The Efficacy of Corporate Governance in Reducing Opportunistic Accounting Earnings Manipulations

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Abstract
This paper presents a review of evidence pertaining to whether effective corporate governance mitigates agency conflict and thus reduces opportunistic accounting earnings management. This study pursues the theoretical arguments, (agency theory), that the principal agent relationship provides an insight that effective corporate governance plays a significant role in reducing agency conflict and information asymmetry. This is on the premise that, it may not be possible to directly observe the managers opportunistic accounting choices, but investors (shareholders) have to take action to protect their interests; as a result firms may have to incur higher agency costs to mitigate managers’ discretionary accounting choices. The findings in this study indicate that corporate governance monitoring is effective in mitigating managers’ opportunistic discretionary accounting choices and reducing agency costs and thus improving the quality of reported accounting earnings.

Keywords: Corporate Governance, Earnings management

1. Introduction
This paper reviews the evidence in the literature pertaining to whether effective corporate governance mitigates agency costs and thus reduces opportunistic earnings management. The theoretical arguments (agency theory) in the principal agent relationship provide an insight that effective corporate governance plays a significant role in reducing agency conflict and information asymmetry. However, it may not be possible to directly observe the managers opportunistic accounting choices, but investors (shareholders) have to take action to protect their interests. As a result firms may have to incur higher agency costs to mitigate managers’ discretionary accounting choices.

The extant literature argues that corporate governance structures are effective in protecting investors’ interests, by monitoring the integrity of the financial reporting process (Fama and Jensen, 1983, Sivaramakrishnan and Yu, 2008). Additionally, corporate governance monitoring is also effective in mitigating managers’ discretionary accounting choices and reducing on agency costs (Dechow et al., 1996; Klein, 2002; Peasnell et al., 2005; Niu, 2006).

The role of corporate governance is paramount and crucial in attaining a high quality financial reporting process and informing investor’s decisions on the value of accounting information (Sampers, 2008; Soderstrom and Sun, 2007). Moreover, the introduction of better accounting standards such as IFRS is helpful in improving financial reporting only for firms with effective shareholder protection and company specific characteristics such as high quality corporate governance (Tanga et al., 2009; Wang and Yu, 2008). Similarly, there is evidence to suggest that the effect of the accounting standards on quality of financial reporting is weak relative to the effect of forces such as manager’s incentives, auditor quality, regulation, legal enforcement and corporate governance (Holthausen, 2009).

Thus this paper attempts to provide a review of existing evidence of the role of corporate governance in mitigating opportunistic earnings management and the contribution of corporate governance to the integrity of financial reporting and protection of investors.

2. Agency Theory and Corporate Governance
2.1 Agency Conflict (Problem)
Agency theory is based on the relationship the owners of financial resources (principals) strike with the human capital (agents) to pursue the creation of economic wealth through industrial production. The owners take risk by contributing capital and the managers invest this capital to create wealth for the owners (Fama, 1980; Jensen and Meckling, 1976).

The managers are employed by the firm’s owners (equity shareholders) to run the affairs of the firm on their behalf; consequently managers are agents of the principals who are the owners. The separation of ownership and control may result to conflicts of interests between insiders (managers) and outsiders (owners) (Jensen and Meckling, 1976).

The Agency conflict may increase due to risk generation on the part of the principals (investors) and the agents (managers). The principal derives risk by investing in the equity of the firm hoping to generate a return for himself. The managers take up risk through provision of labour to manage the investment of the principal, with the aim of generating a return to the investment. However, the separation of ownership from
management provides the managers with the opportunity to take control of the firm (Berle and Means, 1932; Jensen and Meckling, 1976). The control risk increases further when the firm ownership is dispersed, making the coordination among shareholders difficult and expensive, therefore managers become de facto policy makers (Williamson, 1985; Phan and Yoshikawa, 2000).

Furthermore, because managers are insiders, they have access to the firm’s relevant information that is necessary to affect the direction of firms strategic decision making. Consequently, where the managers have to make strategic informed decisions; the owners may face a moral hazard problem because the managers may not take the full consequences and responsibilities of their decisions and actions, leaving the owners to hold some responsibility for the consequences of those actions (Jensen and Meckling, 1976; Phan and Yoshikawa, 2000).

The agency relationship is also fraught with conflicting interests that arise due to divergent management and shareholder objectives and information asymmetry (Coase, 1937; Jensen and Meckling, 1976; Fama and Jensen, 1983). The owners of the firm are driven by the desire to weigh in their interests against any possible losses. They are interested in activities and projects that lead to profit maximisation and cost minimisation as much as possible. However, the delegated agents private interests and decision making control may draw the owners in another direction (Berle and Means, 1932; Pratt and Zeckhauser, 1985). Consequently, when agents become all powerful, they pursue their self interests often to the detriment of value creation for shareholders (Jensen and Meckling, 1976). The principal cannot without incurring costs monitor the actions of the agent, and acquire the information available to or possessed by the agents in order to realise profit maximization and cost minimization ideals (Phan and Yoshikawa, 2000).

The life span of the agents and the principals in the firm also provides potential for agency conflict. Firms have an indefinite life; as a result shareholders are more inclined to having an infinite stream of cash flows. However, managers have finite life span and are always limited to cash flows received from their employment (Farinha, 2003). This kind of conflict is common when managers are approaching end of contract or retirement. Consequently, managers may choose to have short term perspectives on investments, opting for short term investments with instant cash flow returns which may not necessarily be value maximising to shareholders (Farinha, 2003).

Agency conflicts coupled with information asymmetry provide a potential for financial reporting concerns to arise. However, in the absence of agency conflicts (problems), managers may not have the incentive to misrepresent the reported financial accounting information (Beatty and Harris, 1998; Kim and Yi, 2006).

Where agency conflicts exist, managers have the incentives to maximise their own utility at the expense of corporate shareholders (Dey, 2008). In addition, where managers have sufficient latitude in applying accounting procedures; they are inclined to take actions that maximise their utility, even when those actions do not maximise shareholder wealth (Watts and Zimmerman, 1986). These actions include the consumption of corporate resources as perquisites, the avoidance of optimal investments and the manipulation of financial accounting figures to optimize compensation (Dey, 2008). Moreover, where more equity is sold to outside investors, the utility maximising agent has the incentive to appropriate a larger amount of the corporation’s resources in the form of perquisites and to exert less than full effort to create value for shareholders (Jensen and Meckling, 1976).

### 2.2 Control of the Agency Conflict

The essential sources of agency conflicts (problem) discussed in the preceding section include, moral hazard\(^1\), information asymmetry\(^2\) and risk aversion\(^3\). Financial reporting does most to combat the information asymmetry source of agency conflict. Higher levels of information asymmetry are indicators of shareholders sufficient capacity to monitor managers’ actions and possible failure of adequate financial information disclosure practices (Schipper, 1989).

Evidence is provided that, high accounting quality does not only reduce information asymmetry but also decreases overall uncertainty in the market. Thus, transparent financial accounting systems play significant role in the vitality of financial markets (Qi, Subramanyam and Zhang, 2010). Reduced information asymmetry has also advantageous effects on equity and debt market information, therefore benefiting regulators to strive for high quality accounting information. These benefits manifests through reduced cost of capital and market participants understanding of alternative investment opportunities (Kothari, 2000).

Moreover, Raffournier (2008) also suggests that the use of IFRS in financial reporting leads to reduction in information asymmetry in financial accounting information provided by managers. IFRS are market

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1. It occurs when the terms of the contract encourages pervasive behaviour such that one party provides misleading information or has an incentive to take unusual risk before the contract settles. In the firm managers take the risk and owners bear the consequences.

2. Where, the agent (managers) possesses information that is for the principal (shareholders) unobservable or costly to obtain.

3. When organizations grow manager’s become risk averse by potentially protecting their interests as opposed to those of the owners. Managers would like to maximise opportunities for firms that have already brought in rewards, therefore they continue to build structures that increase their opportunity for more control of the firm.
oriented and the disclosure requirements are large. IFRS accounting choices are also specific; the manager’s application of specific accounting treatments is enhanced and is enforceable. Additional evidence suggests that, firms that adopt international accounting standards experience decrease in information asymmetry in financial reporting (Leuz and Verrecchia, 2000; Platikanova and Nobes, 2006; Dumontier and Maghraoui, 2006). For instance, Horton and Serafein (2007) argue that in the United Kingdom at the time of transition to IFRS, firms reporting IFRS earnings lower than earnings computed according to the UK GAAP were penalised by the market. This implied that the market believed IFRS based information as more transparent and reliable.

A reduction in information asymmetry is also a consequence of higher quality financial reporting and practices, coupled with greater oversight by internal and external auditors and directors on the integrity of the financial reporting process (Daske et al., 2008; Bruggerman et al., 2009; Li, 2010).

Information asymmetry can also be reduced through bonding and behaviour contracts that specify activities that managers should engage in. As a result each party to the contract will be assured of maximising his interests. Principals can also monitor consequences of the agent is behaviour through outcome based contracts. One such outcome based contracts are performance related contracts that are reflected in compensation packages (Jensen and Meckling, 1976).

The principal can also limit the agent’s divergent, self maximizing behaviour by making the agent to incur bonding costs. These include retention of equity stake by the managers, or adoption of riskier than desired compensation plan. Alternatively, the principals can also incur monitoring costs. These include costs related to payments to auditors, independent directors on the board etc (Jensen and Meckling, 1976). However, Jensen and Meckling (1976) also argue that there is always a residual loss. This is because in equilibrium, the marginal agency costs should be equal to the marginal benefits of monitoring and bonding.

Corporate governance structures have evolved that help in mitigating agency conflicts (Hart, 1995; Jensen and Meckling, 1976). Corporate governance in its divergent forms is effective in mitigating the agency problem, and providing high quality financial reporting systems. And given an efficient market provides returns to owners’ investment (Sivaramakrishnan and Yu, 2008).

Because agency conflicts vary across firms, the corporate governance structures required to address these problems are also likely to vary. The corporate governance mechanisms available comprise, the market for corporate control, large shareholder monitoring, internal mechanisms such as board of directors, various non executive directors committees, executive incentives and contracts and the regulatory framework of the corporate law and stock exchanges.

An efficient capital market also functions as a monitoring mechanism for managerial use of resources and the actual capacity to maximise value. Farinha (2003) argues that when managers of the firm take actions that are deemed by the market to be value enhancing, the price of the assets of such a firm will rise. On the other hand, managers’ actions that are deemed by the market to adversely affect the value of the firm’s assets will cause the price of those assets to drop. However, managers may attempt to stifle the efficient functioning of the market by managing or manipulating earnings. This will maintain their information advantage over the principals.

The next section provides evidence that shows that effective corporate governance systems lead to a reduction in the agency conflict and an increase in the quality of accounting reporting systems and reliable accounting information. Earnings management should therefore, decrease due to a decline in agency conflict and a decline in information asymmetry and hence accounting earnings should be more value relevant.

3. Earnings Management and Corporate Governance

3.1 Introduction and Definitions of Earnings Management

Earnings management is defined by Schipper (1989) as, “purposeful intervention in the financial reporting of the firm, with intent of obtaining some private gain”. Healy and Whalen (1999) state that, earnings management occurs when managers use their judgement in financial reporting and in structuring transactions to alter financial reports to either mislead stakeholders about the underlying economic performance of the firm or to influence contractual outcomes that depend on the reported accounting numbers.

1 Leuz and Verrecchia (2000) used German data to examine the effect of IFRS and US GAAP adoption on the information asymmetry. They used the effect of bid ask spread, the trading volume and the volatility of returns as measures of information asymmetry.

2 Agents incur bonding costs although these costs are ultimately passed on to the firm and hence to the principal.

3 Corporate governance has been defined by scholars in various ways. Pass (2006) defines corporate governance in terms of the duties and responsibilities of the firm’s board of directors in management of the firm and their relationship with the shareholders of the firm. Shleifer and Vishny (1997), define corporate governance as dealing with the ways in which suppliers of finance to corporations assure themselves of getting return on their investments. Shleifer and Vishny (1997) express the Anglo- Saxon approach to corporate governance, from the perspective of the capital markets, by focusing on the generation of fair return for the investment. Corporate governance is an important factor in an increasingly globalised economy in attracting investment capital and firm sustainability. It provides a framework for minimisation of firm risk and promotion of transparency and integrity of financial reporting. Moreover, corporate governance provides a basis for defining the relationship between the firm owners and managers, with the objective of protecting the interest of the owners.
Opportunistic earnings manipulation is done in order to misrepresent the firm’s financial performance for the interests of the managers (Beneish, 1999). The manipulation consists of an artificial inflation of revenues or deflation of expenses, changes in the timing of expenses and revenue recognition, changes in accounting methods for recognition or valuation of assets and liabilities, abnormal rise of asset accounts as a result of non-writing off of bad debts and accumulated depreciation on the balance sheet date or the capitalization of operating expenses (Beneish, 1999 and Aljifri, 2007).

Opportunistic earnings management is undertaken for various motives. For instance, Burgstahler and Eames (2003) and Payne and Robb (2000) suggest that it is undertaken with the intention of either misleading financial statement users or for the purpose of biasing contractual outcomes that depend on accounting earnings. Managers also use opportunistic earnings to meet analyst forecasts and raise funds on favourable terms (Magrath and Weld, 2002). Some firms also use opportunistic earnings management to avoid violating earnings based debt covenants (DeFond and Jiambalvo, 1994). Managers also alter earnings using discretionary accrual accounting choices to mask (disguise) poor firm performance in order to safeguard themselves from possible dismissal (Dhahran and Lev, 1993).

Ronen and Yaari (2007) suggest that earnings management can be beneficial in that managers take advantage of the flexibility in the choice of accounting treatment to smooth earnings so that it signals the managers’ private information on future cash flows. This enhances information value of earnings by conveying private information to the shareholders and the public (Jiraporn, Miller, Yoon and Kim, 2008; Arya, Glover and Sunder, 2003 and Subramanyam, 1996). Artificial earnings smoothing affects the market perception of earnings volatility and hence the share price since smoother earnings are easy to predict. It is a desirable feature of the quality of accounting earnings compared to opportunistic earnings management. Nonetheless, artificial earnings smoothing by use of GAAP, is associated with costs such as the loss of managers credibility and integrity of financial reporting process as a whole (Goel and Thakor, 2003).

The degree of flexibility and discretion in financial reporting is a key motivator for managers to engage in earnings management (Christie and Zimmerman, 1994). This is supported by the incentive to communicate private value relevant information about the firms’ future performance (Jones, 1991; Healy and Palepu, 1993). Information asymmetry also allows managers to manage earnings in order to maximise their own interests or to signal their private information, thus influencing the value of earnings (Healy, 1985; Holthausen et al., 1995).

### 3.2 Overview of Earnings Management and Corporate Governance Regulation

When managers manage earnings, accounting earnings reliability as measure of the firm’s financial performance may come into question. The less reliable earnings are the less informative and the more difficult it becomes to make informed economic decisions and choices (Kothari, 2001). The dependability of accounting earnings is improved when managers’ opportunistic behaviour is controlled using monitoring systems (Wild, 1996; Dechow et al., 1996). Corporate governance mechanisms are effective in monitoring of managers’ capacity to manage earnings opportunistically (Klein, 2002; Peasnell et al., 2000; Gul and Tsui, 2001). Similarly, Beasley (1996), Dechow et al. (1996) and Jiambalvo (1996), show that a negative relationship exists between effective corporate governance mechanisms and financial reporting decisions that are breach of the generally accepted accounting principles.

Agency theory suggests a direct relation between effective monitoring of management and reduced costs of dysfunctional behaviour, rather than a direct increase of performance (Jensen and Meckling, 1976; Maher and Anderson, 2000). Corporate governance therefore acts as an assurance to shareholders on the reliability of information provided by managers. It achieves this objective by monitoring the management’s performance and inspecting the financial reporting process of the firm.

By aligning the interests of shareholders with those of managers corporate governance systems enhance the reliability of accounting information and the integrity of the financial reporting process (Watts and Zimmerman, 1986). Strong corporate governance systems (e.g. Cadbury report, 1992; OECD, 1999; The UK code of corporate governance, Sarbanes-Oxley Act of 2002, etc) facilitate effective monitoring, thereby encouraging managers to use resources more efficiently. The existence of strong corporate governance may increase the value relevance of accounting information through a perception of greater integrity of financial reporting and improved reliability of reports managed accounting earnings (Cheng et al., 1997).

However, corporate governance regulation may differ across firms or countries due to investor protection requirements and International Financial Reporting Standards (IFRS) adoption (Sarkar et al., 2008). Weak legal institutions and weak shareholder protection, means managers are in position to extract private benefits of control and conceal the true financial position of the firm from outsiders (Leuz, Nanda and Wysocki, 2003; Haw, Hu, Hwang and Wu, 2004). Leuz et al. (2003) argue that, earnings management is expected to decrease with investor protection because strong protection limits insiders’ ability to acquire private control benefits, which reduces their incentives to mask firm performance. Leuz et al. (2003) findings highlight an
important link between investor protection and the quality of accounting earnings reported to market participants.

The next section provides evidence on the role of corporate governance structures (mechanisms) that are used in monitoring of the financial reporting process and protecting shareholder interests and limiting opportunistic earnings management.

3.3 Earnings Management and the Duality of Chief Executive Officer Roles

There is a debate in corporate governance literature on whether the separation of the position of the board chairman from the chief executive officer (CEO) roles leads to better corporate governance. When the chairman of the board of directors of the firm is also the CEO, he or she attains a possible dominant position on the affairs of the firm. CEO dominance indicates exercise of more control and less monitoring over management adverse activities and behaviour (Finkelstein and D’Aveni, 1994).

The role of the board chairman is to monitor the chief executive officer. Consequently the chairman will be compromised in his independence between the board and management when the chief executive officer is also the board of director’s chairman (Jensen, 1983). Thus, the duality of the CEO may lead to more opportunistic managerial behaviour due to the reduction in effective board monitoring over the executives (Finkelstein and D’Aveni, 1994).

Anderson et al. (2003) suggests that the separation of the chief executive officer position from the board chairman positively influences the information content of accounting earnings. Dechow et al. (1996) finds that firms whose chief executive officer chairs the board of directors are more likely to be subject to the accounting enforcement actions by the Securities and Exchange Commission (SEC)².

Sarkar et al. (2008) also argue that, CEO duality and presence of controlling shareholders on the board increases earnings management. While Mulgrew and Forker (2006) suggest that, firms where the CEO is also the founder have a higher propensity to manage earnings.

Firth, Fung and Rui (2006), indicate that investors find accounting earnings more value relevant when the position of the chairman is separate from the chief executive officer. Meanwhile, Chtourou et al. (2001) and Xie et al. (2003) find no relationship between the chief executive officer dominance and opportunistic earnings management. Although, contrary evidence exists, the balance of the evidence suggests that firms with non dual CEO are more likely to restrain opportunistic earnings management. The board of directors of a firm is the shareholders shield against opportunistic behaviour of management (Weisbach, 1998). The board of directors formulates strategic direction of the firm (Kesner and Johnson, 1990). It also performs the agency role of monitoring management for the shareholders, so that they serve to the best interest of the shareholders (Fama, 1980; Fama and Jensen, 1983). Board monitoring of financial reports is important because managers often have self interested incentives to manage earnings potentially misleading shareholders (Vafeas, 2000).

Larger boards are more likely to be vigilant because greater numbers of people will be reviewing management actions (Kiel and Nicholson, 2003). This argument is supported by John and Sebet (1998) who find that an increase in the board size is associated with increase in the boards monitoring capacity of management. While, Chtourou et al. (2001) and Xie et al. (2003), suggest that larger boards are strongly associated with lower levels of earnings management.

When boards become bigger, they are likely to include more independent directors with valuable experience and this will prevent or limit managerial opportunistic behaviour to manage earnings (Xie et al. 2003). Increased board size also breeds expertise and diversity from the public (Dalton, 1998). Moreover, the formation of committees due to large boards brings in more monitoring effect to all areas of management activities and behaviour (Klein, 2002).

However, Yu (2006) suggests that firms with smaller boards restrain earnings management more because of efficiency associated with small numbers. Similarly, Vafeas (2000) argues that the earnings of firm’s with the smallest boards in the sample (with minimum of five board members) are perceived as being more informative by market participants. Similarly, Weisbach (1998) and Yermak (1996) suggest that some firms require smaller boards for effective monitoring of managers activities and their opportunistic behaviour.

Lipton and Lorsh (1992) and Jensen (1983), also suggest that larger boards are less effective than small boards because of higher costs of communication and decision making inefficiencies associated with larger boards. Alexander, Fennell and Halpern (1993) argue that managers in firms with larger boards tend to use their power to entrench themselves as opposed to smaller boards which are administratively focused and maintain their power with frequent review of the performance of the CEO. Moreover, the Higgs report (2003) and the UK code of corporate governance seem to suggest that smaller boards are more effective in corporate governance monitoring compared to larger boards.

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¹ In this paper duality of the CEO is used to imply a situation where the CEO is both the chairman and chief executive officer of the firm.

² The mission of Securities Exchange Commission of the USA is to protect investors, maintain fair and orderly capital markets and facilitate capital formation.
The evidence on the role of board size reviewed appears to be mixed. However, there is more evidence to support the view that smaller boards are more effective in reducing earnings management and increase the reliability of earnings due to increased efficiency and effectiveness in the operations of the board because of its small size.

3.4 Earnings Management and Non Executive Directors

Fama and Jensen (1983), highlight the importance of outside board members in carrying out the board decision control function. Being independent of the management’s influence, outside directors are in a better position than insiders to protect shareholders interests from managerial opportunism. In addition, independent boards are more effective because they are less vulnerable to undue influence by managers (Weisbach, 1998).

Fama and Jensen (1983) also argue that competition in the outside directors’ labour market compels outside directors to have an added incentive to monitor earnings management in order to retain their positions on the boards. Moreover, the labour market for non executive directors values non executive directors from firms that are performing well.

Corporate governance codes around the world, in drawing up the procedures for improving the quality of financial statements, have emphasised the fiduciary role the boards of directors, especially independent non executive directors on the board, play in the reduction of opportunistic earnings management and in ensuring that earnings figures convey true information about the firms operations (Young, 2000). For instance, a pre and post Cadbury study, by Peasnell, Pope and Young (2000) reveals evidence of less income increasing accrual management to avoid earnings losses or earnings declines when the proportion of non executive directors is high, post Cadbury period.

Outside directors may become effective, not just because they have no economic ties to the company beyond their job as directors, but because they are significant shareholders. Disinterested outsiders can mean uninterested outsiders, especially where they have a token ownership interest, if any, in the firms they serve (Monks and Minnow, 1995).

Board independence and significantly the quality of the board, is important in mitigating earnings management. Boards where members are diligent to their monitoring duty are associated with lower earnings management. Diligent boards spend more time scrutinising and monitoring management opportunistic behaviour hence enhancing the reliability of reported earnings (Sarkar et al. 2008).

The board’s ability to successfully curb earnings management is also functionally related to the attributes each non executive director brings to the firm. Outside board of directors with financial expertise have the ability to scrutinise the reported accounting numbers and dig much deeper hence contributing to reliability of reported earnings. While, outside directors with less financial expertise have less ability to scrutinise the reported financial reports. They may fail to detect the misrepresented figures that affect earnings hence failing in their role of monitoring the opportunistic behaviour of managers (Chtourou et al. 2001).

However, there is an argument that, boards that have directors with multiple appointments that involve several other boards exhibit higher earnings management. While these board members bring a wealth of experience and expertise, they may not have enough time and opportunity to perform their monitoring role on management (Sarker et al., 2008).

Similarly, Firth et al. (2006) provides an argument that, the existence of non executive directors on board of directors is positively related to the magnitude of discretionary accruals. They suggest increasing the non executive directors on the board does not necessarily lead to reduction in earnings management. Meanwhile, Park and Shin (2002), also argue that outside directors, as whole, do not reduce abnormal accruals. They suggest that its only directors from financial intermediaries that reduce earnings management and that boards which are represented by active institutional shareholders reduce earnings management further and that earnings management does not decrease with the average tenure of outside directors as board members of the firm, either.

Mulgrew and Forker (2006) find that, earnings management is not associated with the non executive director independence or share ownership. These evidence is consistent with that of Xie et al. (2003) and Piot and Janin (2005), who find little association between non executive directors independence and earnings management. Similarly, Uzun et al. (2004) and Agrawal and Chadha (2005) also fail to identify a significant correlation between non executive director independence and the measures of financial reporting quality.

Although there is contrary evidence on the relationship between earnings management and non executive directors, on the balance of evidence, firms with dominant outside directors who are independent are likely to restrain opportunistic earnings management.

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1 Peasnell, Pope and Young (2000), in their study using constant sample, test whether the association between board composition and earnings management actively differs between the pre and post Cadbury periods.
3.5 Earnings Management and the Audit Committee

The UK code of corporate governance, for example, proposes that, the firms audit committee should be exclusively made of outside directors. The Audit committee meets regularly with the firms’ internal financial managers to review the corporation’s financial statements, audit process and the internal accounting controls.

The work of the audit committee may be complicated, by legitimate differences of opinion that may exist between management and outside auditors in how to best apply the generally accepted accounting principles. These differences may result either in the auditor being dismissed or, more likely, in a negotiated financial report (Magee and Tseng, 1990; Dye, 1991; and Antle and Nalebuff, 1991).

Nonetheless, board audit committees contribute to the increase in the level of integrity of the financial auditing process and the quality of the financial reporting process (Klein, 2002). This is because, in most (if not all) cases audit committees are made of independent non executive directors who bring a wealth of expertise to scrutinise the financial reporting process of the firm. There is also evidence to suggest that firms without an audit committee are more likely to commit financial fraud (Dechow et al., 1996). Similarly, DeFond and Jiambalvo (1991) show that the overstatement of earnings is less likely among firms with audit committees.

McMullen (1996) finds that audit committee existence relates positively to financial reporting quality. For instance, the existence of an audit committee is associated with the correction of quarterly earnings; suggesting that audit committees scrutinise financial reports and dig out the misrepresented facts. Moreover, firms where an audit committee exists tend to report reliable and informative accounting information. Similarly, Karamanou and Vafeas (2005) suggest that firms with effective board and audit committee structures will have manager’s earnings forecasts that are more accurate and elicit more favourable market responses from investors.

Klein (2002) argues that the magnitude of abnormal accruals are more pronounced for firms with audit committees comprised of less than a majority of independent directors. Moreover, firms that change their boards and or audit committees from majority independent to minority independent have significantly larger increases in abnormal accruals vis-à-vis their counterparts. Klein (2002) findings support the argument that audit committees should be constituted of a majority of independent directors.

Similarly, Wild (1994), Davidson, Goodwin-Stewart and Kent (2005) argue that, when an audit committee is composed of a majority of non executive directors it is associated with a lower likelihood of earnings management. Moreover, Ebrahim (2007) finds that the absolute value of abnormal accruals is negatively related to audit committee independence and abnormal accruals are much lower when independent audit committees are more active.

The effectiveness of the audit committee is also associated with its independence and the presence of finance and accounting expertise. For instance, Bryan et al. (2004) find that audit committee independence is positively associated with the information content of accounting earnings. While, Chtourou et al. (2001) suggests that the presence of at least one member with financial expertise on the audit committee is negatively related to the level of earnings management. And, Xie et al. (2003) finds that firms with high proportions of audit committee members with corporate or investment banking backgrounds have lower levels of earnings management.

However, Peasnell et al. (2000), finds no association between the audit committee existence and earnings management. Peasnell et al. (2005) also argues that there is no evidence that the presence of an audit committee directly affects the extent of income increasing manipulations to meet or exceed thresholds. Neither do audit committees appear to have a direct effect on the degree of downward manipulation, when pre managed earnings exceed thresholds by a large margin.

Although contrary evidence exists, the balance of evidence suggests that an audit committee contributes significantly to the quality of the financial reporting process. In addition firms with independent audit committees are associated with lower earnings management. The effectiveness of the independent audit committee is complemented by presence of finance and accounting expertise.

3.6 Earnings Management and Institutional Ownership and Concentration

Ownership structure is associated with managerial incentives to manipulate accounting earnings (Salamon and Smith, 1979). Outsiders who own large blocks of shares have alternative information sources that render such manipulation ineffective (Salamon and Smith, 1979). These outside owners are institutional investors or large investors such as banks, trusts, insurance companies, and pension funds (Bushee, 1998; Velury and Jenkins, 2006).

Increased ownership concentration provides large shareholders with sufficient incentives to monitor managers (Ramsey and Blair, 1993). Large shareholders have greater incentives of monitoring management, because monitoring costs are less than the expected benefits to their large equity holdings (Demsetz and Lehn, 1979).

1 Karamanou and Vafeas (2005) examined how corporate boards and audit committees are associated with voluntary financial disclosure practices proxied by management earnings forecasts
1985; Stiglitz, 1985). In addition, institutional investors have resources, opportunities and abilities to monitor, discipline and influence the actions of managers through formal and informal means (Cubbin and Leech, 1983; Diamond, 1984; Monks and Minnow, 1995).

Firms with large shareholders have a larger capacity for monitoring the discretionary accruals choices of managers because they are driven by the desire to maximise value on their investment (Bennedsen and Wolfenzon, 2000; La Porta et al., 1998). While Barnea et al. (1976), suggests that the incidence of income smoothing varies cross-sectionally and in particular with the degree of outside control. Firms with large shareholders have lower propensity for earnings smoothing than firms with low or dispersed shareholder concentration. Similarly, Yu (2006) finds that firms with strong institutional ownership manage earnings less. While Rajgopal et al. (1999) also find that the absolute value of discretionary accruals declines with institutional ownership.

However, when outside ownership is significant, but diffuse, incentives for manipulation are strongest because monitoring may not be rigorous. Thus, both the motivation and opportunity for managerial manipulation of earnings increases with diffuse outside ownership (Donnelly and Lynch, 2002). While, Hart (1995), suggests that when shareholders hold low stakes in the firm, they have little or no incentive to monitor managers, because monitoring costs will exceed the gains of monitoring. Thus, dispersed ownership leads to weaker incentives to monitor management (Maher and Anderson, 2000).

Chung et al. (2004) argue that when the collective shareholdings of institutions in a firm are high, then significant monitoring of management actions will take place. This contrasts with scenarios where a single institutional investor holds a large stake. Alternatively, when institutional investors have relatively low stakes (shareholding) in a company, there is less incentive to monitor managerial opportunism. In this case, when institutional investors become unhappy with the managers actions, they liquidate their stakes.

Pound (1988), Faccio and Lasfer (2000) and Renneboog (2000) argue that monitoring of managers discretionary accounting actions by institutional investors is not effective. They suggest that agency costs within the institutional investor itself might prevent it from being an effective monitor coupled with high liquidity costs and conflicts of interests and strategy with other investors.

Meanwhile, Jacobs (1991) and Porter (1992) argue that institutional investors have a short term focus, which puts pressure on management to improve current profitability. In such circumstances, managers have to resort to accrual increasing actions to meet the demands of institutional investors because of fear that short term disappointment of institutional investors will cause them to liquidate their shareholdings.

Similarly, Hsu and Koh (2005) argue that short term institutional owners are associated with upward accruals management. However, Koh (2007) suggests that, long term institutional investors constrain accruals management and that there is no evidence that short term institutional investors are systematically associated with aggressive earnings management; among firms that manage earnings to meet their targets.

Sarkar et.al, (2008) show that Indian domestic institutional owners act as a compensating control mechanism to mitigate the detrimental influence of controlling foreign institutional shareholders. They argue that, foreign institutional owners’ interests are always short term, as opposed to domestic institutional owners, thus they will recommend accounting policy choices that suit their interest.

Similarly, Firth et al. (2006) and Chen et al. (2002), find that foreign institutional ownership (shareholders) appear to lower earnings quality by attempting to persuade managers to adopt accounting treatments that suit them which may be less relevant for domestic investors. Firth et al. (2006) also shows that firms with highly concentrated share ownership have lower earnings informativeness which they attribute to the entrenchment effect, where large shareholders may influence firms to adopt accounting policies that reflect the wishes of the large owners rather than the economic substance of the business transactions.

Similarly, Bebchuk (1994) and Stiglitz (1985) suggest that ownership concentration may negatively affect the quality of the accounting earnings because large share holders have the capacity to abuse their position of dominant control at the expense of minority shareholders. While Velury and Jenkins (2006) also document evidence to show that concentrated ownership negatively affects the quality of accounting earnings.

The literature reviewed on the role of institutional ownership in mitigating managerial discretionary accounting choices is mixed. However, the balance of the arguments suggests that institutional owners have alternative information sources therefore reduce information asymmetry that renders managers opportunistic discretionary accruals manipulation ineffective.

3.7 Earnings Management and Managerial Ownership

Dechow et al. (2009) discuss the two competing theories about the incentives that managerial ownership
provides for accounting choice, that is, the entrenchment effect and the alignment effect. Agency theory argues that managers with high ownership interest in the firm are less likely to alter earnings for short term private benefits at the expense of the outside owners (Jensen and Meckling, 1976). This is because manager’s interests are aligned with those of shareholders; therefore, they will not have the motivation to act opportunistically, and report earnings that reflect the underlying economic values of the firm (Warfield et al., 1995: Gul, Chen, and Tsui, 2003). Moreover there is evidence that firm’s value is higher when officers and directors have greater equity ownership (Yermack, 1996).

Warfield et al. (1995) also suggest that managerial ownership is positively associated with earnings informativeness of returns and inversely related to the magnitude of accounting accrual adjustments. Moreover, ownership is less important for regulated corporations, suggesting regulation monitors managers accounting choices. Similarly, Sanchez-Ballesta and Garcia-Meca (2007) find that insider ownership contributes both to the informativeness of earnings and to constraining earnings management when the proportion of shares held by insiders is not too high. When insiders own a large percentage of shares however, they are entrenched and the relation between insider ownership, discretionary accruals and earnings informativeness reverses.

Gabrielsen et al. (2002) find a negative relationship between managerial ownership and the information content of earnings; and positive not significant relationship between managerial ownership and discretionary accruals. Meanwhile Rajgopal et al. (1999) finds that there is no significant relationship between discretionary accruals and managerial ownership.

Yeo et al. (2002) find that the informativeness of earnings does not always increase with managerial ownership. At low level of management ownership, the informativeness of earnings (level of income increasing discretionary accruals) has positive relationship with management ownership. However, at higher levels of management ownership, the relationship reverses suggesting that the entrenchment effect might have set in. Lacker et al. (2007) find that insiders’ power primarily measured by managerial ownership is positively associated with discretionary accruals. Entrenched managers promote their private benefits and use earnings management to conceal firm performance from outsiders (shareholders). Managers have the incentive to conceal their private control benefits from the outsiders because, if these benefits are detected, outsiders will likely take disciplinary actions against them (Zingales, 1994; Shleifer and Vishny, 1997).

Leuz, Nanda and Wysocki (2003) suggest that when managers become controlling owners they have incentives to manage reported earnings in order to mask true firm performance and to conceal their private control benefits from outsiders. For example managers can use their financial reporting discretion to overstate earnings and to conceal unfavourable earnings realisations that would prompt outsider to interfere. Insiders can also use their accounting discretion to create reserves for future periods by understating earnings in years of good performance, effectively making reported earnings less reliable than the firms’ true economic performance.

In conclusion, the review of the evidence on the role of managerial ownership in monitoring discretionary choices of managers is mixed. Two alternative views are derived. Increased managerial ownership aligns the manager’s interests with that of a firm and is expected to lead to reduced earnings management. However, at high level of managerial ownership the managers become entrenched and as such the opportunities for management opportunistic behaviour are increased.

4. Conclusion and Implications
In conclusion, the association between corporate governance mechanisms and earnings management attempts to empirically show that the attributes of corporate governance are generally associated with reduction in earnings manipulations. Such attributes of corporate governance include CEO duality, board composition and characteristics and firm ownership.

Corporate governance monitoring is effective in mitigating managers’ opportunistic discretionary accounting choices and reducing agency costs (Dechow et al., 1996; Klein, 2002; Niu, 2006). Corporate governance mechanisms are also effective in monitoring of managers’ capacity to manage earnings opportunistically (Dechow et al., 1996; Peasnell et al., 2000; Gul and Tsui, 2001; Klein, 2002). Moreover, a negative relationship exists between effective corporate governance mechanisms and financial reporting decisions that are breach of GAAP (Beasley, 1996; Dechow et al. 1996; Jiamalvo, 1996).

The dependability of accounting earnings is improved when managers’ opportunistic behaviour is controlled using monitoring systems (Wild, 1996; Dechow et al., 1996). Choi et al. (2011), argue that the decrease in value relevance of discretionary accruals is high among firms with weak institutions and high information asymmetries. Chung et al. (2004), suggests that accounting earnings are value relevant when managers’ discretionary actions are controlled using monitoring systems. Such systems reduce information asymmetry so that managers’ discretionary choices are seen to maximise or to signal their private information on the value of earnings in the market. High quality corporate governance is also associated with better disclosure and less information asymmetry (Donnelly and Mulcahy, 2008). So regardless of whether discretionary accruals are considered opportunistic or if they are a method of signalling private information their value
relevance should be increasing with improvements in the quality of corporate governance. Moreover, evidence reviewed attempts to provide a justification to the view that accounting conservatism and earnings manipulation may not be mutually exclusive. Implying that, firms with strong corporate governance have the capacity to use accounting conservatism practices to unmask managers’ opportunistic behaviour.

References


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