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

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In this chapter part of the framework for managerial influence over accounting income as provided in the previous chapter is further analyzed. It explains the role of incentives on the firm’s income strategy and earnings management. Incentives are possible factors of influence on managerial use of financial accounting discretion and follow in general from the economic consequences of accounting data. Accounting income is one of many informational signals on the state of the firm to the efficient capital market. The reaction of the capital market to accounting data provides management with an incentive to exert influence over accounting income. This influence is visualized by the line from market reaction to incentives in figure 2.2. In paragraph 3.3 incentives for managerial use of financial accounting discretion are discussed from the capital market perspective. Incentives may also follow from the economic consequences of accounting data because of existing and potential contracts, both explicit and implicit. The incentives resulting from explicit and implicit contracts are visualized by the lines from accounting income through explicit contracts to incentives in figure 2.2 and from implicit contracts to incentives in figure 2.2. In paragraph 3.2 incentives for managerial use of financial accounting discretion are discussed from a contracting perspective.

This introduction deals with two general notions that lay the foundation for incentives for income strategies and earnings management: asymmetrical information and economic consequences. First, however a brief historical research perspective is given on the awareness of incentives for income strategies and earnings management in the financial accounting process.
3.1.1 Historical perspective

In early accounting research incentives for income strategies were not recognized\textsuperscript{32}. The approach in this early research is characterized by attempts to formulate logical conclusive theories in relation to preferably valuation and income issues, where economic income is the ideal and also the starting point. The research was aimed at developing an accounting system which would optimally reflect the actual status of the business activities in the financial statements. The accounting system itself was aimed at the stewardship function of the firm’s management and was evaluated on the relation between economic (true) income and accounting income (see figure 3.1). This true income perspective on financial accounting is normative in the ways of prescribing the best accounting practices in order to come to the optimal reflection of the true status of the business activities.

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{figure3.1.png}
\caption{The true income perspective}
\end{figure}

In early accounting research the standard setting process was of great importance because accounting standards were there to facilitate the firms management in reflecting the true financial picture in the financial statements. The incentives for income strategies in the financial accounting process were not an object of study in early accounting research because the accounting system under this approach was there to ensure that financial statements reflected this true financial picture. From a true income perspective, unmanaged accounting

\textsuperscript{32} White et al. (1994) call this the classical approach to accounting theory.
income is a noisy measure of economic income because the rules of accrual accounting and GAAP lead to accounting numbers that measure economic income with error. Economic income is meaningfully defined only under certain conditions, some of which are not found in actual accounting conditions. Under actual accounting conditions economic income does not exist objectively, it is intersubjectively constructed by the social actors in question (Beaver and Demski, 1979, p. 42). Managing accounting income under this perspective changes the properties of the noise, such as its amount, bias, or variance (Schipper, 1989, p. 93). Implicit in early accounting research is the assumption that users of financial statements do not access other sources of information and do not adjust for the effects of alternative accounting methods.

In the late 1960s the perspective in financial accounting research shifted from a true income perspective to an informational perspective (Beaver, 1989, p. 4). The publication by the American Accounting Association in 1966 of “A Statement of Basic Accounting Theory” was of great importance for this development (Feenstra, 1991, p. 273). The statement defined accounting as the process of identifying, measuring, and communicating economic information to permit informed judgement and decisions by users of the information. This user or informational perspective became dominant over the true income perspective in the early 1970s in the US.33

Under the informational perspective accounting data play two distinct, but related roles. The first role is to facilitate stakeholders in making investment and valuation decisions. The second role is to facilitate contracting. Under the contracting perspective existing and potential contracts, both explicit and implicit, between stakeholders and the firm create incentives for income strategies. In the remainder of this text the first role of accounting data under the informational perspective is referred to as the capital market perspective and the second role of accounting data is discussed under the contracting perspective. The first role is often called the pre-contracting role while the second is often called the post-contracting role of accounting data (Beaver, 1989, p. 6).

33 As stated in chapter 1 accounting research in the Netherlands however, focused on accounting issues until the early 1990s.
The shift in research perspective mentioned above was, apart from the fact that the true income perspective was incomplete\(^3\), the consequence of two separate influences. The first influence came from the advances in finance theory in the 1960s and resulted in research on the decision-facilitating role of accounting data. It is commonly referred to as market based accounting research. In market based accounting research the market reaction on accounting data is the main object of study. The second came from the increasing influence of “outside forces” in the standard setting process and resulted in research on the contracting facilitating role of financial statements and is commonly referred to as Positive Accounting Theory (PAT).

3.1.2 Asymmetrical information

It is often assumed that management is more informed about the firm than stakeholders are. Hence, there are general concerns that management will use the information advantage to maximize self-interest at the expense of the firm’s stakeholders. This is a problem of moral hazard. In general a problem of moral hazard exists when one party to a transaction may take certain actions that affect other parties valuation of the transaction and these other parties cannot monitor or enforce the transaction perfectly. Moral hazard does not only include such acts as fraud and shirking, it also includes other actions that are not in the best interests of the stakeholders.

A phenomenon closely related to moral hazard is adverse selection. Here the problem is that high transaction costs or the difficulty of obtaining information may make it impossible to assess the performance of firms correctly.

The most likely responses to adverse selection and to the problem of moral hazard are (Beaver, 1989, p. 39):

1. Provide a contract with incentives for management in order to align the interests of management and the stakeholders. Profit-sharing agreements and stock options are

\(^3\) Incomplete in two ways: 1) the ideal of economic income measurement is not conceptually clear (see Beaver and Demski, 1979), 2) the lack of consensus on reporting practices, even when there is conceptual clarity (Beaver, 1989, p.5).
examples of incentive schemes that align more closely the interests of management and shareholders. Contracting as a response to asymmetrical information is discussed in more detail in section 3.2;

2. Provide for public disclosure of the firm's information in order to reduce the superior information position of the management. Signaling behavior may also arise. In this case managers signal their private information, stating they have nothing to hide. The effectiveness of this signaling behavior will however depend on the credibility of the signal (i.e. the extent to which managers with something to hide can imitate the signaling behavior). Signaling as a response to asymmetrical information is discussed in more detail in section 3.3;

3. Auditing. The audit provides an external and objective check on the way in which the financial statements are prepared and presented. Audits are a reassurance to all stakeholders. Auditing as a response to asymmetrical information will be discussed in section 4.4.

3.1.3 Economic consequences

There are a number of potential economic consequences of accounting data in a general sense. By “economic consequences” is meant the impact of accounting data on the decision-making behavior of business, government, unions, investors and creditors (Zeff, 1978, p. 56). The involvement of employers' federations, trade unions, investor organizations and accountants' organizations in debates surrounding the establishment of accounting guidelines in the Netherlands from the late 1960s may be regarded as an effect of economic consequences of financial statements. If accounting data had no economic consequences, accounting guidelines and, more specifically, the choice of accounting methods would not have been perceived substantive enough for this broad stakeholder involvement. Examples of economic consequences of accounting data include the effects on (Beaver, 1989, p. 43):

1. The distribution of wealth among individuals;
2. The aggregate level of risk and allocation of risk among individuals;
3. The aggregate consumption and production;
4. The allocation of resources among firms;
5. The use of resources devoted to publicly available information;
6. The use of resources devoted to regulation; and
7. The use of resources devoted to private search for information.

The economic consequences of accounting data relating to incentives for income strategies are discussed from the two roles of accounting data under the informational perspective discussed in section 3.1.1. The first role states that because investors delegate decision making to managers there is a demand for information about the actions that are taken for the purpose of controlling them. Gjesdal (1981) calls this the stewardship demand for accounting data. From a contracting perspective the stewardship demand can be considered as the demand for accounting data to monitor the manager/shareholder contract. Accounting numbers are frequently used in contracts that often include restrictions on parties’ actions conditional on certain accounting numbers. Hence, there is a demand for financial statements from a contracting perspective, both for specifying and monitoring contracts. If accounting data is an important part of the firm’s contracting process and agency costs, and firm value and/or managers’ compensation, vary with different contracts, accounting procedures have the potential to affect firm value and/or the manager’s compensation (Watts and Zimmerman, 1986, p. 196). Economic consequences of contracts provide incentives to manage the mechanical outcome of the financial accounting process. The economic consequences of explicit contracts are shown in figure 2.2 by the line from accounting income to incentives. The line from implicit contracts to incentives shows the economic consequences of implicit contracts. The different contracts are discussed in the next section.

The second role of accounting data follows from the value of accounting data to stakeholders (in a broad sense) making investment and valuation decisions. This capital market perspective asserts that stakeholders demand information on current and future cash flows and the market value of assets and liabilities. Although accounting data usually does not provide all the information that stakeholders need, it may be one of the information elements in economic decision-making. The International Accounting Standards Committee’s (IASC) Framework for the Preparation and Presentation of Financial Statements (§12) states: “it is the primary

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35 According to the FASB (1976), stewardship is also subsumed under the informational perspective.
36 Accounting data will usually not be sufficient for decision-making since they largely portray the effects of past events.
objective of financial statements to provide information about the financial position, performance and changes in financial position of a firm that is useful to a wide range of users in making economic decisions". Because stakeholders’ investment and valuation decisions affect firm value and/or managers’ compensation, the capital market perspective also provides incentives to manage the mechanical outcome of the financial accounting process in order to provide better information about the future cash consequences of firms’ activities. From this perspective accounting income is one of many information signals on the state of the firm to the efficient capital market. The line from market reaction to incentives shows the informational perspective in figure 2.1. The contracting perspective and capital market perspective are not mutually exclusive; both can exist at the same time. Accounting data that is used in valuing the firm’s securities in the capital market perspective is often also useful in the accountability of management for the resources entrusted to it (IASC, Framework for the preparation and presentation of financial statements, §14). The capital market perspective on managerial influence over accounting income is discussed in more detail in paragraph 3.3.

3.2 Incentives from the firm’s contract set

In a world without contracting costs, financial accounting would be irrelevant. All prices relevant for decision-making would be costlessly observable, prices would be sufficient for decision-making, and thus no resources would be devoted to producing accounting numbers for decision-making purposes. In a world with contracting costs, to explain the general existence and the specific forms of accounting rules and accounting numbers, one must investigate the contracting contexts in which accounting numbers are used. This notion of contracting costs was introduced to the accounting literature by Watts and Zimmerman (1978). Their work, usually referred to as Positive Accounting Theory (PAT), builds upon the principal/agent analysis of Jensen and Meckling (1976), which was based on the seminal work of Coase (1937), who observed that in a hypothetical world without contracting costs firms would be irrelevant\(^{37}\).

\(^{37}\)Generally referred to as the "general institutional irrelevance theorem".

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In PAT the firm is viewed as a set of contracts and it is assumed that it is the firm's objective to minimize the contract costs associated with these contracts. In competition among firms, those that organize themselves to minimize contracting costs are more likely to survive (Fama and Jensen, 1983). The concept of contracting costs and the notion of accounting methods as part of efficient organizational technology play key roles in PAT. In PAT the incentives for income strategies in the financial accounting process are a main object of study. The ultimate objective in this research is to understand and predict accounting policy choice across different firms. By using the term "positive" Watts and Zimmerman wanted to emphasize the difference in approach with earlier, normative theory (1990, p. 148). Many of these contracts (implicitly) relate to accounting variables and thus give incentives for the firm's accounting strategy in general and income strategy more specifically. PAT assumes that managers are rational and will choose the income strategy in their own best interests given the accepted set of accounting procedures. The objective of a firm's income strategy relates to the firm's incentives and to managers' perspective. Managers may either aim the strategy at maximizing the value of the firm by efficient contracting or by providing better information, or be motivated opportunistically at the expense of other contracting parties (Holthausen, 1990, p. 209). The perspectives are not mutually exclusive, the relative amount of value maximization and opportunism depends on constraints on managers' accounting discretion (Christie and Zimmerman, 1994, p.539). The constraints on managerial behavior are discussed in chapter 4.

Managers have the discretion to choose any accounting method within their accepted set of methods. Usually the accepted set is the same as under GAAP, but contracts may as well specify the accounting methods to be used and limit the accepted set. Contract parties would only restrict the accepted GAAP set for efficiency reasons. The optimal set for contract parties would result from the trade off between contracting costs and the possibility for the firm to adapt for changes in the business activities and the accounting system. Contracting parties expect some opportunistic actions and this will ex ante be reflected in the price in order to protect themselves against the redistributive effects of accounting discretion (Watts and Zimmerman, 1990, p. 136).

38 Although PAT has been criticized by for example Whittington (1987), and Christenson (1983), it is a very productive mainstream accounting research approach.
Early research in the field of PAT was based on the agency theory. The agency costs associated with debt contracts and management compensation contracts together with the agency, information and other contracting costs associated with the political process provided the hypotheses tested in these studies\(^\text{39}\). Hence, agency costs arise from two sources in this literature: private and political. In the studies that followed it was however recognized that other contracts and related costs may as well affect the firm’s accounting strategy. The fact that costs used to explain the contracts in later studies often appear in contractual scenarios quite differently from the standard principal versus agent setting resulted in the introduction of the terms contracting costs and contracting theory instead of agency costs and agency theory. In PAT incentives are not restricted to the relation between the firm and its stakeholders. In the firm versus stakeholder relation it is the formal task of the firm’s management to further the interests of the firm in order to maximize its value. In many cases the maximization of the firm value will also result in the maximization of the managers own market value. In PAT there are however also incentives for the firm’s management to exercise the accounting discretion opportunistically in order to increase their own wealth at the expense of other stakeholders and potentially at the expense of the firm’s value. In these cases the interests and the incentives resulting from the contract set are different for the firm, its stakeholders and its management.

Watts and Zimmerman (1990, p. 143) make a distinction between left-hand-side variables and right-hand-side variables in PAT. The left-hand-side variables are the dependent variables in the income strategy. The right-hand-side variables are the independent variables in the income strategy. The incentives discussed in this chapter are the independent variables in the income strategy. Zmijewski and Hagerman (1981, p. 133) suggest that firms do not react on the individual incentives mentioned above, but use an income strategy taking into account all the relevant incentives. Their study supports PAT by indicating that four independent variables\(^\text{40}\) have a significant association with the choice of a firm’s income strategy.

\(^{39}\) The bonus plan, debt/equity and political cost hypotheses.

\(^{40}\) Size, management compensation, concentration and the debt/equity ratio.
Since this study is of an explorative nature, in respect of the dependent or measurement variables as well as the independent variables for income strategies, the number of possible incentives from the firm's contract set is discussed rather extensively. Incentives from the firm's contract set with possible relevance for financial accounting in the Netherlands are discussed in more depth than incentives with little relevance in the Netherlands.

3.2.1 Explicit contracts

In contracting theory a distinction is often made between explicit contracts and implicit contracts. In the first case contracts are explicitly related to accounting variables and thus directly influenced by accounting income. In figure 2.2 the relation is shown by the line that goes directly from accounting income to incentives. Explicit contracts are the subject of study in early contracting research. Explicit contracts resulting in incentives for income strategies that are recognized and discussed are: management compensation contracts, debt covenants and taxation.

Apart from the distinction between incentives from explicit and implicit contracts a distinction can be made between recurring and non-recurring incentives. Non-recurring incentives, such as management buy-out offers, initial public offerings and executive changes induce a short term perspective that may cause the use of different interventions to influence accounting income because the reversal effect of the intervention on income in subsequent periods may be of minor importance to the initiator(s). The reversal of the effect on accounting income of different methods and interventions is important when management decides to choose among them to influence accounting income. In general, a distinction can be made between methods with no reversal effect and methods with reversal effects in the short or long run. Reversal, or self-correcting nature of accrual accounting, means that income increasing accounting interventions in the current period lead to a decrease in accounting income in future periods and vice versa.

In case of recurring incentives, such as management compensation contracts and the general stakeholder relationship, the reversal effect on accounting income is important because next years incentives may be the same and accounting income may be of equal importance to the
firm and its management. In the latter case the firm and its management will take account of the reversal effect of methods to influence accounting income on income in future years.

**Management compensation contracts**

Total managerial compensation may include salary, bonuses based on accounting performance measures and payoffs based on the firm’s security price performance (stock option plans). Stock option plans are discussed as an implicit contract in the next section.

The bonus plan hypothesis which is tested in the management compensation contract studies, assumes that managers of firms with bonus plans are more likely to choose accounting procedures that shift accounting income from future periods to the current period (Watts and Zimmerman, 1986, p. 208). In the US, firms compensate managers under terms of formal, legally-executed plans that are placed in the public domain. As a consequence the data are accessible for research purposes and are of high quality (Ball and Smith, 1992, p. 344). However, in the Netherlands this is not the case. According to section 383, subsection 1, BW2, the total remuneration, including pension contributions, of members and former members of the board of directors should be disclosed. Since this type of disclosure does not specify the compensation contracts it is hard to analyze the influence of bonus schemes on income strategies in the Netherlands.

Because management compensation may be based, explicit or implicit, on accounting income, and because managers have some discretion over accounting income it is logical to ask whether managers exercise that discretion in their self-interest. In the US this hypotheses has for example been tested by Healy (1985), Gaver et al. (1995), Holthausen et al. (1995) and Guidry et al. (1999). Using an accrual based research design as well as a design based on changes in accounting procedures, Healy (1985) found support for earnings management by managers of firms with bonus plans. The results appear robust because Healy shows that ceilings (i.e. the upper earnings bound in the bonus scheme) in compensation contracts have a predictable effect on accounting accruals. When earnings fall below the lower bound Healy finds that managers manage earnings downwards and “take a bath”. Gaver et al. (1995)

41 Unless the statement ultimate relates to a single natural person.
extend the study of Healy by using discretionary accruals instead of total accruals. They find that when earnings before discretionary accruals fall below the lower bound, managers select positive discretionary accruals (i.e. do not “take a bath”) and that the reverse is true when earnings before discretionary accruals exceed the lower bound in the compensation contract. They believe that managerial behavior is more consistent with income smoothing than with Healy’s bonus hypothesis. Holthausen et al. (1995) use confidential data of short-term bonus plans and also investigated the extent to which CEOs influence accounting income to maximize the present value of bonus plan payments. They expand Healy’s work in seven areas, among other things by using discretionary accruals, and also find evidence consistent with the hypothesis that managers bias accounting income downwards when their bonuses are at their maximum. Similar to Gaver et al. (1995) they find no evidence that managers bias accounting income downwards when earnings are below the lower bound. Guidry et al. (1999) expanded the research on the bonus maximization hypothesis to the level of business units. Their innovations yield robust evidence consistent with Healy (1985).

**Debt covenants**

One source of demand for accounting data arises from contracts between firms and suppliers of debt capital. The interest of suppliers of debt in accounting data arises, apart from credit analysis purposes, from the possibility that managers, acting on behalf of stockholders who appoint them, can increase the wealth of stockholders at the expense of the wealth of debtholders. Debt covenants are (part of) contracts between the debtholders and firms, aimed at the protection of the debtholders’ claims. The debt covenants may for example relate to restrictions on dividends and other distributions to stockholders such as stock repurchase. Some of the contractual provisions are expressed in terms of numbers contained in audited financial statements, such as reported debt/assets ratios and earnings/interest coverage ratios. The debt covenant hypothesis traditionally assumes that the larger a firm’s debt/assets ratio, the more likely the firm’s manager is to select accounting procedures that shift accounting income from future periods to the current period (Watts and Zimmerman, 1986, p. 216). According to the hypotheses managers aim their income strategy at avoiding the renegotiations and the rewriting cost of contracts. Although debt covenants are not often disclosed in financial statements in the Netherlands they are mentioned by for example Ahold,
Boskalis, Hagemeyer, Nedlloyd and Pakhoed in the research period of this study. An issue that frequently arises in the literature related to debt covenants is whether the debt/assets ratio is a valid proxy for the costs associated with income strategies. Duke and Hunt (1990) address this question and they find a significant relation between the leverage ratio proxy and the tightness of actual covenants. Since it is likely that firms in the Netherlands also have debt covenants based on debt/assets ratio restrictions it is possible to analyze the influence of the ratio on the firm's income strategy. It is expected that firm's with higher debt/equity ratios will report less conservatively than firms with lower ratios.

In the US the debt covenant hypothesis in relation to accounting method choice is tested by for example Dhaliwal (1980), DeFond and Jiambalvo (1994) and Sweeney (1994). Dhaliwal (1980) found that firms employing the full-cost method of accounting for exploration costs have higher financial leverage than firms that use the successful effort method since the latter method reduces reported equity and earnings in most cases. Using actual debt covenant violations, DeFond and Jiambalvo (1994) found support for earnings management by managers of firms with debt covenant violations both in the year of violation and the year prior to the violation. Sweeney (1994) investigated 130 firms reporting debt covenant violations in financial statements. She found that firms approaching default respond with income increasing accounting changes and that the default costs imposed by lenders together with managers accounting discretion are important determinants of managers' accounting response. Cotter (1999) investigated whether managers of Australian firms use upward asset revaluations to reduce debt-contracting costs. She finds that, although prior research did come to this conclusion, this is not the case. The conclusion drawn from additional analysis is that the relatively closer relationship between firms and their bankers in the current institutional setting has caused many firms to choose footnote disclosure of undervalued assets in preference to recognizing an upward asset revaluation in the balance sheet. Since valuation at current value is an option for tangible and financial fixed assets and stocks in the Netherlands this research has relevance for accounting research in the Netherlands. Research by De Feijter and Van Rooijen (2000) indicates that valuation at current value is used by only 5% of listed

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42 See for example Healy and Palepu (1990) and Begley and Feltham (1999) for accounting based dividend constraints.
firms in the Netherlands and that one-third of the firms rather use footnote disclosure of undervalued assets\(^{43}\).

Taxation

Taxation is an explicit contract between the government and the firm if the accounting procedures used in the financial accounting process affect the accounting procedures used on the tax returns. In the US there are some examples (LIFO inventory valuation) were accounting policies affect fiscal accounting. In the Netherlands this is formally not the case, but there may be a tax influence on the firm’s income strategy, for example in relation to the acceptance of accounting estimates by the tax authorities. It is however not expected that fiscal accounting will have any material impact on the income strategy of listed firms in the Netherlands. In the US Boynton et al. (1992) and Guenther (1994) examined the influence of taxation on the use of discretionary accruals in various settings.

3.2.2 Implicit contracts

Implicit contracts are indirectly related to accounting variables. In these cases the outcome of the financial accounting process is likely to influence existing and potential contracts between the firm and its stakeholders because it influences stakeholders’ perception of the firm. This perception may influence decision-making and hence have economic consequences for the firm and/or the firm’s management. The term “contracts” in implicit contracts should not be defined as legal contracts (contacts seems more appropriate). Although a legal relation often exists between the firm and its stakeholders one can not say that there is a strict contractual relationship with pre-specified contracts and with an explicit relation to accounting variables. In figure 2.2 these relations are shown by the line that goes from implicit contracts to incentives. The following examples of implicit contracts resulting in incentives for income strategies are recognized and discussed here: stock option plans, government regulations, labor union contracts, executive changes, management buy-out offers, desire for external financing, dividends, general stakeholder relationships and earnings forecasts.

\(^{43}\) See also De Bos and De Kimpe (1993) for valuation at current value in the Netherlands.
Management stock option compensation

Total managerial compensation may include salary, bonuses based on accounting performance measures and payoffs based on stock price performance (stock option plans). The compensation plans are formally designed and justified by their ability to reduce conflicts of interest between managers and shareholders. Management compensation in general is an important topic in the US and also in the Netherlands, this especially holds for stock option remuneration. There is an extensive debate in the popular press on the level of management compensation and the relation with corporate performance. In the Netherlands there is a substantial trend toward paying executives in stock options. Although, in case of stock options there is no explicit relationship with accounting income, returns on equities appear to be explained overwhelmingly by the firm’s cumulative earnings during the period. This effectively (and implicitly) ties stock option compensation close to accounting income over a longer period. It is common practice in the Netherlands to disclose, or mention managers’ stock option compensation. As stock options are disclosed on a regular basis, it is possible to analyze the influence of stock options on the firm’s income strategy. Since return on stock options are dependent on stock price performance and stock price performance is positively related to accounting income it is expected that firms with stock options for managers will report less conservatively.

Government regulations

Government bodies may examine accounting income if there are complaints or other indications that a firm is making excessive profits by taking advantage of the general public.

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44 Critics question the effectiveness of compensation contracts to align manager and shareholder interests and the effectiveness of the labor market for executives. See Pavlik et al. (1993) for a review of studies on the compensation-performance relationship.

45 ASM Litography for example experienced social unrest in 1998 after 45 managers received a stock bonus totaling $440 million from its former owner Philips N.V.

46 Aegon for example changed its option plan in 1999 after the firm was criticized for its generous option plan, four members of the board of directors earned $100 million in stock options. In the future the number of options received by management are related to Aegon’s relative stock price performance.

47 Especially larger firms have stock option plans. In 1988 60 percent of the AEX firms used in this study disclosed stock option plans and in 1997 90 percent of the AEX firms used in this study disclosed stock option plans. For information on stock option compensation in 2000 see Blij and Mertens (2001).

48 It is required to disclose stock option compensation for managers according to CAR Guidelines 1999 (section 240, subsection 111).
Financial statements in general and accounting income more specifically may be examined to see whether this is the case. Government actions may result in political costs such as price measures, tax measures or the withdrawal of government aid. The political cost hypothesis is often presented as a size hypothesis (Watts and Zimmerman, 1986, p. 235). It is argued that the larger the firm, the more likely the manager is to choose an income strategy that reduces accounting income in the current accounting period. This hypothesis is tested by Zimmerman (1983) and he found that size is a noisy proxy for political costs since it may be proxying for other unspecified factors. From the available studies it can be concluded that the effect of government regulations can only be tested meaningfully under specific conditions. Specific governmental conditions, especially regulatory-imposed wealth transfers, may give specific motives for income strategies for a relevant sample of firms.

Jones (1991)\textsuperscript{49} for example tests earnings management for a sample of firms that would benefit from import protection. She finds that managers decrease accounting income through earnings management during import relief investigations by the US International Trade Commission. Cahan et al. (1996) also found evidence that is consistent with the political cost hypothesis. Their paper examines earnings management of chemical firms at the end of 1979 when US congress was considering legislation over chemical firms and setting up a fund to cover cleanup costs, largely to be funded by the chemical industry. They found some evidence that chemical firms took income-decreasing accruals in 1979. Hall and Stammerjohan (1997) test the hypothesis that managers of oil firms make accounting choices to reduce accounting income during litigation in which the firm is a defendant and faces potentially major damage awards. They find that managers of these firms choose income-decreasing accruals relative to managers of other oil firms. Key (1997) tests the political costs hypotheses by examining the cable television industry during periods of Congressional scrutiny. The results are consistent with the hypothesis that firms for which proposed regulations are expected to be more harmful have greater income-decreasing accruals. Han and Wang (1998) investigated whether oil firms who expected higher earnings resulting from sudden product price increases in the Gulf War managed earnings downwards in order to reduce political sensitivity. Their results

\textsuperscript{49} The relevance of this study from a measurement perspective will be discussed in chapter 6.
show that these oil firms reduced reported quarterly earnings during the Persian Gulf crisis in 1990.

Labor union contracts

According to the preliminary results of research by Hassink (1998) 83% of labor union bargainers in the Netherlands say they use financial statements of firms in bargains, but his results show that accounting income is not the most important item in financial statements for bargainers. However, when it is likely that payoffs to other employees are a function of accounting performance measures as well, management has incentives to reduce accounting income in order to reduce wage demands. Especially during labor union negotiations managers may have incentives to reduce accounting income in order to lower union wage demands and improve their own bargaining power. If however, management's own compensation is tied to accounting income management has to trade off the positive effect of a lower accounting income on lower wages against the negative effect on their own compensation. Liberty and Zimmerman (1986) tested the labor union hypothesis but found no support for it. They explained this by claiming that the firms had fewer incentives to reduce accounting income because they were already performing poorly during the negotiation period.

Executive changes

A variety of income strategy incentives exist around the time of a CEO turnover. A CEO who approaches retirement when the firm is profitable faces short-term bonus plan incentives to use income increasing accounting interventions in order to maximize his bonus. By this intervention the CEO borrows income from the future and his successor will pay. On the other hand, new CEOs may “take a bath” and create accounting “reserves” for the future in order to increase the probability of a good future earnings record. However, when the write-offs can be rightly blamed on the previous CEO, and given their bonus incentives this may be the case, the “bath” is not a discretionary managerial action of the new CEO, but a consequence of the discretionary behavior of the former CEO. Discretionary behavior of the former CEO not only relates to the decisions in the immediate years before the turnover, but may also relate to income smoothing behavior by the former CEO above sustainable levels. Apart from the
earnings management explanation of managerial accounting behavior around CEO turnover it may also result from different perspectives, or different views of the world by new management. Accounting interventions for troubled firms may be different since managers have incentives to reflect their firms' financial difficulties (DeAngelo et al., 1994). Given the incentives above it may be necessary to distinguish between CEO turnover for troubled firms and non-troubled firms and to analyze the year(s) preceding the CEO change as well as the year(s) after the CEO change. Accounting choice around CEO change in the US setting is analyzed for example by Moore (1973), DeAngelo (1988), Dechow and Sloan (1991), Pourciau (1993), LaSalle et al. (1993) and Murphy and Zimmerman (1993).

Moore (1973) finds that discretionary accounting decisions that reduce accounting income are more likely to be made in a period of change in management. DeAngelo (1988) states that poor earnings can lead to a hostile management change. She finds that during a proxy contest current management exercises their accounting discretion to paint a favorable picture of their own performance to voting shareholders.

If elected, new board members tend to take an immediate earnings “bath” which they typically blame on the poor decisions of prior management. Dechow and Sloan (1991) investigated the hypothesis that CEOs in their final years of office manage discretionary investment expenditures to improve short-term earnings performance. Their results show that CEOs spend less on R&D during their final years in office. Pourciau (1993) examines evidence of earnings management associated with non-routine CEO changes. She finds, contrary to expectations, that departing CEOs record accruals that decrease earnings during their last year of tenure. Further, her evidence is consistent with the hypothesis that incoming CEOs manage accruals in a way that decreases accounting income in their first year and increases income the next year. LaSalle et al. (1993) report evidence that is consistent with the hypothesis that new CEOs exploit their accounting discretion to blame the predecessor for

50 Firms experiencing financial trouble have a relatively high annual CEO turnover rate of 25%, compared to firms without financial difficulties who have on average an annual CEO turnover rate of 11.5% (DeAngelo et al., 1994).
51 A proxy contest is a political campaign in which stockholders who disagree with managerial policies seek election to the firm’s board of directors.
52 Usually referred to as “the blaming hypothesis”.

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poor performance, establish a lower benchmark for subsequent performance evaluation, and relieve future earnings of charges that would otherwise have to be made. Murphy and Zimmerman (1993) on the other hand found no evidence that CEOs approaching retirement in strong performing firms used accounting discretion to maximize accounting income and found no evidence of successors taking a “bath”. They did however find evidence that incoming CEOs of poorly performing firms took “baths”.

**Management buy-out offers**

A management buy-out (MBO) is the sale of a firm, or business unit of a firm, to current management. Current management may have incentives to reduce accounting income in the year of the MBO and the years prior to the MBO in order to reduce the takeover price. This assumption has for example been tested by DeAngelo (1986) and Perry and Williams (1994). DeAngelo (1986) did not find evidence supporting the earnings management hypothesis. Perry and Williams (1994) on the other hand found evidence of discretionary accruals management in the predicted direction in the year preceding the public announcement of management’s intention to bid for control of the firm.

**Desire for external financing and mergers**

Financial accounting data such as accounting income presumably is a useful source of information in valuing the shares of Initial Public Offerings (IPOs). This raises the possibility that managers, especially when they are current shareholders or have stock options of firms going public or issuing shares may manage accounting income prior to the IPO or issue in the hope of receiving a higher share price. Like an MBO an IPO creates a non-recurring incentive that may result in a short-term perspective for earnings management. Management may use accounting interventions that are not likely to be used in case of recurring incentives. If management is however not leaving the firm after the IPO they have to explain the decrease in accounting income to the new shareholders. Earnings management in relation to the desire for external financing has been examined a number of times in the US setting. Friedlan (1994) investigated earnings management before IPOs. Friedlan concluded that IPOs did make income increasing discretionary accruals in the latest period prior to the IPO. Dechow et al. (1996) found that the desire to attract external financing at low cost is an important motivation.
for earnings manipulation by firms subject to accounting enforcement actions by the SEC. Teoh et al. (1998) found that equity issuers who raise accounting income by altering discretionary accruals prior to the offering have lower post-issue long-run abnormal stock returns and accounting income. Their evidence is consistent with investors naively extrapolating pre-issue earnings without fully adjusting for the potential manipulation of accounting earnings. Rangan (1998) also found that the stock market temporarily overvalues issuing firms and is subsequently disappointed by predictable declines in accounting income caused by earnings management of issuing firms prior to the issue. Erickson and Wang (1999) investigated whether acquiring firms attempt to increase their stock price prior to a stock for stock merger in order to reduce the cost of buying the target. They found that acquiring firms manage earnings upwards in the periods prior to the merger agreement.

Dividends
Kasanen et al. (1996) provided evidence of dividend based financial accounting strategies in a debt-dominated capital market (Finland). Because equity owners, especially large institutional investors, appreciate a smooth dividend stream there is an incentive to smooth accounting income\(^3\) in order to payout a dividend accordingly. The research findings support the assumption that accounting income is smoothed in order to pay a predictable dividend stream.

General stakeholder relationship
Bowen et al. (1995) examined the influence of the incentives created by the many implicit contracts that exist between a firm and its stakeholders. Their research contained four major stakeholder groups: customers, suppliers, employees and short term creditors. They argue that stakeholders use accounting income to help assess the likelihood that the firm will honor its implicit claims and argue that this creates incentives for management to choose long-run income-increasing accounting methods. Examples of these implicit claims are: service, continuing availability of parts and service, timely payment, continuation of the trade, working conditions, job security and future prospects.

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\(^{3}\)Kasanen et al. (1996) state that on the other hand it is costly to manage earnings upwards because of tax consequences.
Bowe et al. found support for their hypothesis that implicit claims variables are important in explaining managerial preference for long run income increasing accounting methods, such as FIFO inventory valuation instead of LIFO and straight-line depreciation instead of accelerated depreciation. DeFond and Park (1997) argue that concern about job security creates an incentive for managers to smooth earnings in consideration of both current and future relative performance. Their evidence suggests that when current earnings are below sustainable future levels, managers manage earnings upwards. When earnings are above sustainable future levels they find that managers use income-decreasing interventions to “save” earnings for the future.

Earnings forecasts
Assessment of managerial performance often includes comparison with one or more benchmarks, for example the earnings forecast that managers themselves make in financial statements and financial analysts’ earnings forecasts. Dorsman et al. (1997) show that management has incentives to engage in discretionary accounting to improve the accuracy of their (qualitative) earnings forecasts. Their empirical results indicate that there is a relationship between high pre-discretionary forecast errors and the adoption of accrual accounting in the Netherlands. After adopting discretionary accounting, the forecast errors are reduced. Bannister and Newman (1996) argue that management has incentives to use discretionary accounting accruals to move earnings upward towards analysts’ forecasts because shortfall may lead to actions with economic consequences. A shortfall may not only lead to a negative capital market reaction, but may also influence the decisions of other stakeholders, for example of the members of the remuneration committee. They find that firms whose earnings before discretionary accruals are below analysts’ forecast use income-increasing discretionary accruals and do so to a greater extent than firms whose earnings before discretionary accruals are above analysts’ forecasts.

3.3 Incentives from a capital market perspective

Under an informational perspective, accounting income is one of many signals which may be used to make certain investment and valuation decisions. Because signaling often relates to
the valuation of securities, this perspective is usually referred to as the capital market perspective. The line from market reaction to incentives shows the capital market perspective in figure 2.2. The capital market perspective on income strategies and earnings management addresses the question how (potential) investment and valuation decisions influence accounting decisions. Since an investment introduces a contractual relationship between the firm and the stockholders of the firm one could also see signaling as a result of an implicit contract between the firm and (potential) stockholders. The contract is implicit since there is no pre-specified contract with an explicit relation to accounting variables.

The capital market perspective on income strategies and earnings management assumes managers have non-public information which they can communicate to outside stakeholders by choosing elements from a feasible set of accounting rules. However, this communication process is imperfect when the following two conditions are satisfied (Healy and Palepu, 1993, p. 2):

1. Managers' incentives are not perfectly aligned with all stakeholders' interests (i.e. moral hazard / imperfect contracting); and
2. Accounting rules and auditing are imperfect.

Because relative to stakeholders, managers have an information advantage on their firms' business strategies and operations and the two conditions are often satisfied in practice distortions in accounting data will arise. When it is costly to assess the degree of distortion in financial statements, some firms are misvalued, even in an efficient capital market. This problem is analogous to the "lemons" problem in the used car market discussed by Akerlof (1970).

Management may signal their superior information if, and only if, they feel it is beneficial to do so. Firms that are undervalued have incentives to reveal private information in order to increase their firm's market value and reduce their cost of equity in the capital market. However, it is only useful to reveal private information if this can be done credibly. The problem of separating firms with credible private information (high type) from firms with non-credible information (low type) has been extensively considered by means of signaling models. A signal is an action taken by a high-type manager that would not be rational if the
manager was low type. A crucial requirement is that the signal is less costly for a high-type manager than for a low-type. This is what gives a signal its credibility (Scott, 1997, p. 342). A number of signals have been suggested that are relevant for financial accounting. One way for managers to improve the credibility of their financial information is through voluntary disclosure. A second way is through the firms finance policies, for example a firm’s capital structure or dividend policy. By definition, reported values of accounting numbers, the ways in which accounting techniques are used, and changes in accounting techniques may serve as signals if they reflect information about the unobservable attributes of the firm (Gonedes, 1978, p. 27). A firm’s accounting strategy thus can have signaling properties. For example, managers may have some private information about the likelihood of success of restructuring actions, the manager may recognize all or part of the expenditure associated with his future restructuring action by reporting a discretionary restructuring provision. Under certain conditions the conservative accounting strategy can be interpreted as a signal that the manager is confident about the firm’s future (Frantz, 1999, p. 110). From this perspective earnings management can be a device to convey credible inside information to the market. A manager would do this to increase the firm’s market value, reduce its cost of capital and possibly affect his own bonus scheme. Gaeremynck and Veugelers (1999, p. 124) indicate that the revaluation of assets is found to be a negative signal since poorly performing firms benefit more from revaluing assets than well performing firms. As a consequence, footnote disclosure of undervalued assets instead of revaluing these assets can be a powerful mechanism used by successful firms to signal their success. Thus, signaling with accounting strategies may reduce information asymmetry. Since information asymmetry has economic consequences for both managers and stakeholders this may be an incentive for income strategies and earnings management.

The capital market perspective asserts that stakeholders demand information on current and future cash flows and the market value of assets and liabilities when making investment and valuation decisions. Although accounting data usually does not provide all the information stakeholders need, the accrual accounting system reflects information in addition to cash receipts and disbursements. Accruals reflect management’s expectations about future cash flows and are based on an information system potentially more comprehensive than past and
current cash flows (Beaver, 1989, p. 7). Because accrual accounting not only requires managers to record past events, but also to make forecasts of future effects of these events, it can be said that accruals involve some implicit and explicit predictions of the future. Therefore, accruals can convey information not contained in cash receipts and disbursements and accounting data has the potential to convey managers’ superior information. Although the flexibility of the accounting system and the sensitivity of accruals to managerial influence may imply that resulting accounting income could in principle be managed to the point of uninformativeness, it may also transform cash flows in order to provide a better indicator of future cash flows and dividend paying ability than current cash flows do. It is for this reason that it is sometimes argued that earnings management schemes are far from being uninformative, and give management a cost-effective way of signaling certain kinds of information to capital markets. Although the efficacy of accrual accounting is still an open issue, some empirical evidence indicates that accruals do in fact have a certain information content (Schipper, 1989, p. 91). According to Easton et al. (1992) medium to long term returns to equity appear to be explained overwhelmingly by the firm’s cumulative earnings during the period. Bowen et al. (1987) and Wilson (1987) find that accruals, on average, have incremental information content above cash flows. Dechow (1994) also provides evidence that accrual-based accounting income is a superior measure of firm performance compared to cash flows. Subramanyam (1996) states that this evidence does not establish whether the superiority of accrual-based earnings is because of, or despite, management’s discretionary accounting choices. Subramanyam finds that discretionary accruals are associated with contemporaneous stock prices and future earnings and cash flows, and concludes that managers choose accruals to enhance the informativeness of accounting income. Bernard and Skinner (1996) criticize the reliability of the Subramanyam study because possible mismeasurement of discretionary accruals can have crucial effects on the outcome of the study54. Warfield et al. (1995) find evidence that earnings management renders earnings reports less informative, but Hunt et al. (1995) find that managerial discretion can render earnings more informative to investors because managers can use their accounting discretion to signal their superior information regarding future earnings prospects.

54 Bernard and Skinner (1996) state that the only way to resolve this problem is to develop better specified models of the accrual process.
Christensen et al. (1999) provide evidence that the greater managers' incentives for earnings management, the less informative earnings announcement to investors are. From the literature above it can be concluded that the informativeness of income strategies and earnings management is still open to debate.

Although signaling motives may influence income strategies and earnings management there is little empirical evidence of signaling being a major influence in the financial accounting process. There are however a number of papers which model the potential motives of income strategies from a signaling perspective. Demsni and Sappington (1990) for example state that in a multi-period setting the communication process remains imperfect when the information asymmetry persists. If managers could communicate all their private information without creating costs, contracts could be arranged so that managers would have incentives to reveal all that private information truthfully. Demsni and Sappington (1990) introduce the assumption of blocked communication to let the information asymmetry persist. Managers obtain private information, and this information can be prohibitively costly to communicate to the stakeholders (i.e. the communication is blocked). They show that the presence of blocked communication can reduce the efficiency of contracts or reduces the value of the firm and therefore both managers and stakeholders have incentives to try to eliminate or reduce the blocked communication. Signaling by means of the firms accounting strategy may be a way of unblocing the manager's inside information. Thus, stakeholders may allow a reasonable amount of income management to persist as a way to communicate blocked, inside information to the market.

3.4 Summary and implications for this study

Asymmetrical information and the economic consequences of accounting data lay the foundation for incentives to exert influence over accounting income. Under the informational perspective incentives follow from the pre-contracting as well as the post-contracting role of accounting data. The focus of this study is on the post-contracting role of accounting data.

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The effect of income strategies and earnings management on investment and valuation decisions is not an element of the empirical part of this study.

Not all the incentives from the firm's contract set discussed in this chapter are relevant in this study since some incentives are only relevant in other institutional settings, relate to specific financial accounting conditions or are only relevant for a pre-selected sample of firms. The following incentives are not included in the empirical part of this study:

- *Management compensation contracts*, although expected to be relevant for financial accounting in the Netherlands, are not used to explain managerial influence over accounting income because there is no variable compensation data available in the public domain;

- *Taxation* is not used in this study since there is no formal relationship between accounting income and tax returns in the Netherlands, neither is it expected to influence accounting income of listed firms in the Netherlands;

- The effect of *government regulations* can only be tested meaningfully under specific conditions. These conditions are not present in the research sample of this study and therefore the influence of possible government regulations on a firm's income strategy is not tested for in this study;

- The use of accounting data for *labor union negotiations* is investigated by Hassink (2001) in the Netherlands. His research indicates that accounting income is not the most important item in the financial statements for bargainers.

- The effect of *management buy-out offers* and a firm's *desire for external financing* on managerial influence over accounting income is not tested for in this study because they are only relevant for a pre-selected sample of firms;

- The effect of the firm's *dividend policy* on managerial influence over accounting income is not tested for in this study because it is unlikely to be relevant in the institutional setting in the Netherlands;

- The effect of *managerial earnings forecasts* in financial statements is not tested for in this study because Dorsman et al. (1997) already tested for this influence in the Netherlands.
The following incentives are expected to be relevant and are taken into account in the empirical part of this study:

- **Debt covenants** are reported by a number of firms in the Netherlands and it is likely that debt covenants influence managerial accounting choice. It is expected that firm's with higher debt/equity ratios will report less conservatively than firms with lower ration. This is expected for firms with and without reported debt covenants;

- **Stock options** are disclosed on a regular basis in the Netherlands. It is expected that firms with stock options report less conservatively than firms without stock options.

- **Executive changes** are observable in financial statements in the Netherlands. It is expected that executive changes will affect managerial influence over accounting income in general and more specifically that incoming CEOs bias accounting income downwards;

- **The general stakeholder relationship** is likely to be relevant in any institutional setting. It is expected that firms will in general prefer long run income increasing accounting methods and will report relatively non-conservatively, even after controlling for debt covenants, stock options and executive changes;

Although the incentives to exert influence over accounting income may be strong in certain situations and accounting income may sometimes be managed to the point of un informativeness there are a number of constraints on managerial influence over accounting income. The next chapter provides a detailed discussion of the different constraints on managerial influence over accounting income.