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FACTORS AFFECTING EARNINGS MANAGEMENT – A SUMMARY OF LITERATURE

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ABSTRACT

This paper attempts to present a brief summary of the important research in the area of earnings management. The paper encompasses not only the conceptual aspect of the topic, but also the other firm specific factors which are related with earnings management. This paper is unique as it creates a comprehensive understanding about earnings management in the minds of the reader.

KEYWORDS: *Earnings Management, Comprehensive Understanding*

INTRODUCTION

Earnings management is well known the literature of accounting and Finance, as the ways and means of manipulation of reported earnings to serve the interest of the managers who are incentivized. Earnings management does not mean illegal practices rather earnings management is changing the reported income being very much within the legal framework of Accounting and Finance. In the literature, prominent authors have discussed about the issue of measuring the extent of earnings management by innovative models. Earnings management can be either upwards or downwards. When due to continuous loss, the stock prices in the market starts falling down, then the managers try to inflate the earnings to prevent the fall of stock prices. Managers of many companies have stock options as incentives or bonus plans. These managers always try to maximize the value of the stocks in the secondary markets so that the value of their incentives increase and their personal gain is maximized. In many countries, taxation is an important issue and there are countries where taxation is higher. In such countries, managers are expected to deflate the reported income basically to avoid higher taxes in the high income slabs. Among the means of earnings management, showing one period's sales to the next is pretty common. Manipulation of non-cash expenses like depreciation is also another means of earnings management. To accomplish earnings management, managers may resort to many more innovative and creative ways. In the literature, there is no specific definition of earnings management but evidences of earnings management are present from all parts of the world. In this paper, apart from introduction of the concept of earnings management we have also presented the snapshot of some of the methods and models which are commonly used to measure earnings management. Apart from the models and methods, we have also given comprehensive ideas about various factors which influence the levels of earnings management in a firm. Some of the factors which are specific to the farm and which can influence earnings management are i) the quality of audit, 2) the presence of institutional holding, 3) influence of bank loan, 4) the quality of disclosure, 5) the extent of stock options of managers, 6) the range of income of the company, 7) the independence of the board and 8) CEO incentives. All the areas are explained in the following seven sections with brevity.

Audit Quality and Earnings Management

We, at first introduce the concept of relationship between earnings management and the audit quality. It is expected that if the auditor is of very high reputation, then that is reflected in the quality of audit also. There have been many studies which tried to look into the issue weather the big auditor or the big-4 can really make the reporting quality higher and the earnings management lower. The literature bears evidence that quality of audit substantially reduces the level of earnings management. The researchers who have researched in this area have tried to identify the influence of big auditors on earnings management after controlling for other variables in the statistical models. Bartov *et al.* (2000) have thrown light in the area of audit quality which is one of the widely read papers.

Models Used To Measure Earnings Management

Most of the researchers have either used Healy (1985) or Dechow *et al*.(1995) model or the famous Jones (1991) model. Jones model has a variant which is known as Modified Jones Model. Among all the models as mentioned earlier, the Jones model has been widely cited in this area. Hribar and Collins (2002) have elaborated on estimation errors of different models. Earnings management is measured by a proxy which is known as Discretionary Accruals. This concept is elaborated in the Jones model itself.

Disclosure-Quality and Earnings Management

Disclosure quality of the firms, to some extent, is related with the quality of auditor which has been dealt with separately by the researchers. Most of the researchers have proven that upgraded disclosure-quality reduces the scope of earnings management. From another angle, we can say that after the adoption of International Financial Reporting Standards, the financial reports became standardized and comparable and because of better comparability, the value-relevance of accounting information has increased. From this perspective, we can expect that upgraded disclosure to reduce earnings management. Jo and Kim (2007) have discussed about this issue in details.

Institutional Holding and Earnings Management

Institutional holding of stocks is very much related with the level of earnings management. Block holding of stocks means that those institutional investors would appoint nominee directors in the boards of the firm which would enhance the process of continuous screening. This would substantially reduce the scope of earnings management. Many studies have elaborated on this concept. Mehran (1995) is one of the very important papers in this area.

Board Independence, Audit Committee and Earnings Management

Independent directors are very important in the studies related with earnings management. If there are more number of independent directors in the board, then they would ensure the true and fair view of the financial statements and hence the scope of earnings management will substantially reduce. Studies have proved that the boards with higher independence points out to substantially reduced earnings management. In most of the countries the concept of an audit committee is very common. In the audit committee, the independent directors play an important role. More is the number of independent directors; more is the efficiency of audit committee. An efficient audit committee would always suppress earnings management within the company.

Klein (2002) has explained this in greater details in his famous paper.

CEO Incentives and Earnings Management

Studies have proved this with substantial evidence that employee stock ownership plans play very importantrole in the area of research which is related with earnings management. Studies have shown that in United States of America there has been tremendous increase in the stock ownership plans offered by the companies to the managers. This incentivised manager's target to inflate to the reported income to serve their own interest. The employee stock ownership plans remain as one of the major reasons behind earnings management. (Bergstresser and Phillippon, 2006; Halthausen *et al.,*1995; Guidry *et al.,*1999; Gaver *et al.*, 1995) are some of the very famous researches in this area.

Long-Term Underperformance of IPO and Earnings Management

Researchers have shown that in many countries, IPOs have substantially underperformed in long-term. The literature have shown that this is due to introducing the IPOs in the market at unexpectedly high prices after sustained earnings management which would create an upward bias in prices and expectations. The underperformance of IPOs have been very common in India as well in the past decade. Teoh *et al., (*1998) is a torchbearer in this area. Gompers *et al*., (2003) is another important research paper in this area.

DISCUSSIONS AND CONCLUSIONS

The width of the gamut of earnings management is huge. Some authors have proven that earnings management practices depend on the range of corporate income. At the low and very high ranges of income, the managers do not manipulate earnings. Some authors have even found clustered behaviour of accruals. With passage of time, newer areas of researches are coming up which are related with earnings management in some way or the other. Whether earnings management has reduced after the adoption of IFRS or convergence standards remains as a future scope of study in this area.

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