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BUSN3001 Research Essay

Earnings Management and Corporate Governance

Executive Summary

This essay investigates the relationship between corporate governance and earnings management by reference to a considerable amount of resources and empirical studies from previous works in Part A. To beginning with this essay, earnings management has been divided into two sections, which are real earnings management and accrual-based management. Next, five motivations have been introduced and this paper explains in brief how these five motivations incentivise managers to manipulate earnings management. Also, corporate governance involves internal corporate governance (e.g. board of directors and audit committee independence) and external corporate governance (e.g. regulators and blockholders). Through the research of the relevant literature, a series of challenges and opportunities have been found and mentioned in the following essay.

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1.0 Introduction

In pursuance of Healy & Wahlen (1999, p.368), earnings management is reporting behaviour that is used to mislead stakeholders about the underlying performance of a company. A lot of enterprises have collapsed for the reason of the opportunistic use of earnings management like Enron, Subprime Mortgage and WorldCom (Kumari & Pattanayak 2017, p. 224). According to its material impacts, more and more corporations choose to pay their attention to earnings management. It is inevitable to extirpate or alleviate this risk for modern corporations nowadays. This essay focuses on analysing impacts of different types of corporate governance mechanisms on earnings management and how to use these mechanisms to prevent earnings management. Also, several empirical evidence are involved in the following essay in order to analyse the relationship between corporate governance mechanisms and earnings management.

2.0 Types of Earnings Managements

2.1 Accrual-Based Earnings Management

Accruals is the differences between net income and cash flows. Refer to a non-discretionary accrual, managers will increase or decrease income by creating accruals when they engage in earnings management. However, when managers manipulate the changes in reported earnings by creating accruals (e.g. using increasing or decreasing estimates on bad debt expense), it is the discretionary accruals. Therefore, accrual-based earnings management is accomplished by using estimation based on intentionally formed biased judgement (Zang 2012, p. 676).

2.2 Real Earnings management

Real earnings management is achieved by estimating and adjusting actual business transactions based on earnings management involves the timing and structuring of actual business activities in the purpose of achieving desirable financial outcome (e.g. providing more "lenient credit terms" or price discounts to accelerate the timing of sales) (Zang 2012, p. 676).

Nowadays, managers often trade-off real activities' manipulation verse accrual-based earnings management based on their costliness because both activities are costly, and managers will engage in less costly activities. Managers may unlikely to choose accrual-based manipulation if real earnings management is more flexible. Also, Cohen et al. (2008, p. 770) conclude that the level of accrual-based earnings management declines while the level of real activities manipulation increases after the post- SOX. With the highlighted scrutiny of accounting practice, firms will more likely to choose real earnings management as a technique to explain the overall effect of earnings management activities. (cited by Zang 2012)

3.0 Motivations of Earnings Management

3.1 Bonus Plan Hypothesis

The bonus plan hypothesis indicates that managers will try to manipulate accounting policies so that future earnings are shifted into the current period. The efficiency view of this hypothesis is to align managers' bonus and profit with companies in order to reduce some agency problems such as interest's confliction between manager and shareholders. However, this hypothesis will also make managers have an opportunistic motivation to utilize earnings management and Healy (1985, p. 90) discovered that managers in organizations with bonus incentive plans often adopted accrual policies to maximize their expected bonuses.

Managers will try to downward their earnings management through some methods such as increasing the provisions for bad debts when their expected profit is larger than the actual one and reversing a part of this year's earnings back in the future. Also, managers will upward their earnings when the estimated net income is slightly below the actual performance, for instance, managers can increase the extent of capitalization or slow down amortization of previously capitalized expenses to get higher earnings (Guidry, J. Leone and Rock, 1999, p. 121). Managers will choose to 'take a bath' if net income is sufficiently below the actual profit.

3.2 Debt Hypothesis

The efficiency view of debt covenant hypothesis is to alleviate the agency problem between debtors and shareholders, for instance, shareholders tend to choose higher risk and higher return project, otherwise debtors prefer to choose lower-risk projects. However, managers are more likely to use accounting policies to manipulate reported earnings if they want to compromise the debt covenant in order to avoid technical defaults.

Managers will manipulate earnings to make sure their debt-to-equity ratio is not above 2, because it will make debtors think the firm probably cannot pay back if the ratio is above 2. Also, managers will increase their interest coverage ratio by increasing earnings before interest and taxes (EBIT) or decreasing the interest expense, under this way to make debtors have confidence that the firm can pay interest on its outstanding debt (Press & Weinthrop 1990, p. 82). Based on debt hypothesis, managers also consider about the income smoothing of the company and managers try to smooth their profit to make the outsiders feel that the company's economic situation is stable and lower risk will need to take if outsiders lend money to this company. As a result, the company will gain a lower cost of capital and it can attract financing at a lower cost.

3.3 Political Cost

Based on the positive accounting theory, firms are likely to understate their income in order to reduce public scrutiny, prevent wealth transfer and avoid a tax penalty. Daley & Vigeland (1983) indicate that large firms are more likely to reduce their profits rather than small companies since large firms with high visibility are the main targets of the government's wealth transfer. Hall (1993, p. 423) finds that giant petroleum and gas firms reduce reported income to avoid the political cost. In additional that oil companies might manipulate their earnings by discretionary accruals, thereby preventing the high political costs of rising oil prices during the Gulf crisis on 1990 (Han & Wang 1998, p. 104). Same actions have been taken to the petrochemical companies when oil prices were high during the year 2005 to 2006 (Zhang 2008, p. 115).

3.4 CEO Turnover

Strong & Meyer (1987 p. 652) illustrates the relationship between large discretionary write-offs and CEO turnover. The initial 'earnings bath' allowed the new management team to blame the poor performance of the former manager on mismanagement and manipulate the profit downwards at the beginning of the year and subsequently reported an increase in performance during the following years in order to achieve higher expectation form public. Dechow and Sloan (1995, p. 199) showed that the outgoing CEOs will increase short-term earnings through reducing research funding by managing discretionary investment expenditures in order to gain higher reputations (cited by Rahman et al. 2013).

3.5 Analysts Forecasts

Analysts forecast a company's performance and prospect and the purpose of forecasting is to help people who use this information to make more rational decisions in order to earn more profit from that. Barth and Taylor (2010, p. 28) present evidence of meeting or beating analyst earnings forecasts will lead to a positive market response. Also, managers perceive that the earning forecast from analysts is one of the most important factors that affect the share price of their operations (Graham, Harvey, and Rajgopal, 2005, p. 55). Due to the fact, the share price will increase when reported earnings are greater than analysts' expectations. On the contrary, the share price will decrease when analysts predict a negative earnings surprise. As a result, managers have strong incentives to adjust earnings to meet and beat the analysts' expectations to implement their stock-related compensations. There is an endogenous relationship between earnings management and analyst forecast accuracy. Analysts' reputation will be affected if their results are discrepant largely from the earnings of a company because investors will think that this analyst does not have enough ability to predict accurately about the forecasts. Therefore, in some situations, the earnings manipulation may mislead analysts to get over-valuate or under-valuate forecasts (Embong and Hosseini, 2018, p. 103).

4.0 Corporate governance mechanisms (preventing earnings management)

4.1 Internal Corporate governance

4.1.1 Board of directors

The board of directors plays a critical role in the corporation. The primary duty of the board is to represent the rights of shareholders, involved but not limited by monitoring the performance of managers. Besides, a larger size of board has affirmative effects on board independence as the prediction of agency theory. (Ramdani & Witteloostuijn, 2010, p. 612).

4.1.1.1 Independence of the board

In accordance with agency theory, a high-independent board will eliminate, or at least extenuate any agency conflicts between shareholders and managers in order to reduce the agency cost (Bathala & Rao, 1995, p. 63). Further, boards with a high proportion of independent directors are associated with reduced levels of earnings management (Benkel, et.al, 2006, p.68). Compared to a higher cost from exposure of earnings management, managers will less likely to manipulate earnings management due to a higher chance to be caught and punished by an independent board.

However, there are several types of research argued that an independence board is less effective due to cultures, policies among different countries, and other factors that may influence the performance. According to Neville's research, (Neville et.al, 2018, p. 2546), independence board corporate has a negative effect on misconduct, includes earnings management, especially in some countries with more corruption.

It's possibly from a result of self-interests among independent directors, exclusive chief stuff, and shareholders. Further studies, such as Ashforth & Anand (2003, p. 36) had discussed corruption in detail.

4.1.1.2 Size of the board

Another endogenous factor associated with earnings management is board size. Larger board of directors is more effective on the monitoring. According to the result of William's group, the number of illegal violations is significantly reduced among those firms having larger boards of directors (William, et.al, 2005). Further, the proportion of independent directors may also be increased through recruiting more experienced and professional outsiders during the expansion of the board (Xie, Davidson III & DaDalt 2003, p. 305), and Benkel et.al (2006, p. 70) had discussed the relationship between the proportion of independent directors and detection of earnings management. In that case, a larger board can provide higher efficiency in detecting earnings management.

Nevertheless, some evidence concludes a negative relationship between board size and earnings management. Yermack suggests that companies with small boards are more efficient and provide stronger CEO performance through penalty and threat of dismissal (Yermack, 1996). The theoretical point of view suggests that even though the ability of monitoring is increased by expansion of the board, the opportunity cost such as slow decision-making, dissembling discussion, and bias of information among the board, will exacerbate the agency conflict and potentially, or significantly increase the opportunity of earnings management. Indeed, Conyon & Peck's study (Conyon & Peck, 1998) stands for the view of Yermack. Whereas, they also mentioned that their test is limited due to the control and sample selection.

4.1.2 Audit Committee Independence

Audit Committee is formed by directors and auditors with appropriate financial or accounting expertise. However, it is independent of the board due to its role of verifying and ensuring the financial reports are released in true and fair view. Hence audit committee independence is an important factor that affects the efficiency of its monitoring responsibilities.

Audit committee independence significantly influenced the ability of monitoring. Klein (2002) found reductions inboard or audit committee independence significantly raise abnormal accruals due to earnings management. Therefore, a negative relationship exists between audit committee independence and earnings management. Moreover, independence is also influenced by knowledge and information of financial and accounting that assessed by the committee. Defund et. al (2004, p. 174) suggest audit committees with accounting financial expertise improve corporate governance. Further research also concludes with firms with a less independent audit committee that have less, or non-financial accounting expertise, are more likely to be identified with internal control weakness (Zhang & Zhou & Zhou, 2007, p. 301). It may owe to information asymmetric among the committee, the board, and managers. Hence a high level of internal control weakness raises the risk of manipulating earnings management under the inefficient ability of monitoring.

4.2 External Corporate governance

4.2.1 Regulators

As same as the internal corporate governance, external corporate governance can present a positive effect to prevent the opportunistic behaviours as well. According to Shleifer and Whipple (2005, p. 446), regulations need to have a responsibility to set standard rules and regulators should have obligation to turn into neutral arbiter.

However, similar like capture theory, most regulators as well as all other people, prefer to be driven by self-interest and will only “propose and support regulations which lead to favourable outcomes for themselves” (Shleifer & Whipple, 2005, p. 439). The regulation might be introduced to benefit the public at first, but the regulated party might try to take charge of the regulators subsequently. To be more specific, standing on the point of regulators, it’s easy to create a corrupt environment for the managers of the corporation. In response to Manzetti and Wilson (2007, p. 952), if a weak rule of law is combined with an ineffective government, more transaction and agency costs may be generated by the firm and thus, bring about a lower gross profit. If so, some company managers are arguably more motivated to make use of the relatively higher levels of asymmetry information to generate earnings in order to procure a larger proportion of the finite profits created by the company (Richardson, 2000, p. 325).

4.2.2 Blockholders

Apart from regulators and managers, blockholders (known as major shareholders) also play a critical role in preventing earnings management. Since the participation extent shall stimulate large shareholders to affect and monitor the company strategy in which they have invested (Gabrielsen et al., 2002, p. 981), that means blockholders make a significant contribution in firms' internal control. Correspond with the efficient monitoring hypothesis (Jensen & Meckling, 1976, p. 306), blockholders should reduce opportunism managerial behaviour and behave more incentive to enhance corporation value (Shleifer & Vishny, 1997, p. 739). It will provide a positive effect on financial reporting quality (FRQ) because making full use of monitoring by shareholders participation can lower the motives by the owners to dispossess minority shareholder wealth (Boubakri et al., 2005, p. 370). Therefore, as Alzoubi (cited in Klein, 2016) mentioned, raised ownership is an active corporate governing system to control management accounting decisions and lead to a higher FRQ and if such kind of monitoring system is executed by external, separate blockholders, earnings management operations will be declined (Byrd & Hickman, 1992,p. 198).

However, as mentioned above, when the number of blockholders exceeds an extremely high level, the agency issues may be caused as the violation of minority shareholders' interest (Boubakri et al., 2005, p. 387). They may enforce their private penchants so that they can obtain their advantages even if most of their predilections are against the interests of minority shareholders (Shleifer & Vishny, 1997, p.741). As a result, it is possible that large shareholders take part in the corporation's management and may induce managers or regulators to employ in earnings management to maximise their benefit(Edmans, 2014).

5.0 Conclusion

Despite relevant laws have been carried out to regulate the use of earnings management, EM activities still can be discovered from time to time. This report firstly started by discussing the characteristics of two types of earnings management. Then, we analysed the motivations behind earnings management and demonstrated five different scenarios for which earnings management would possibly occur. In the fourth section of this report, we have further investigated the approachable preventions for earnings managements in terms of corporate governance mechanisms. In particular, preventing the EM activities through ensuring independence and structure of the board. Additionally, block holders and government can also undertake certain actions as external parties to facilitate the success of corporate governance. In conclusion, it is essential for corporations to prevent themselves form earnings management activities and act in the best interests of their shareholders.

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