees as measured by the number of outside members, experience less earnings management and fraud. (see also Klein,1999). Xie *et al* (2003) also find that firms in whose boards and audit committees meet more frequently and have greater financial expertise experience less earnings management. Black *et al* (2003) find that firms with a large percentage of outside directors and or an audit committee, command higher market valuations, and value the earning stream more highly for such firms.

Another source of internal assurance is the internal audit function. According to Molley(2004), internal auditors often serve as the first line of defense against disclosure errors ferreting out unintentional errors caused by weakness in a company's internal controls and intentional errors due to fraud. As a result, if investors can assess internal audit quality, then companies with strong internal audit departments may have higher disclosure credibility. Thus the level of internal assurance can affect management disclosure credibility. This takes us to the next hypothesis. H<sub>4</sub> : There is a positive relationship between management disclosure credibility and the level of internal assurance.

#### **Disclosure precision and time horizon**

Disclosure precision and time horizon are some attributes or characteristics of the disclosure itself that may affect the credibility of the particular disclosure. According to Molley (2004), management disclosures vary in their degree of precision. It has been argued that imprecise disclosures signal managements uncertainty and are therefore regarded as being less credible than more precise disclosures (Hassel *et al*, 1988; King *et al* 1990).

Also, it has been argued that time horizon covered by a disclosure affect its credibility. In this connection, it has been asserted that short horizon disclosure such as interim earnings forecast are generally more credible than longer horizon disclosures such as annual earnings forecasts. This is based on the assumption that information about immediate outcomes are more certain than these about later outcomes. This was established by Pownal *et al* (1993) when they show that interim management earnings forecasts generate larger stock price reactions than annual management earnings forecast. Thus we hypothesis that:

H<sub>5</sub>: Disclosure credibility is related to disclosure precision and time horizon.

#### **Support information and inherent plausibility**

Usually companies provide supplementary information or explanations to support their disclosures. It has been asserted that

supplementary information add to the credibility of disclosures by management. Gorgler (1994) argues that disclosure decisions often reflect a tension between providing investors with share relevant information and providing competitors with proprietary information. According to him, disclosures proprietary information is costly and therefore has a value which translate into investors perception of a greater credibility of the disclosure so supported. Hutton *et al* (2003) note that supplementary statements should increase disclosure credibility because these statements increase the ex-post verifiability of the disclosure. In other words, managers reduce their ability to take subsequent opportunistic actions to realize forecasts or to rationalize unexpected results when they make specific statements about forecast components.

Investors usually have expectations about certain outcomes and they are more skeptical about any information that deviates from this. Scientists' judgments are influenced by their prior beliefs when a research paper's conclusions disagree with a scientist's prior beliefs, he rates the study study's methodology to be relatively lower in quality. According to Molley (2004), when this applied to financial disclosures, a disclosure that deviates from significantly from investors' expectations will be less credible than one that does not. Thus we hypothesis that; H<sub>6</sub>: Management disclosure credibility is related to the availability of support information and the inherent plausibility of the disclosure.

#### **Research method**

The research is a structured cross – sectional survey of 150 respondents in Edo state. The research is on Investors Assessment of the Creditability of Management Disclosures in Nigeria, but due to resource constraints and the practical difficulty in accessing every respondent in Nigeria, the study was limited to Edo State, which is considered a fair representation of the whole country on issues of investment in the capital and money market. The respondents were drawn from among investors potential investors and their advisers in Edo state. They were classified into three groups viz (a) Bank portfolio

managers, (b) financial Advisers and (c) Individual investors. The bank Portfolio Managers were selected from banks located in Edo State to serve as a proxy for institutional investors. Financial advisers were collected from among chartered Accountants and stockbrokers in Edo State. Other investors were collected from among individual investors and potential investors.

The five point Linkert scale was used in the design of the questionnaire, which was the research instrument. The scale was constructed by assembling a number of statements about factors used in assessing the credibility of management disclosures. The respondents were asked to indicate whether they strongly agree, agree,

undecided, disagree or strongly disagree with each of the same of statement. The questionnaire consist of two parts. Part I contain questions on information about the respondents for the purpose of respondent classification. Part I consist of 23 questions under six (6) sections (appendix).The one – way analysis of variance (ANOVA) was used as the inferential statistics.

**Results**

During the data gathering exercise, a total of 150 questionnaires were administered to the three groups, with each group receiving 50 questionnaires. Table 1 below shows the distribution of the questionnaires and the response rates of the various groups.

**Table 1 Questionnaire Distribution**

Respondents	No. of Questionnaires administered of	No. of Questionnaires Returned	Response Rate (%)
Individual Investors	50	27	54.00
Bank Portfolio Managers	50	20	40.00
Financial Analysts	50	30	60.00
<b>Total</b>	<b>150</b>	<b>77</b>	<b>51.33</b>

In order to avoid group dominance in the result of the research, equal number of respondents was selected from the various groups. The minimum response of 20 from the bank portfolio managers

group was used as the reference datum for selecting the other two groups for analysis. The questionnaires consequently analyzed are shown in Table 2 bellow.

**Table 2 Questionnaires Analyzed**

Respondents	No of Questionnaires Received	No of Questionnaires Analyzed	No of Questionnaires rejected	%of Questionnaires Analyzed
Individual Investors	27	20	7	74.07
Bank Portfolio Managers	20	20	-	100.00
Financial Analysts	30	20	10	66.67
<b>Total</b>	<b>77</b>	<b>60</b>	<b>27</b>	<b>77.92</b>

The demographic Characteristics of the respondents where responses were analyzed are shown in Table 3.

**Table 3 Demographic Characteristics of Respondents**

AGE	FREQUENCY	PERCENTAGE
21-30years	8	13.33

31-40years	30	50.00
41-50years	12	20.00
51 years and above	10	16.67
Total	60.00	100.00
<b>GENDER</b>		
Male	45	75.00
Female	15	25.00
Total	60.00	100.00
<b>YEARS WORKED</b>		
Under 5 years	6	10.00
06-10years	12	20.00
11-15years	16	26.66
16-20years	10	16.67
21-25years	10	16.67
25 years and above	6	10.00
Total	60	100.00

**Descriptive statistics and test of hypotheses**

Table 4 shows the while Table 5 shows a summary of the result of the hypotheses testing

Table4 Descriptive Statistics

	Situational incentives	Management credibility	External assurance	Internal Assurance	Disclosure precision	Support information
Mean	3.92	3.85	3.94	4.02	3.96	4.03
Median	4.00	4.00	3.92	4.00	4.00	4.13

Mode	4.00	3.50	3.67a	4.00	4.00	4.25a
Std. Deviation	.62	.766	.557	.435	.755	.47
Variance	.39	.587	.310	.189	.570	.216

**Table 5 Hypotheses testing**

		Sum of Squares	df	Mean Square	F	Sig.
H1	Between Groups	4.459	2	2.230	6.949	.002
	Within Groups	18.289	57	.321		
	Total	22.748	59			
H2	Between Groups	6.100	2	3.050	6.089	.004
	Within Groups	28.550	57	.501		
	Total	34.650	59			
H3	Between Groups	3.712	2	1.856	7.245	.002
	Within Groups	14.603	57	.256		
	Total	18.315	59			
H4	Between Groups	1.623	2	.812	4.843	.011
	Within Groups	9.553	57	.168		
	Total	11.176	59			
H5	Between Groups	4.658	2	2.329	4.580	.014
	Within Groups	28.988	57	.509		
	Total	33.646	59			
H6	Between Groups	1.527	2	.764	3.874	.026
	Within Groups	11.234	57	.197		
	Total	12.761	59			

a. Multiple modes exist. The smallest value is shown

### **Situational incentives**

H<sub>1</sub>: management disclosure credibility is related to situational incentives. The mean of the responses is 3.92 with a standard deviation of 0.62.. The hypothesis was tested and the result shows a calculated value of F=6.949 which is greater than the critical value of 3.15 The hypothesis is thus accepted.

### **Management credibility**

H<sub>2</sub>: there is a positive relationship between the credibility of management disclosure and management credibility. The result of the hypothesis testing shows a calculated value of

F=6.089 which is higher than the table value of F=3.15 . The hypothesis is thus accepted

### **Level of external assurance**

H<sub>3</sub>: there is a positive relationship between the credibility of management disclosure and the level of external assurance. The mean of the responses is 3.94 with a standard deviation of 0.56. The hypothesis testing yields a calculated value of F=7.245 which is higher than the table value of F=3.15 hence the hypothesis is accepted.

### **Level of internal assurance**

H<sub>4</sub>: there is a positive relationship between the credibility of management disclosure and the level of internal assurance..The mean of the responses is 4.02 with a standard deviation of 0.44. The hypotheses results show a calculated value of F=4.843 which is greater than the table value of 3.15, hence the hypothesis is accepted.

### **Disclosure precision and time horizon**

H<sub>5</sub>: there is a positive relationship between the credibility of management disclosure and the disclosure precision and time horizon. The mean response for the variable is 3.96 with a standard deviation of 0.76. The calculated value of F=5.580 from the hypothesis testing is higher than the critical value of F=3.15 The hypothesis was therefore accepted.

### **Support information**

H<sub>6</sub> : the is a positive relationship between the credibility of management disclosure and

availability of support information and inherent plausibility. The mean response is 4.03 with a standard deviation of 0.22. The results show a calculated value of F= 3.871 which is higher than the table value of 3.15 .Thus, the hypothesis is accepted.

### **Summary of findings**

The study was out to examine how investors assess the credibility of management disclosures. From the study the following findings are made:(1)The situational incentives at time of disclosure affect the credibility of the disclosure, (2)If a management is credible or has good reputation, investors would place high premium on the credibility of disclosures made by the management (3)Investors would give high credibility to management disclosures of companies where there is a high level of external and internal assurance (4)Characteristics of the information itself like availability of support information, time horizon inherent plausibility etc affects investors assessment of the credibility of management disclosures.

### **Discussion of findings**

In this section, we examine the implication of the findings for the issues raised on the investors assessment of the credibility of management disclosures. The results show that respondents believe that situational incentives affect investors assessment of the credibility of management disclosure. Bad news is disclosed in financial statements are more credible than good news disclosure. Bad news has negative effect on a company, and management is usually not ready to disclosure bad news except it becomes imperative. Thus when bad news is disclosed, it is most likely to be credible. Also financially distressed companies are desperate to hide their true state from the outside world. They are therefore not likely to give credible disclosures. Invariably disclosure credibility should be tied to management credibility. If a manager is credible he is expected to give true disclosures otherwise, he is no longer credible. Management credibility is evidence from past records, and one of the best evidence in this regard is the past credibility of disclosure made by the manager. Hence



management disclosure credibility is affected by management credibility. This finding is line with earlier findings of McNichols( 1989), Kelley(1972), and Koch(1999).

The results have also indicated that the level of external assurance affect the credibility of management disclosure. External assurance is a measure of the level of monitoring of the companies affairs of operations. Such assurance is provided by auditors, regulators, financial analysts and institutional investors. The activities of these external agents gives some form of assurance that proper processes are being followed by the company. This inspire the confidence of the investor in the disclosures made by such companies. The finding on level of external assurance is consistent with the findings of Libby(1979), Hodge(2001), Leftwich(1983), Blackwell *et a*(1998), Gogoi(2001), and Li(2002).

Internal assurance play a similar role in the assessment of the credibility of management disclosure. Agents of internal assurance include board of director audit committee and internal audit department. The quality and expertise of these internal assurance agents is critical to the existence of a good corporate governance framework. The finding of the study for internal assurance is consistent with existing literature (Xie, *et al*, 2003; Beasley, 1996; Wild, 1996; Klein,1999; Fox, 1999).

The findings of the study has further shown that management credibility disclosure is a function of characteristics of the disclosure itself like the level of precision of the disclosure, whether the disclosure is for the short term (short horizon) or the long term (long-horizon), the availability of support information and the inherent plausibility of the disclosure. These findings are consistent with most pieces of findings in the literature such as Hassel *et al*(1988), King *et al*(1990), and Pownal, *et al*(1993) for disclosure precision and time horizon; and Gorgler(1994), Hutton, *et al*(2003) for support information and inherent plausibility.

The study did not examine interactive effects of the various factors. This should be a subject for further investigation.

### **Conclusions and recommendations**

The current study contributes to the established literature addressing factors affecting investors assessment of the credibility of management disclosures. The study is considered unique at least in Nigeria in that it consider the factors affecting investor assessment of the credibility of management disclosures directly from the perspective of the investors using primary data. Other studies before it have examined some aspects of the issues using mainly secondary data. There is no doubt that the assessment of the credibility of management disclosures will continue to be of interest in Nigeria, just like in other countries of the world.

This study will therefore be of particular interest to management of companies who want to improve on the credibility of their disclosures. This study has confirmed to them the factor that investor take into consideration when assessing management disclosures. The study will also be useful relevant to investors and potential investor, analysts other uses of financial statement who have reasons to assess the credibility of management disclosures. The study will also be of importance to professional bodies regulators and policy makers who are involved in regulating management disclosures.

The following recommendations are made for organisations who desire a fair assessment of their management disclosures: (1) They should ensure that they retain credible managers, (2) They should endeavour to provide both external and internal assurance for their disclosures, (3) They should ensure that adequate corporate governance structures are put in place.(4) Estimates disclosed by the mangement should be as precise as possible,(4)When making forecasts, short term horizon elements should be incorporated as much as possible, (5)They should provide adequate support information to accompany management disclosures, and (6) They should enrich their

shareholders profile by incorporating large institutional investors.

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