Consideration of Corporate Governance Principles in Borsa Istanbul Corresponding to Earnings Management Applications

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Abstract

This study tries to shed light to explain why Borsa Istanbul is exposed and motives behind earnings manipulation. Moreover, this paper highlights earnings management concept by reveling its motives, objectives, sanctions of Capital Market Board of Turkey and its implications. The outcomes of the study disclose that weak governance structures related to ownership structure of companies, weak internal control systems together with benefits of managers and pressure on management motivates earnings management manipulation. Furthermore, it provides an insight to low education level, small individual investor participants, and lack of intermediary and supportive firms as main reasons behind the manipulations in Borsa Istanbul.

Keywords: Earnings management, manipulation, Borsa Istanbul (BIST)

1. Introduction

Development of a country’s markets depends on true, sufficient and reliable information that market participants can obtain about the market instruments in which they invest. The major tool for existing and potential investors to have information about firms’ financial condition is financial statements that are prepared through the accounting system. Financial statements, as an indicator of the company’s economic and financial performance, are an important source of information for internal and external users as well as investors. Thus, users of financial statements often take their decisions based on company’s financial statements. This important function of the financial statements forces them to be reliable in their preparation and presentation.

Financial statements and reports, which are produced by the accounting system, include alternative arrangements to ensure applicability to many different situations. Information that is on financial statements and reports can be manipulated through different ways by using flexibility and gaps in the preparation process of accounting standards that is suitable for developments in financial markets or practices that are contrary to legal regulations. Manipulation can be realized by methods like earnings management, income smoothing, fraudulent financial reporting, creative accounting, and aggressive accounting. With the aim of personal or business purposes, false financial information can be presented through interfering financial reporting process. It may also be presented by; changing publicly disclosed financial information or changing financial condition and results of operations related to the company.

As being one part of financial manipulation, earnings management can be defined as presenting earnings in a company other than actual numbers in order to achieve aims of executives, but this kind of management may mislead users of financial statements. Users of financial statements, especially the investors, make most of their decisions by taking firm’s earnings as a base. Since earnings management practices change company’s actual operating results, investors and other users of financial statements can get damaged.

In today’s world of globalization, financial statements are recognized as fulfilling duty tools for spreading economic information to related individuals and institutions both on national and international markets. Since financial statements are very important arguments in terms of investment, taxation and credit ratings, financial statements must be reliable and must transfer accurate data in terms of the economic system. Therefore, within the globalization, the losses incurred by investors do not just leave negative impacts on the country’s economy, but also do harm on the other economies. The most recent examples of this situation are Enron and WorldCom scandals that had been experienced by the United States. These scandals revealed the importance of financial information manipulation once again. Financial information manipulation creates unfair competition, and also restrains rules and principles that protect investors. Thus, it prevents the formation of healthy price in markets and formation of efficient markets in many developed and emerging markets.

Users of financial statements lose their confidence in financial system due to numerous negative impacts. To avoid this, users need to be informed and be aware of earnings management practices. In recent years earnings management gain an increasing importance especially for managers, also for accountants, internal and external auditors, financial analysts, academics and candidate students of business management field. In this respect, one of the starting point of this study is to inform users of financial statements about earnings management practices in Turkey.

The purpose of this paper is to inform and enlighten users of financial statements about the reasons and aims...
behind earnings management practices in Borsa Istanbul. This exploratory study is derived from a wide perspective of secondary research sources in order to explain why Borsa Istanbul is exposed to manipulation. Furthermore, another objective is to highlight earnings management concept covering its reasons, aims, sanctions of Capital Market Board of Turkey and its implications. The results of the study reveal that weak governance structures, weak internal control systems, benefits of managers, ownership structure of companies and pressure on management causes earnings management practices. Additionally, it shed light upon the low education level, small individual investor participants, and lack of intermediary and supportive firms as primary reasons behind the manipulations in Borsa Istanbul.

2. Importance of Corporate Governance Principles with respect to Financial Information at Capital Markets

Since corporate governance has boosted the global competitive power of financial markets all around the world over the past decade, the perception of various stakeholders towards the importance of corporate governance has increased significantly. One of the fundamental and significant reason behind the emergence of corporate scandals and financial crisis at the end of the 20th and beginning of the 21st century can be ascribed to the lack of strong corporate governance principles (CMB, 2003). The four main principles of corporate governance, which are fairness, transparency, accountability and responsibility, are widely accepted and essential for capital markets.

- Fairness minimizes the conflict of interest between principles and agents by treating them equally within all activities of the companies (CMB, 2003).
- Transparency aspires to disclose accurate, clear and complete financial and non-financial information that is related to the company on a timely basis (CMB, 2003).
- Accountability is the obligation of an organization or individual to account for its activities, undertake the responsibility for them and reveal the consequences in a transparent way (Business Dictionary, 2014).
- Responsibility is the duty or obligation to adequately complete a task in the best interests of the company within the legislation (Business Dictionary, 2014 and CMB, 2003).

In order to achieve strong and good corporate governance, it is vital that a company must provide healthy business practices, reliable financial reporting, transparent and trustful collaboration between all parties and stakeholders. These are the prerequisites for strong and good business ethics and corporate governance (Telenor ASA, 2013).

Reliability, transparency and quality concepts are essential for capital markets. Reliability of the information adjusts the efficiency level of the market and it allows the market to serve as a signaling device for suitable and accurate capital allocation. Number of people who are investing via retirement funds or managing their portfolios actively are increasing more and more. Therefore, they are affected and influenced by the financial information that is spread to the market. Regardless when financial information is reliable and transparent, it supports and adds efficiency to the functioning of the economy together with capital markets (Rezaee & Riley, 2011). Additionally, according to Doğan (2009);

- Insufficient and unclear financial information can damage the functioning of capital markets and may increase the cost of capital.
- Reliable and timely financial information increases the confidence of decision-makers and makes it possible to take decisions that directly affect growth and profitability of the company.
- The disclosed financial information directly affects the company’s stock price. Besides, it also indirectly affects the external decision makers (stakeholders, investors and lenders) by influencing their initiative about gathering information of the company.
- As the quality and quantity of the disclosed financial information increases, the uncertainties about the company disappear.

3. Evaluation of Earnings Management Practices with respect to Corporate Governance

Earnings management is one of the methods that can be categorized under “information based market manipulation”. Earnings management is the manipulation activity that changes financial information of the firm by misrepresenting actual numbers. It is practiced usually by the managers with the intention of reaching a desired goal about himself/herself or about the organization. Earnings management applications arise from the flexibilities within the accounting standards and manager’s own judgment (Acar, 2011).

Opportunity for earnings management practices arises due to numerous reasons like flexibility within the accounting standards, indefinite accounting measurement bases, estimations, judgments and predictions, insider dealings, force on managers to reach short-term results, balance budget, increase market share prices and the reclassification or presentation of financial numbers (Odia & Ogiedu, 2013).

According to Jensen and Meckling, the main cause of earnings management practices is the conflict between principles and agents, also called agency theory. (Jensen & Meckling, 1979.) Weak corporate
governance and ownership structures make a room for earnings management practices, since it is connecting with misleading accounting information. On the other hand, companies with strong corporate governance structures are less likely to manipulate earnings, since they have qualified, reliable, experience and independent audit committee that represent true and trustful information to the public (Dechow & Skinner, 2000). Earnings management practices succeed where the auditors connivance with managers or have strong connection with clients.

Models in corporate governance declare that information asymmetry is the starting point for earnings management behavior. The scope of information asymmetry states that managers can behave opportunistically and tries to manage accounting numbers so as to provide results that are expected by the market or in their own favor (Schipper, 1989).

Theoretical background for opportunistic behavior has been provided by five theories in the field of corporate governance, which are agency theory, signaling theory, legitimacy theory, stakeholder theory and institutional theory. Agency and signaling theories are considering the investor’s informational data concerning the financial performance that is associated to this data. Moreover, the other three theories think through society as a whole. Additionally, three theories consider the stakeholders’ specific needs of information that is covered in the companies’ disclosures. Those disclosures present different views, since social and environmental performances are managed supporting the fact that manipulation is not only associated with financial performance (Odía & Ogiedu, 2013).

La Porta et. al. defined corporate governance as “a set of mechanisms through which outside investors protect themselves against expropriation by the insiders” (La Porta et. al., 2000). Corporate governance safeguards the companies and increases confidence of investors. It protects the stakeholders against dishonesty, mishandling, corporate or management wrongdoings and frauds. Furthermore, it supports effective risk management, transparency, reliability and accountability. Corporate governance includes policies, processes, laws, customs, and mechanisms that affect the style a company is directed, managed or controlled (OECD, 2004).

Turkey is a developing country with an emerging economy and capital market. The general corporate governance structure of Turkish listed firms is categorized by weak protection of investors and minority rights. Additionally, the ownership structure of the firms is pyramidal and highly family oriented. Most of the family members on Turkish listed firms may be CEOs, top managers or board members (Karaibrahimoglu, 2013).

Family oriented ownership structure may not be a problem in countries with strong corporate governance structures, effective laws and regulations for protecting the rights of minority shareholders, however it may cause real problems in developing countries. In Turkey, the new generation in family oriented firms cares more about corporate governance in order to survive in a rapidly changing, competitive world. They are aware that the four pillars (responsibility, accountability, fairness and transparency) of corporate governance are unavoidably important (Özsoz & Gurarda, 2014).

In Turkey, the growing attention of the public to the corporate governance started with the economic crisis at 2001. Corporate governance reforms turned out to be unavoidable in the period following the crisis. In order to improve the corporate governance in listed firms, the capital markets board of Turkey (CMB) issued “Corporate Governance Principles of Turkey” in 2003. It has been actively in use starting from 2005. The CMB requires all listed firms to have official web sites and obligates them to present “Corporate Governance Compliance Report” in their annual financial reports. This report has to clarify the level of compliance or non-compliance regarding to CMB guidelines (CMB, 2003).

Correspondingly, in order to provide the accuracy of the financial reports, the CMB issued “The Communiqué on Independent Auditing Standards in Capital Markets (Serial: X, No: 22)” in 2006. It outlines the legal requirements and the importance of independence of the auditors. Moreover, it controls the quality of auditing services, clarifies the auditor tenure and presents auditing standards aligned with International Standards on Auditing. Additionally, firms listed in Borsa Istanbul are obligated to have independent external audit for the closure of the financial reports (CMB, 2006). The latest regulatory law that has been introduced by CMB on 2012 to improve corporate governance and obliges all publicly traded firms to have at least one female member on the board of directors, in order to address the issues of diversity at board structures of the firms (CMB, 2012).

There are five fundamental reasons for practicing earnings management in Borsa Istanbul.

3.1 Weak governance structures of companies.

In order to have a strong corporate governance structure, a company must have effective ownership structure and board of directors. Additionally, strong corporate governance structure is related with independency of board of directors that should represent all shareholders with ideal number of experienced, qualified and diversified members (Karaibrahimoglu, 2013).

On the other hand, weak corporate governance structure brings negative outcomes to companies. Companies with weak governance structure are expected to have financial difficulties and distress. Also, the probability of going bankruptcy is high for those companies (Yeun-Wen et. al., 2008). Since managers’ choice
on earnings management is affected by corporate governance structure, companies with weak corporate governance structure are more likely to engage in earnings management practices rather than companies with strong governance structure.

3.2 Ownership structures of companies and benefits of managers.
A strong corporate governance structure requires the separation of ownership and control in a company. The ownership structure is effective when it is free from the CEO’s dominance. Additionally, the ownership structure has to be diversified with institutional shareholders. According to capital market boards of Turkey, the independency of board of directors is crucial when making objective decisions. Also, it helps for better monitoring and controlling activities over the management (CMB, 2003).

Moreover, the size of the board of directors is negatively correlated with effective ownership structure. The large size of the board of directors might create communication and coordination problems between members. Therefore, small size of board of directors might be more effective in performing its responsibilities. Besides, the position of CEO and chairman should not be hold by the same person. It should be separated. The reason behind this thought is that the person will have dominant power which is expected to decrease the monitoring and controlling capability of the board of directors over management’s activities. Thus, in order to protect balance between management and control, the position of the CEO and chairman should be separated (Jensen, 1993).

3.3 Weak internal control systems, inadequate independent audit committees or complete absence of independent audit in companies.
Internal controls are methods or procedures that companies use to protect their assets and to present accurate and reliable financial statements. When a company has weak internal controls, fraud and manipulation practices arise much easier. Companies ought to protect themselves from threats, risks and potential problems by auditing committees (VanBaren, 2014).

Audit committee is accountable for the harmonization between internal and external audit as well as ensuring the independence of external auditors. Institutional investors are more qualified and experienced then individual investors. They also have timely access to relevant information, which makes them more effective in monitoring and controlling activities of management (Siregar & Utama, 2008).

The role of external audit is to secure the accuracy, quality and reliability of financial information to all users of accounting information. External audit is a must for minimizing asymmetric information and smoothing agency problems between agents and principles. Auditing and transparency are positively correlated. The transparency of companies increases as auditing quality increases. This supports all users of accounting information to have more reliable information. Thus, strong corporate governance requires an external independent audit (Watts & Zimmerman, 1986).

3.4 Applying periodic information instead of real time information, in terms of reporting financial information in the financial reporting process.
Investors want to achieve real time information, but they can only access to periodic information. Periodic information fall short of satisfying the needs of investors, since they desire companies to offer better transparency of information with a faster flow. Investors want to access information in a continuous routine, rather than periodic time breaks. Real time information would improve the confidence level of corporate reporting and also, it would increase investor returns and investment attraction. Applying period information creates a gap for practicing earnings management (e.g. post ponding or early recordings of earnings). Thus, companies should provide real time information for better corporate governance (ACCA, 2013).

3.5 Flexibilities within the context of accounting standards.
Flexibilities in accounting standards regulation covers the realization, allocation and accrual concepts, also includes the transactions that generates economic consequences and timing, amount and reporting of situations. The management might choose the change policies, and these changes may only be identified after few years later, since it is hard to reveal. In this time interval, one can practice earnings manipulation very easily (Schipper, 1989).

According to a different study that is conducted by Küçüksözéen (2004) Borsa İstanbul is exposed to manipulation with the following structural reasons:

- Low education level
- Small-individual investor participants
- Lack of intermediary and supportive firms
- Extreme competition in the commission and credit market
- Due to low free float, the stock prices does not reflect the potential impact of company’s cost of capital
and administrative control

- Lack of additional protection for manipulators to deter in the investigations

When we look into the driving factors that are behind financial information manipulation of the managers, we can summarize them as follows. The managers get involved in earnings management practices (Ayarlıoğlu, 2007):

- To maximize their incentives (included bonuses and stock options)
- To maintain their power or job security
- To get promoted
- To maximize stock prices, hence to maximize firm value
- To minimize the possibility of bankruptcy
- To ensure compliance with the criteria of loan agreements and provisions
- To minimize the inspection of normative establishments (Example; to minimize the profits against accusation for excessive profit)

4. Capital Markets Board of Turkey (CMB) and Manipulation

According to the studies carried out by the CMB, many manipulative operations have been identified in the past. Therefore, the CMB of Turkey had arranged market manipulation and penalized under Article 107/1 and 107/2. Market manipulation can be practiced by various ways. Due to negative impact on markets, manipulation is arranged as a separate abuse type and according to this, need for new prohibitions on certain types of transactions were emerged.

The new Capital Market Law (CML) No. 6362 has been issued on December 30, 2012 and released a new framework. The aim of this law is to regulate and oversee capital markets to make sure that the capital markets function in an accountable, transparent, reliable, efficient, fair and competitive environment. Also it has the mission of protection the rights of the investors. The two types of manipulation is separated as “Information based market manipulation” and “trade based market manipulation” and are penalized under the new CML (Article 107/1 and 107/2) and the reversed Capital Markets Law No. 2499 (Article 47/LA-2 and 47/LA-3) (CMB, 2012).

The first paragraph of Article 107 (107/1) prescribes trade based market manipulation. According to article: “Those who make purchases and sales, give orders, cancel orders, change orders or realize account activities with the purpose of creating a wrong or deceptive impression on the prices of capital market instruments, their price changes, their supplies and demands, shall be sentenced to imprisonment from two years up to five years and be punished with a judicial fine from five thousand days up to ten thousand days. However, the amount of the judicial fine to be imposed due to this crime cannot be less than the benefit obtained by committing the crime” (CMB, 2012).

The second paragraph of Article 107 (107/2) prescribes information based market manipulation. According to article: “Those who give false, wrong or deceptive information, tell rumors, give notices, make comments or prepare reports or distribute them in order to affect the prices of capital market instruments, their values or the decisions of investors, shall be sentenced to imprisonment from two years up to five years and be punished with given a judicial fine up to five thousand days” (CMB, 2012).

5. Aim of Financial Information Manipulation

The fundamental objective of financial information manipulation is to mislead or misinform investors by presenting financial information that does not show the financial positions and performances truthfully. Financial information manipulation hinders decision makers to make logical, rational and realistic decisions. Hence, revealing and blocking financial information manipulation is extremely important (Isa & Valentin, 2011).

According to Küçüksözen and Küçükkocağlu (2005), there are ten aims of financial information manipulation. These are:

- To influence stock prices and risk of a company
- To meet the financial conditions in debt contracts
- To keep good relations with investors, creditors and employees
- To manipulate management fees
- To increase the amount of funds provided by public offerings or capital increase
- Insider trading
- To avoid risks that may arise from political and legal arrangements
- To reduce the perceived risk of investors on the company
- To send positive signal to the market about the company’s future performance
- To provide tax advantage

5.1 To influence stock prices and risk of a company.

The practice of financial information manipulation might lower the uncertainty that is correlated with profit.
Additionally, it might help to reach expected profit figure by the market and might procure low volatility in
profits. Thus, due to these reasons, manipulation may influence the stock prices and the risk of a company
(Küçüksözen, 2004).

5.2 To meet the financial conditions in debt contracts
There are numerous indicators to create good impression for creditors and investors about credit worthiness of a
company. The major indicators can be counted as large amounts of assets, high profits, small amounts of
liabilities and high amounts of equity. Companies that have an effective credibility might lower the borrowing
costs. Therefore, some companies practice financial information manipulation by increasing their profits, current
assets and equities or cutting their liabilities to lower borrowing costs (Wilson & Shailer, 2007).

5.3 To keep good relations with investors, creditors and employees
The strong and stable profit is the essential point for keeping good relations with creditors, investors and
employees. Investors have the tendency to acquire the shares of a company that has stable profit records.
Creditors lend money to low risk companies, which can be reflected by low volatility and uncertainty in a
company’s profits. Employees need stability for their job security as well. They check stability to understand
company’s situation for providing future remuneration, retirement benefits and opportunities for employees.
(Kothari & Barone, 2011 and Mulford & Comiskey, 2002).

5.4 To manipulate management fees
Managers are likely or expected to practice financial information manipulation when their performance is based
on profit earnings. They display opportunistic behavior for their own benefits and try to manage current period
profits so as to get higher premium income, which in return will maximize their short-term bonus plans.
Especially, managers use accruals to manage profits, because higher profits bring higher bonuses (Scott, 2008).

5.5 To increase the amount of funds provided by public offerings or capital increase
Investors are deprived of market value information for the shares of new public offerings. Therefore, Investors
have to trust on financial information that is accessible in financial statements for their buying decisions.
Managers use this gap by manipulating company’s profits to increase the share price of new public offerings and
generate more funds (Stolowy & Breton, 2004).

5.6 Insider Trading
Insider trading takes place when an insider leaks information out for the ones who benefit from transactions of
securities. In other words, insider trading is the ability to gain or avoid from possible loss by using confidential
information about the company. This confidential information is used to change future market value of shares by
practicing transactions within securities (Tezcanlı, 1996).

5.7 To avoid risks that may arise from political and legal arrangements
Companies are likely to manipulate their financial information by cutting their profits through discretionary
accruals during periods of political pressure. Large and potential high-profit earning companies are likely to
practice financial information manipulation, in order not to draw attention from the regulatory authorities.
Likewise, companies are possible to practice financial information manipulation to escape from government
auditing when (Watts & Zimmerman, 1986).

5.8 To reduce the perceived risk of investors on the company
Investors generally look at the company’s earnings power, when they are making their investment decisions.
Earnings power is correlated with generating cash according to company’s stability and growth rate of profit.
Investors look at the “current period profits” and “future expected profits” when evaluating company’s earnings
power. This is because; investors are likely to be attracted to the shares that have greater earnings power
(Küçüksözen, 2004).

5.9 To send positive signal to the market about the company’s future performance
When a new executive is appointed in a company, he/she is likely to practice financial information manipulation,
so that he/she might display that previous executives are responsible for poor performance. By doing this he/she
might prove that he/she is performing better. Likewise, he/she might gain favor from the improved performance
of the following years. Similarly, executives are likely to practice financial information manipulation during
operational and financial decisions. The reason behind this is to express better performance or to handle their
concerns about goal failures (Küçüksözen, 2004).
5.10 To provide tax advantage
Companies are likely to practice financial information manipulation to lower tax base or to pay in the least possible amount of tax. Companies practice manipulation by lowering operating income and increasing expenses. This can be done by recognizing unearned service bills as an expense, declaring incorrect sales costs, receiving fraudulent invoices from vendors for advertising and recording financial expenses directly as an expense instead of adding financial expenses to cost of asset (Schilit, 2002).

6. Conclusion
In general we find that the main reason behind earnings management practices is the flexibilities within the context of accounting standards. In the case of Turkey, the main driver behind earnings management practices is family oriented ownership structure. It brings weak governance structure to the companies. Correspondingly, earnings management practices arise from weak internal control systems, inadequate independent audit committees, application of periodic information, and benefits of managers.

Earnings management includes many ethical issues, since the personal values, honesty, integrity, belief, judgment, morality, training and discipline play an important role. Earnings management wrongdoings and corporate financial reporting failures have been largely remained unnoticed and continued until 2001 crisis. The failures have their origins in deceitful management decision cover-ups of illegal activities. It affected the economy and corporate environment dramatically.

Actually, the 2001 crisis and its multiplier effects brought the accounting profession under strict inspection by a disturbed and confused public, questioning the competence and trustworthiness of managers and accountants. It creates many doubts about the existing standards of corporate governance on the minds of the stakeholders. For this reason, new policies and regulations are issued about auditing standards, financial reporting standards, corporate governance principles and the legal enforcements in capital markets to underline the importance of corporate governance in financial reporting and to assure the true and fair view of the financial statements so as to protect the rights of investors and the public.

Still, agency problems occur in Turkey between family and minority shareholders, this serves well for opportunistic people to make investment by help of information asymmetry or misleading information disclosed by companies.

Therefore, to increase public trust in Turkey, companies with weak corporate governance structure needs higher quality audit. In other words, companies with weak ownership structure, weak internal control systems, inadequate independent audit committees, application of periodic information, less independent board of directors, CEO and chairman positions duality and presence of non-institutional owners are creating opportunities to practice earnings management. As a result, to minimize the earnings management practices and to obtain strong corporate governance structure, companies in Turkey need better audit quality.

References


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