Flexibility in Financial Accounting Income Strategies and Earnings Management in the Netherlands

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Chapter 1

Introduction

1.1 Concern about the quality of financial statements

The usefulness of financial statements and the barriers to interpreting accounting data are often object of discussion for financial journalists. Financial journalists discuss cases where corporate Chief Executive Officers (CEOs) quite obviously manage the accounting income of listed firms in order to influence the performance evaluation of and future cash flow predictions by investors. These articles are furnished with catchy headlines such as “The pension fund as saving angel1”, “De Boer Unigro and the little earnings management pot2” or “Deal with Rabobank made up seventy five percent of Philips profit3”. Het Financieele Dagblad had a series of editorial articles called “Cijferblik” in its Saturday edition discussing financial accounting matters and even had a set of three articles critically discussing recent developments in financial accounting4. The articles were titled: “The annual report hinders the true and fair view more and more”, “The balance sheet as playground for opportunists” and “Accounting income as goal in itself”. The articles discuss several cases of earnings management and the authors conclude that:

- Financial statements are getting more artificial; the accounting numbers are less guarantee for future corporate success;
- The balance sheet has become a playground for corporate managers and the users are easily misled;
- Firms, who can search well, can find the profit they want to find.

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1 Het pensioenfonds als reddende engel, NRC Handelsblad, August 24, 1996.
These articles tend to simplify the phenomenon earnings management and draw general conclusions on the perceived behavior of only a few firms. The central questions raised in these articles are nonetheless very important because they are related to the (perceived) quality of financial statements.

Not only financial journalists are concerned about the quality of financial statements. The former CEO of SHV Holdings, Fentener van Vlissingen (1995, p. 66), wrote “It is a misconception that everything in financial statements is true because these are audited. Of course the auditor’s opinion is necessary and there is no doubt about their intentions and their skills. However: a creative accountant can do a lot with accounting numbers without committing fraud, cheating or misleading in a legal sense. The average financial statement has a bias of about twenty percent. The so-called hard financial statements can be biased by approximately forty percent, the difference between reasonably good and bad, reasonably healthy and alarming unhealthy, just above the line or well under the line. The pressure on directors to show what stakeholders want to see is great, greater than outsiders would believe”. The importance of showing good results is increasing since earnings announcements that deviate negatively from expectations may result in share price losses of more than 10%. Van Helleman, the former chairman of the Council for Annual Reporting (CAR) in the Netherlands, stated in an interview with NRC Handelsblad that it is tempting to use accounting tricks in order to disguise the true performance of the firm. Further, Van Helleman stated that in the Netherlands there are hardly any sanctions against earnings manipulation.

The concern about the quality of financial statements however is neither new nor typically a problem of financial accounting in the Netherlands. In the early 1970s Abraham Briloff became known as a critic of contemporary financial accounting standards in the United States (US) and of financial accounting practices of individual US firms. Two decades later Smith (1992) shocked the business establishment in the United Kingdom (UK) with his book titled “Accounting for Growth; stripping the camouflage from company accounts”. Smith gave

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5 Perceived because earnings management behavior is only certain if the journalist is able to ascertain directly from managers, whether earnings have been managed.
6 SHV Holdings is the largest family-owned firm in the Netherlands.
7 Accounting in the Netherlands: honesty declines (June 1, 1999).
8 See for example Foster (1979, 1986) for a discussion of the Briloff Phenomenon.
examples of UK firms where much of the apparently good performance in recent years was in fact the result of accounting sleight of hand. Furthermore, the increased attention for corporate governance was, among other factors, a direct result from the continuing concern about standards of financial accounting and accountability. In the Report of the UK Committee on the Financial Aspects of Corporate Governance (1992) this concern was expressed in paragraphs 4.47/4.49: “A basic weakness in the current system of financial reporting is the possibility of different accounting treatments being applied to essentially the same facts, with the consequence that different results or financial positions could be reported, each apparently complying with the overriding requirement to show a true and fair view. In addition, the wider the scope for alternative treatments, the less useful financial reports become in terms of comparability over time and between firms”. Although the US are generally known for their high quantity and quality of financial accounting standards, legal liability for financial accounting and calls for additional regulation are at an all-time high. The former chairman of the Securities Exchange Commission (SEC), Arthur Levitt (1998), more recently stated his concern about the quality of financial statements in a speech on earnings management. Levitt stated “the motivation to meet Wall Street earnings expectations may be overriding common financial accounting practices. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation”.

The quality of financial statements is important since it has a direct effect on two essential functions of it: accountability and decision making ability. Current financial statements are of poor quality if they mislead us in our performance evaluation and in making forecasts of future (residual) earnings. There are three potential sources of poor accounting quality (Palepu et al., 1996, pp. 3-5). Accounting rules introduce noise and bias because it is often difficult to restrict management discretion without reducing the information content of accounting data. Another source of noise in accounting data arises from pure forecast error, because managers cannot predict the future consequences of current transactions perfectly. The third source of noise and bias in accounting data arises from managers’ use of financial accounting flexibility and is reflected by the firm’s income strategy and earnings

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9 Accounting quality is particularly important in forecasting because of the way that accounting reverses.
management. Low quality accounting makes current profitability a poor indicator for performance evaluation and a poor indicator of future profitability. Since both have economic consequences financial accounting quality matters for those who regulate, prepare and use financial statements. Knowing more about financial accounting quality in general, and about managers' use of financial accounting flexibility specifically, could help to increase the usefulness of financial statements.

1.2 Prior empirical research in the Netherlands

There is little existing research on the quality of financial statements in general and on managerial use of financial accounting flexibility in the Netherlands more specifically. Since Watts and Zimmerman introduced their Positive Accounting Theory (PAT) in the mid 1970s, a growing number of research papers were published on this topic in especially the US. Examples of early work in this respect are the seminal papers of Watts and Zimmerman (1978) and Zmajewski and Hagerman (1981), of Dhaliwal et al. (1982) and Healy (1985) on compensation contracts and accounting policy choice, of Leftwich (1981a, b) and Daley and Vigeland (1983) on debt contracts and of Leftwich et al. (1981) on voluntary corporate disclosure. Until a decade ago, accounting papers in the Netherlands however were still of a more normative nature (i.e. the search for the superior method of financial accounting). A factor of obvious importance in this respect is the traditional emphasis among accounting academics in the Netherlands on the development of normative theory in the area of valuation and income determination (Camfferman, 1996, p. 5). While accounting research in the Netherlands focused on accounting issues until the early 1990s, hypothesis testing in line with PAT was underexposed. The fact that in other countries an accounting revolution took place was of minor importance in the Netherlands (Feenstra, 1991, p. 276).11

However since the 1990s a number of empirical studies on topics related to managers' use of financial accounting discretion have been published in the Netherlands. The behavior of management concerning changes in accounting policies was, among other things, analyzed by

10 Existing research in other countries will be discussed at length in the next chapters.

1.3 The motivation and objectives of this study

Motivation of this study

The quality of financial statements is in debate, within the Netherlands as well as outside the Netherlands. Financial journalists and academics as well as participants in the regulatory and financial accounting process have expressed concerns about the quality of financial statements.

It is for this reason that the Limperg Institute\textsuperscript{12} started a research project on the quality of external financial accounting in the Netherlands in 1995. The research project is divided in twenty parts, grouped in three clusters: The Development of a Theoretical Framework, Empirical Research among Financial Statement Users and Empirical Financial Statement Analysis.

\textsuperscript{12} The Limperg Institute, which is named after the Dutch professor Theodore Limperg jr. (1879-1961), is a cooperation for research purposes between five universities with a post-doctoral education program for auditors and the Dutch professional body of chartered accountants (Royal Nivra).
The aim of this research project is to gain insight in the quality of financial accounting in the Netherlands and to propose possible quality improvements. The Limperg Institute's concern about the quality of financial accounting in the Netherlands was without a doubt strengthened by some of the newspaper articles mentioned before. The research proposal stated that: "Poor financial accounting quality means that the goal of financial accounting is not achieved and that financial accounting information is inadequate. A lack of quality can lead, for example, to sub-optimal allocation behavior of stakeholders". Another impulse may have come from the ongoing internationalization of financial accounting standards. Compared to the financial accounting standards in other countries Nobes and Parker (2000, p. 173) state that "the almost extreme permissiveness with high professional standards is an important feature of Dutch company financial reporting". Taking into account the unparalleled position of financial accounting flexibility in the Netherlands and the interest of the international accounting community in this field, there is an intensive need to gain more understanding of this flexibility.

The University of Amsterdam, a member of the Limperg Institute, started a PhD project in 1996 titled “Flexibility in Financial Accounting Policy Making”. The project relates to the Limperg Institute's quality project, and more specifically to the cluster Empirical Financial Statement Analysis. This study is the result of the PhD project “Flexibility in Financial Accounting Policy Making”.

Objectives of this study

The purpose of this study is primarily to describe and explain income strategies and earnings management by listed firms in the Netherlands. However, before conducting such a study it is important to know more about financial accounting flexibility in the Netherlands in general and of individual (listed) firms more specifically. Further, in order to measure financial

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13 The quality improvements were presented on 23 November 2000 on a Financial Reporting Quality Symposium at the University of Amsterdam. The project’s general conclusion is that the quality of financial accounting in the Netherlands is mediocre and that there is ample room for improving financial accounting quality in the Netherlands.

14 The full results of the Limperg Institute’s quality project are published by Hoogendoorn and Mertens (2001).

15 A firm’s income strategy is a subset of a firm’s general accounting strategy. Earnings management can be interpreted as part of the implementation of the income strategy. Income strategy and earnings management will be defined in chapter 2.
accounting flexibility for individual firms\textsuperscript{16} and to describe and explain its use for income strategies and earnings management, methods of detection and analysis are required. Thus, in this study the following four main research questions are addressed:

RQ1: What are the general possibilities to adapt financial accounting data within the opportunities offered by accounting standards in the Netherlands?

RQ2: How can financial accounting flexibility be observed and its use for income strategies and earnings management be detected and analyzed?

RQ3: What are the firm specific possibilities to adapt financial accounting data by real transactions and pure accounting decisions?

RQ4: How can the use of financial accounting flexibility for income strategies and earnings management by listed firms in the Netherlands be explained?

The first part of this study provides a framework for managerial use of financial accounting flexibility, a general discussion of incentives for income strategies and earnings management and a discussion of constraints on managerial influence over accounting income. In the second part of the study the research questions are addressed. The first research question will be addressed by way of an in-depth investigation of the number and characteristics of alternative accounting policies that the management of a firm can choose in general. The result is a detailed overview of the general financial accounting flexibility in the Netherlands based on the Civil Code and the Guidelines issued by the CAR. On the basis of this detailed overview a new proxy to measure financial accounting flexibility and to detect managerial influence over accounting income is developed. Detection often focuses on managerial use of specific observable discretionary items or on discretionary accruals. However both detection methods are not complete and fully correct. The problems with both methods leave room for the development of new proxies for managerial use of financial accounting flexibility. While the first research question is of a descriptive nature, the second research question is of a more explorative nature.

\textsuperscript{16} In chapter 2 financial accounting flexibility for individual firms is referred to as financial accounting discretion. Financial accounting discretion is defined as the firm specific possibilities to influence accounting information by real transactions and pure accounting decisions.
The third and fourth research questions are answered by using the newly developed proxies to study the financial statements of 65 listed firms over the period 1988-1997. A total of 603 financial statements of non-financial institutions have been examined in depth. A firm’s specific possibilities to adapt financial accounting data by real transactions and pure accounting decisions create a range of possible accounting income numbers. By measuring this range for individual listed firms, the third research question is answered. The final part of this study aims at explaining the use of financial accounting flexibility for income strategy and earnings management purposes. The third and fourth research questions are of a positive nature since they are aimed at explaining managerial use of financial accounting flexibility. The empirical investigation used to describe and explain managerial influence over accounting income does not only create insight into firms’ accounting behavior, but also results in a yardstick that can be very useful for financial analysis.

1.4 Chapter outline

This study is organized as follows. Chapter 2 presents a framework of managers’ use of financial accounting flexibility. The framework is the basis for the discussion of the empirical study’s background provided in the next chapters. Chapter 2 also provides definitions of financial accounting flexibility, financial accounting discretion, income strategy, earnings management and related concepts in order to clarify the basic concepts used. Chapter 3 discusses the possible incentives for managers to exert influence over accounting income. After a historical perspective is given in the first section, the incentives from the firm’s contract set and the incentives from a capital markets perspective are discussed. The incentive structure is used in subsequent chapters to explain the use of financial accounting flexibility. Chapter 4 contains a discussion of the constraints on managers to influence accounting income. Given the general accounting alternatives in the Netherlands, the constraints on managers to influence accounting income limit the set of a firm’s accounting alternatives. Apart from managers’ ethical standards and the role of the firm’s governance structure, the probability of observation, legal constraints and the role of market forces are discussed. Chapter 5 provides a detailed overview of the general accounting alternatives in the Netherlands, answering the first research question. This overview of financial accounting
flexibility is based on the Civil Code and the Guidelines issued by the CAR. Chapter 6 reviews prior methods used to detect managerial influence over accounting income.

On this basis, and on the basis of the detailed overview of financial accounting flexibility provided in chapter 5, new proxies to detect managerial influence over accounting income are developed in chapter 7 and thus the second research question is answered. In order to broaden the perspective of this explorative study an income strategy approach to financial accounting flexibility is chosen, following Zmijewski and Hagerman (1981) and more recently Pierce-Brown and Steele (1999). In an income strategy approach the firm’s set of accounting decisions is treated as a single comprehensive decision since in practice management is less likely to consider each accounting choice on an isolated basis. The income strategy approach recognizes the fact that management is likely to select a set of accounting decisions the combination of which produces the required effect on accounting income. Chapter 8 contains a discussion of the empirical findings based on the newly developed measurement variables and offers alternative explanations for income strategies and earnings management in the Netherlands. Chapter 8 presents the outcome for the total sample of firms, in relation to the incentives for and constraints on managerial influence over accounting income and aims at answering the third and fourth research questions. However, in the light of the fact that it concerns newly developed proxies, the findings are of an explorative nature only. Finally, chapter 9 contains a summary and discussion of the research questions and empirical findings.