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Earnings Management and Corporate Governance

Mr. Okpe Innocent Ikechukwu
Department of Accountancy, Enugu State University of Science and Technology, Enugu, Enugu State of Nigeria

Abstract
This paper studies the relationship between different corporate governances mechanisms and earnings management. It examines two categories of governance devices; internal (ownership concentration and board structure) and external (take-over pressure and institutional ownership). Controlling for other characteristics, I find that firms with stronger internal governance, such as higher ownership concentration and smaller boards, manager earnings more, while firms with stronger external governance, such as higher institutional holdings and high take over pressure, manage earnings less.

1. Introduction

By the evolution of today's modern business, many of the corporations have became owned and controlled by families and the major agency problem exist not only between management and owners in general but between the management (the controlling family) and minority shareholders as well. Due to the increase in this conflict the issue of trust has taken the key position in today's financial analysis procedure.

Because management is accountable to shareholders and within the business other stakeholders are also present and each stakeholder has his own interest in the business, so each one is having anywhere any authority try to comment the result of that authority into his own favour. Earnings management is one of the examples which accountant by the will of authorities smoothen their earnings. Here a need has been assessed in the result of which concept of appropriate corporate governance emerged. In the confirmation of which Securities and Exchange Commission of Pakistan gave a Code of Corporate Governance in March 2002. Better governance is supposed to lead to better corporate performance by preventing the expropriating of controlling shareholders and ensuring better decision making.

This expropriation may be due to the result of smoothening of earnings intention which known as earnings management. This study attempts to assess that whether corporate governance creates any impact on earnings management or not. Good governance means little expropriation of corporate resources by managers or controlling shareholders which contribute to better allocate resources for better performance.

As investors and lenders will be willing to put their money in firms with good governance. They will face with lower costs of capital, another source of better firm performance. Other stakeholders, including, employees and supplies will also want to be associated with such firm as the relationship are likely to be more prosperous, fairer, longer lasting than those with firms with less effective governance. Over the past two decades a number of prominent participant in the debates surrounding professional accounting and auditing standard have increased the attention given to the role of corporate procedure in financial reporting practices. Corporate governances is not just about the process by which elicited representatives as directors make decisions. It is also about the way organizations are held accountable. The obvious way is via financial reporting.

A lot of financial reporting issues have remain under discussion in the financial literature earnings management is one of them. Impact of corporate governance on earnings management is the core theme of this paper.

Implicit in all of their recommendations is the assertion that the creditability of financial statement information is related to specific institutional features of corporate governance. The purpose of this paper will be to identify the empirical evidence that such a relation exist. The purpose is also to find out between different measures of earnings management and the composition of firms boards of directors particularly the subset of directors serving in the audit committee.

In developing countries like Pakistan, more attention needs to be paid to the corporations owned and controlled by families and with family members holding key managerial position however the major agency problem exist not between the management and owners in general but between the management (the controlling family) and minority shareholders.

The existence of large shareholders may by itself not be a matter of concern or may even be a blessing but the beneficial effect of large shareholders should be expected only when management is separated from ownership or when proper corporate governance mechanisms are in place so that outsiders shareholders can effectively check misbehaviour by controlling owners. These conditions are generally not met in most companies in Pakistan.

2. Relevance of the Research

a. The banking industry in Nigeria will find the research findings or report useful in decisions making.
b. Investors and other interested parties such as shareholders and business oriented individuals will find the research finding useful for investment decisions.
c. Society: which is made up of individual and organizations will finds the research findings useful for investment decisions.
d. Government: authorities and agencies will find the research findings useful in the areas of making tax policy and investment decisions into corporate organizations.
e. Analysts and future researchers such as professional accountants, auditors and academicians will find the research findings useful for analyzing the role of corporate governance on earnings management through financial reporting and the future research by academicians.
f. Data bank future studies: the research findings or literature will serve as a research topic for future studies by academicians and researchers.

3. Earnings Management

Schipper (1989) states that earnings management is a purposeful intervention in the external financial reporting process with the intent of obtaining some private gains.

Healey and Wahlen (1999) state that earnings management occurs when managers use judgment in financial reporting and structuring transactions to alter financial reports to either mislead some stakeholders about the underly economic performance of the company or to influence contractual outcomes that depends on reported accounting numbers.

Bantor (1993) and changes in R & D expenditure Bushee (1998) several earnings management methods available to managers such as real decisions like asset, sales and financial reporting decisions like accounting method changes.

Watts and Zummerman (1986) and accrual choices Healy (1985) manipulation of operating accruals is likely to be favoured instrument for opportunist earnings management because they have no direct cashflow consequences and are relatively difficult to detect.

3.1 Management Compensation Contracts

Guiding et al (1998) find that divisional managers for a large multi-national firm are likely to defer income when the earning target in their bonus plan will not be met and when they are entitle to the maximum bonus permitted under the plan.

Healey (1985) and Holthausen et al (1995) show that firms with cap on bonus awards are more likely to report accruals that defer income when that caps is reached than firms that have comparable performance but which have no bonus cap.

3.2 Earnings Management Using Classification Shifting

An examination of core earnings and special items. Lipe (1986), Fairfield et al (1996) stated in the closer a line item is to sale, the move permanent this item tends to be.

Lipe (1986), Elliot and Hawa (1996), Francis et al (1996), David (2007), Bradshaw and Sloan (2002) furthermore investors appear to recognize this destruction and weight individual line items within the income statement differently.

Nelson et al (2002) finally, GAAP income does not change, thus limiting the scrutiny of auditors and regulations. Hwang (1994) as an anecdotal example of classification shitting, the SEC determined that Borden Inc, classified $192 million of marketing expenses as part of a restructuring change when it should have been included in selling, general administrative expenses.

Jones (1991) for a sample of 76,901 firm year observations from 1989 to 2003, decompose firms core earnings into expected and unexpected components by modeling expected core earnings in a similar vein as the crucial model.

Skinner (2000) for example Dechow and Skinner note that earnings management will likely be greater when the action allows mangers to meet the analyst forecast when they other wise would not. Skinner and Sloan (2002) consistent with classification shifting representing an earnings management tool, find that classification shifting is more pervasive when it allows the manager to meet analyst forecast especially for growth firms.

Healy 1985, Jones 1991, McNicols and Wilson 1988, Rangan 1998, Teoh et al. Phillips et al 2003, prior accounting research has documented two main methods of earnings management the most commonly studied method is accrual management.

Baber et al 1991, Dechow and Sloan 1991, Bushel 1998, a second type of earnings management can occur through the manipulation of real activities such as providing price discounts to increase sales and cutting discretionary expenditures such as research and development to manger earnings.

Doyle et al (2003) more over while prior research suggest managers use profomer earnings to meet the analyst forecast.

Longee and Manquanf 2004, Doyle and Soliman 2005), this paper presents evidence how managers might undertake this activity.

Nelson et al (2002) find that the use of reserves is a common type of earnings management that is often left unadjusted by auditor if detected. Bungstahler et al (2002) managers can also use accrual management to overstate current period expenses or reserves associated with restructuring changes can be reversed into income in future periods.

Kumey and Trezevant (1997) show that managers are far more likely to break out income decreasing special items than income increasing special items on the face of the income statement.

3.3 Earnings Management and Resource Allocation

Bushman et al (2005) find relationship between properties of accounting information and investment decisions.

Healy and Wahlen (1999) note, only a small part of the earnings management literature addresses the consequences of earnings management or resource allocation, and the finding of this literature are mixed.

Teoh et al (1998) conclude that earnings management contribute to IPO mispricing.

Brave et al (2000) find that the long run returns of IPOs are similar to those of seasoned firms with similar market capitalizatism, suggesting the findings may be due to a more pervasive return pattern in broader sample of public companies.

Foster (1979), Dechow et al (1996), Beneish (1997), and Palmrose et al (2004), finds that the market reaction to disclosure of misleading reporting is significantly negative, indicating that investors were not completely aware of the manipulation. Bushee (1998) examines how research and development (R & D) spending is affected by incentives to meet earnings targets, and whether this is influenced by the composition of the firm institutional investors.

Barth et al (1996) another example is the opportunistictiming by banks of sales of held for sale securities.

3.3 Earnings Management and Investment Decisions

Dechow et al (1996) study firms targeted by SEC enforcement actions and concludes that a desire to attract external financing at cost is an important motivation for earning manipulation. Bar-Cull and Bebchuk (2005) predicts that inefficient investment projects will more likely be undertaken by companies that misreported prior to undertaking the projects because firms overstating their financial results will be able to obtain cheaper financing.

Wang (2006) finds that misreporting firms are more likely to over-invest in R & D and stock financed merger and acquisitions.

3.4 Earnings Quality and Investment Decisions

Biddle and Hilary (2006) and Vendi (2006) predicts and finds that better accounting information reduces information asymmetry between managers and outside suppliers of capital allowing for more efficient investment.

Biddle and Hilary (2006) find that measures of accounting quality are negatively related to investment-cash-flow sensitivities indicating that the effect of financing constraints on investment is lower for firms with higher accounting quality. Vendi (2006) finds accruals quality is significantly negatively associated with both over investment and under investment.

Bushman et al (2006) argue that timely accounting recognition of economic losses makes managers less likely to engage in ex-ant negative net present value investment projects.

Richandson et al (2002) find that firms that financial results tend to be growing firms attempting to report consecutive earnings increases 2 percent of asset in the quarter of a stock acquisition. Teoh, Wong and Rao (1998) also report that approximately 62 percent of firms making initial public offers have higher unexpected accruals than a matched sample of control firms. Dechow (1994) findings that current earnings are better predictors of future cashflows than current cashflows.

Beaner et al, 1989, Wahlen 1994, Beaven and Engel 1996, Lin and Ryan 1995, Lin et al 1997, studies of loan loss accrual in the banking industry show that stock returns are negatively related to normal changes in loan loss provision and are positively related to abnormal loan loss provision. Petroni (1992), Anthony and Petroni (1992), Penalva (1998), Bearer and McMcholis (1998), Petroni et al (1999), similar results merge from stock returns associated with unexpected claim loss reserve revision for property-casualty insurers.

Teoh, Welch and Wong 1998 several recent studies have challenges the view that investors see through management. For example, the studies of earnings management surrounding equity issues show that firms with income-increasing abnormal accruals in the year of a seasoned equity offer have significant subsequent stock performance.

Foster (1979) finds that firms criticized by Abraham Briloff in the financial press for misleading financial reporting practices suffered an average drop in stock of 8 percent on publication date. Dechow et al (1996) report that firms subject to SEC investigation for earnings management showed an average stock price decline of 9 percent when the earnings management was first announced.

Beneish (1997) shows that GAAP violations earn significant negative abnormal returns for two years following the violations.

Sloan (1996) reports that future abnormal stock returns for firms whose earnings include large current accrual components and positive for firms with low current accrual components. Xu (1998) shows that these results are largely attributable to shocks to abnormal accruals, rather than normal accruals. Xu (1998) also evidence that the shocks to abnormal accruals are consistent with earnings management incentives. Hopkins (1998) conduct a behavioural experiment with experienced financial analyst to test conditions in which they are more likely to detect and undo the strategic timing of realized gains on investment securities.

3.5 Lending Contracts

Healy and Palepu (1996) and De Angelo et al (1994) examine whether firms close to their dividend constraints changed accounting methods, accounting estimates, or accruals to avoid cutting dividends or making costly restructuring decisions.

Holthausen (1981) examines whether firms close to their dividend constraint switched to straight accounting practices adversely affects shareholders and in contrary to an underlying concept representation of faithfulness of earnings closely associated with earnings management is the concept earning quality which according to Schipper and Vincent is the extent to which reported earnings faithfully corresponds to change in net economic asset other than transactions with owners other than transactions with owners. Their concept is a departure from the earnings quality constructs based on time series properties of earning i.e. persistence, predictability and variability of earnings.

Dechow et al (1995) evaluated the relative performance of competing models for measuring discretionary accruals.

Jones Model (1991) modified to detect revenue based earnings management provide the most powerful test of earnings management which can be discussed or enhancing financial reports prior to an I.P.O or secondary equity offering to attract better valuations.

3.6 Earnings Management Internal Control Sarbanes-Oxley, Section 404

Sarbane-Oxley Act of 2002 (SOX) under Section 404 of SOX management is required to issue a report assessing the effectiveness of a firm internal controls. McDonald and Francis (2005), Hagenty (2005).

There are several recent high profile cases of corporate accounting problems that may have been portly the result of weak internal controls. Kinney and McDaniel (1989) suggest that weak internal controls can increase the probability of material errors in accounting disclosures.

Ashbangh-Skaife et al (2005) and Doyle et al (2005) also suggests that weak internal controls can lead to low quality accounting accruals from international earnings management and unintentional earnings management and unintentional accounting errors.

American Institute of Certified Public Accountants ACCPA (1995), this is consistent with the discussions in Statement of Auditing Standards No. 78 that the effectiveness of internal controls can be adversely affected by human failures such as simple errors or mistakes and or inappropriate management override internal controls. Kimey (2000) given the lack of public data internal controls, there is only limited empirical evidence on the characteristics of firms with internal control problems and the effects of weak internal control firms. Klein (2002) and Bedand et al

(2004) find a negative relationship between the qualities of audit committees and the amount of discretionary accruals in their samples.

Bryan et al (2004) also find a positive relationship between audit committee independence and the earnings response coefficients. Krishan (2005) examines the relationship between audit committees quality and internal control problems using a sample of firms reporting such problems in their 8-k reports when the firm switched auditors.

Krishan (2005) finds that the proportion of independent members on the audit committee and the number of financial expert members on the audit committee are associated with a lower probability of reporting internal control problems at the time of audit charges. Gc and McVay (2005) examines characteristics of firms reporting material internal control weaknesses under SOX's Section 302 which has been effective since August 2002.

Gc and McVay (2005) find that firms reporting material internal control weakness under SOX Section 302 which has been effective since August 2002; Gc and McVay (2005) find that firms reporting material control weakness have more operating segments are more likely to report foreign currency translation are smaller in firm size, have shorter firm history, and are less profitable compared to other firms.

Ashbaugh-Skaife et al (2005) examine a sample of firms reporting internal control weaknesses under Section 302 and find similar results. Ashbaugh-Skaife et al (2005) also finds that these firms are more likely to be involved in acquisition and restructuring.

Doyle et al (2005) argue that weak internal control can create more opportunities for intentional earnings management and unintentional accounting estimation errors.

3.7 Corporate Governance and Financial Reporting

One of the most important functions that corporate governance can plan is in ensuring the quality of the financial reporting process.

Levitt (1999) stated in a speech to director the link between a company directors and its financial reporting system has never been more crucial.

Further the Blue Ribbon Commission (1999) called for auditors to discuss with the audit committee the quality and not just the acceptability of the financial reporting alternatives.

Corporate governance has received increasing emphasis both in practice and in research e.g. Blue Ribbon Committee Report 1999, Ramsay Report 2001, Sarbane-Oxley 2002, Palmrose and Scholze (2002), Lanker et al (2004).

This emphasis is due in part of the prevalence of highly publicized and egregious financial reporting frauds such as Enron, Worldcom, Aldephia and Parmalat, an unprecedented number of earnings restatements (Krugman 2002).

Further academic research has found an association between weakness in governance and poor reporting quality earnings manipulation by corporate management. Dechow et al 1996, Beasley 1996, further academic research has found an association between weakness in governance and poor financial reporting.

3.8 Board Independence

Farma and Jesen (1983) argue that the board of directors is the highest internal control mechanism responsible for monitoring the actions of top management.

Farma (1980) suggest that the domination by top management on the board of directors can lead to collision and a transfer of shareholder wealth. Williamson (1984) state that managers have a huge information advantage due to their full-time status and insiders knowledge so that the board of directors can easily become an instrument of management, thereby sacrificing the interests of shareholders.

Farma (1980) and Farma and Jensen (1983) state that outsider director have incentives to carry out their monitoring task and to avoid colluding with top managers to expropriate shareholders wealth. Lee et al (1992) state that in management buyouts shareholders wealth increases when boards are dominated by outsiders directors.

Kosmik (1987, 1990) states that firms resisting green mail payments have more outside directors relative to boards of firms not resisting green mail payments. Weishbach (1988) argues that the turnover of C.E.Os of poorly performing firm is greatest when the proportion of non-executives director is high.

4. Conclusion

Corporate governance impacts on earnings management in most companies at different levels of performance.

The C.B.N. (2009) termination of chief executives of five commercial banks in Nigeria, and recapitalizing them with funds for their financial operations is an indication of poor corporate governance to the affected banks as it relates to their core functional areas which were mismanagement.

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