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

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Chapter 4

Constraints on managerial influence over accounting income

4.1 Introduction

Flexibility is an important feature of the current accounting environment in the Netherlands. Given the flexible nature of the current accounting standards, managers can choose from a large set of methods to influence accounting income. Zeff (1992, p. 267) calls into question the wisdom of applying accounting principles in a flexible voluntary environment in a climate where genuine auditor independence in relation to clients may not be the safe assumption that it was in the past. This question not only relates to the flexible nature of the accounting standards in the Netherlands, but also to the lack of pro-active compliance mechanisms (other than auditing) that have been found necessary in the US and the UK. According to the general opinion in the UK, accounting standards are of not much use if compliance is not monitored actively (Van Everdingen, 1993, p. 28). The Financial Reporting Review Panel was established in the UK to actively monitor compliance with accounting standards. Firms who draw attention are selected for review and the panel can ask the firm to change the financial statements. In case of an accounting dispute, the panel has the authority to start a court procedure. In the US the SEC reviews the financial statements of filing firms. According to the SEC every filing is read for about fifteen minutes and 10-15 percent of the filings is non-random (based on “hot accounting issues”) selected for review. Ultimately, the SEC can force registrants to amend the filing. The lack of compliance mechanisms in the Netherlands was also addressed by Van Helleman who stated that although there are compliance mechanisms for the stock market, this is not the case for the quality of financial statements.

56 According to recommendation number 13 of the Limperg Institute’s Financial Reporting Quality Project it is advisable to institutionalize an accounting body responsible for monitoring financial accounting practices in the Netherlands to the example of the Financial Reporting Review Panel in the UK.
57 Accounting in the Netherlands: honesty declines (June 1, 1999).
Notwithstanding the lack of compliance mechanisms, this chapter provides a discussion of the factors that may or will limit managerial influence over accounting income in the Netherlands. Accounting income may be influenced to achieve different accounting objectives related to the firm’s incentives. The objectives may be to provide better information, may be opportunistically motivated or may be motivated for efficiency reasons. Different constraints may limit accounting interventions for different objectives. Where accounting objectives relate to income strategies, the methods to influence accounting income relate to the actual accounting interventions (i.e. earnings management or earnings manipulation). Apart from real transactions, accounting income may be influenced through pure accounting decisions within GAAP and beyond GAAP. Different constraints may or will limit the use of pure accounting decisions within and beyond GAAP.

Given the impact of financial statements on the firm’s stakeholders it is logical that stakeholders and financial accounting regulators perceive the accounting environment as important and therefore impose constraints on managerial influence over accounting income. The influence of stakeholders and regulators on the constraints is shown in figure 2.2 by the line from stakeholders and regulators to constraints. The most important constraints on methods to influence accounting income are discussed in this chapter. As discussed in the next paragraph manager’s ethical standards may limit the objectives as well as the methods to influence accounting income. The firm’s governance structure may also limit managerial influence over accounting income and is discussed in paragraph 4.3. Auditing is discussed in paragraph 4.4 and the probability of observation, market forces and legal constraints as factors that may limit managerial influence over accounting income are discussed in paragraph 4.5.

4.2 Ethical standards

This paragraph discusses the role of manager’s ethical standards as a factor that may limit the income strategies and earnings management. Ethical standards may be defined as the position of management towards the behavior of others and themselves, which is judged as reprehensible, permitted or praiseworthy. Ethical standards relate to behavior, not to events. Ethical questions in business occur at three levels: at the micro-level, regarding individual
business dilemmas, at the meso-level, regarding business culture and at the macro-level, regarding the basic structure of our society (Van Luijk and Schilder, 1997, p. 24). Income strategies and earnings management both relate to individual business dilemmas, to a firm’s business culture and to the basic structure of our society. The basic structure of our society relates to the question how far the social responsibility of a firm reaches. Regarding managerial influence over accounting income this means that managers should take into account the broader consequences of their actions in relation to the economic order where the firm operates. In this respect it is for example important to be aware of the fact that the Netherlands has a dual tier boards of directors, hardly a market for corporate control and a tradition of consensus and involvement. Widespread opportunistic earnings management for example is liable to have negative consequences for the basic business structure of our society. Loss in credibility of management and auditors will result in a decline in social trust and the perceived usefulness of financial statements and auditing.

A firm’s business culture relates to the general position of the firm towards the rights and obligations of all stakeholders. This means that not only the individual actions, but also the attitude of the firm as a whole towards earnings management can lead to moral comments. This attitude towards earnings management does not only relate to the firm’s moral code but also to the firm’s governance and internal control structure. The role of the firm’s governance and internal control structure is discussed in more detail in the next paragraph.

Regarding accounting interventions one can speak of an individual business dilemma when the intervention makes one group stakeholders better off at the expense of another group. When managers exercise their discretion to make themselves better off at the other contracting parties expense, management acts opportunistically (Watts and Zimmerman, 1990, p. 135). Most studies on earnings management take an opportunistic perspective in contrast to both the perspective that managers make accounting choices to provide better information about future cash flows and the perspective that managers make accounting choices for efficiency reasons, that is, to minimize the firm’s agency costs that arise from conflicts of interest among firm stakeholders. In the remainder of this paragraph earnings management is discussed as an individual business dilemma.
Earnings management versus earnings manipulation

Earnings management is by definition restricted to managerial accounting interventions within GAAP in chapter 2. Interventions in the financial accounting process beyond GAAP are classified as earnings manipulation. When discussing the role of ethical standards as a factor that may limit managerial influence over accounting income, the distinction between earnings management and earnings manipulation is especially important since interventions beyond GAAP are an economic crime. Earnings manipulation will be limited by auditing, internal controls, a strong governance structure, management’s ethical standards and the possible consequences. Earnings manipulation is an economic crime and for most managers breaking the law will be unethical. This does not however mean that earnings manipulation does not occur. Dechow et al. (1996) for example analyze firms subject to accounting enforcement actions by the SEC for alleged violations of US GAAP. In the Netherlands earnings manipulation has not been subject to research yet, but some cases of earnings manipulation are known; for example Text Lit in 1987. The Enterprise Chamber of the Court of Justice in Amsterdam stated in its verdict that the financial statements of this bankrupt listed firm did not comply with the criteria for financial statements. The Enterprise Chamber qualified the incorporation of a “ghost-order” from the Philippines in the financial statements as mismanagement, opening the possibility to hold the management, the members of the supervisory board and the auditor responsible for the (other) shareholders’ damages. Due to the severe consequences when caught, it is expected that not many managers are willing to manipulate earnings.

The distinction between interventions within and beyond GAAP however is sometimes difficult to make. In the US, compliance with US GAAP, with no constraints on choice within GAAP, is the firm’s prime responsibility. In the Netherlands, as well as other countries in the European Union, the overriding qualitative objective for financial accounting explicitly states that the firm’s prime responsibility is to give a true and fair view.\[^{58}\]

\[^{58}\] According to Nobes and Parker (1998, p. 30-31) “The requirement of the EU’s fourth Directive that “true and fair” should override detailed rules in all member states may lead to a mask of uniformity that conceals the unchanged old differences”. In practice this implies that, especially in continental European countries, there is no true and fair view override.
Due to this difference the distinction between earnings management and earnings manipulation is harder to make in the Netherlands than in the US. The meta-rule of true and fair view is problematic, since it seems to imply that there is some objectively existing "economic reality" of which financial statements should give a true and fair view. But "economic reality" does not exist objectively, it is intersubjectively constructed by the social actors in question. Accounting income results from the application of relevant accounting conventions and these conventions can be applied to produce a range of different accounting income numbers. Earnings management is a purposeful intervention in the application of the conventions in order to obtain some private gain. This is possible because the interpretation and application of the meta-rule are inherently subjective. Earnings management does not violate GAAP and as for compliance with the meta-rule, auditors are the final arbiters whether accounting income gives a true and fair view. Due to this inherently subjectivity, earnings management as such cannot be classified as misleading and is not by definition unethical.

Earnings management as an ethical dilemma

Regarding the ethics of earnings management as an individual business dilemma Blake et al. (1998, p. 33) distinguish between the deontological view and the teleological view. In the deontological view moral rules apply to actual interventions and a distinction can be made between accounting interventions beyond GAAP, interventions within GAAP and real decisions. As stated above interventions beyond GAAP will generally be considered unethical. Bruns and Merchant (1990) investigated the ethical perception of earnings management under different circumstances for different interventions. The focus of their investigation was on short term earnings for internal management accounting purposes. A total of 649 managers in the US were asked to fill in a questionnaire with earnings management examples and label the examples from unethical to ethical. Surprised by the outcome Bruns and Merchant found large differences in the ethical perception among managers. Not a single situation was judged unanimously or even close to unanimously. Further, they found that interventions within GAAP in general were experienced less ethical than real decisions and that the magnitude as well as the direction of the intervention was important. In general, they experienced that the larger the magnitude the less ethical the
intervention and that inflating accounting income was less ethical than deflating accounting income.

Although ethical questions are in essence about objectives and attitude, both are difficult to observe. Yet, if it is not possible to observe the objectives it can hardly be said that managerial influence over accounting income is understood. In the teleological view moral rules apply to the moral worth of the outcome. This view relates to the incentives for income strategies and earnings management. Most studies on managerial influence over accounting income take an opportunistic perspective, the intervention results in an increase in the wealth of one stakeholder at the expense of other stakeholders. From a teleological point of view there is an ethical problem when managers act opportunistically, increasing their own wealth, without increasing aggregated wealth. On the other hand when managers bias accounting income in order to provide better information about future cash flows or to minimize the firm’s contracting costs, earnings management is permitted or even praiseworthy. Or as Dopuch (1996, p. 40) in his review paper on earnings management puts it: “the fundamental issues in this area of research are simply who benefits and who pays the costs of allowing managers to manage earnings?”

Ethical standards are different from manager to manager, from firm to firm, from society to society, and change over time. Accounting interventions raise ethical questions in relation to the methods used as well as to the objectives and outcome. Although accounting interventions beyond GAAP will generally be considered unethical, the ethical perception of other interventions ranges widely. Regarding the objectives of earnings management there are also different ethical perceptions. In general most accountants accept the notion that management exerts influence over accounting income. Some managers may try to give an unbiased view of the companies performance, but even then this is a subjective view since the economic reality does not exist “objectively”. Other managers choose accounting procedures to maximize the value of the firm or provide better information about future cash flows. At the other extreme, managers may bias the firm’s performance in order to mislead other stakeholders and act opportunistically. Widespread opportunism will lead to a decline in the perceived usefulness of financial statements and auditing and eventually will lead to detailed accounting regulation.
Apart from management’s own ethical standards, opportunism may be limited by the firm’s governance structure, including internal control systems and monitoring by the board of directors, auditing, the probability of observation, market forces and legal constraints.

4.3 The firm’s governance structure

Opportunistic earnings management may be limited by a manager’s own ethical standards. Since ethical standards differ widely, the relative amounts of efficiency and opportunism will largely depend on other controls on managers’ accounting discretion. Such controls include monitoring by the supervisory board, auditing and the discipline of the market for corporate control. This paragraph discusses the influence of the firm’s governance structure on managerial influence over accounting income. A firm’s governance structure is the structure by which a firm is directed and controlled. The structure includes the firm’s ownership structure, the role of shareholders, the supervisory board, the firm’s internal control structure and auditing. Since auditing is discussed in a separate paragraph, the focus in this paragraph is on the other items mentioned. Corporate governance in general has received much attention in the past few years. In a number of countries commissions were formed to study the role of corporate governance and/or internal control. This recent attention is a direct result from the continuing concern about standards of financial accounting and accountability, heightened by a number of failing firms and the controversy over directors’ pay (Report of The Committee on the Financial Aspects of Corporate Governance, 1992, p. 9).

Ownership structure

The firm’s ownership structure may limit the objectives to influence accounting income. Management controlled firms are firms that are characterized by a diffuse ownership structure and have managers who typically own no more than a small portion of the firm’s equity shares. In management controlled firms management may have incentives to allocate the firm’s resources in ways that are non-value maximizing for the firm so there is a need for

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controlling and monitoring management’s behavior in this respect. In owner controlled firms, managers own a substantial or controlling part of the firm’s equity shares and this will influence management’s objectives for accounting interventions. Two theoretical arguments are used to support the relation between ownership and managerial influence over accounting income. First, according to managerial economics literature the incentives for accounting interventions have a differential motivating effect on the managers of different firms, depending on the ownership structure of the firm. Since an owner-manager will have greater job security and less fear for outside takeovers there are less incentives to manage accounting income in a favorable way in order to obscure poor managerial performance and keep shareholders satisfied. The second argument is based on both theoretical arguments and empirical evidence (see below) that the probability of a firm having an earnings-based bonus plan is negatively related to managerial ownership. From this it is expected that the level of managerial ownership is likely to affect the objectives of accounting interventions since earnings-based bonus plans include incentives to influence accounting income.

Dhaliwal et al. (1982) examined the effect of owner versus management control on the choice of accounting methods. Their paper compares the depreciation methods used by a sample of management and owner controlled firms. The research reveals that there is a significant difference in the depreciation methods adopted by management controlled and owner controlled firms. They conclude that management controlled firms are more likely to adopt depreciation methods which increase accounting income. Niehaus (1989) examined the relation between inventory method choice and both managerial ownership and outside ownership concentration and finds that inventory choice appears to be related to both. When managerial ownership is high, LIFO is likely to be used when LIFO is the tax minimizing method. When managerial ownership is low, LIFO is less likely to be used, even if this is the tax minimizing method, since managers’ compensation is usually positively related to accounting income. Further, higher outside ownership concentration appears to increase the likelihood of LIFO because higher outside ownership concentration increases the level of monitoring.

60 Dahya et al. (1998) found that when the CEO is an important equity holder unexpected CEO changes due to poor company performance are less likely.
Dempsey et al. (1993) examined the relation between corporate ownership structure and earnings management by examination of extraordinary item reporting. Their results show that there were significant differences in extraordinary item accounting practices among US firms with different ownership structures in a period in which US GAAP allowed considerable management discretion in accounting for extraordinary items. In particular, management controlled firms selected income increasing accounting alternatives for extraordinary items more often than owner controlled firms. Their findings thus provide evidence that the extent of managerial ownership is related to the extent and direction of earnings management. Warfield et al. (1995) examined whether the level of managerial ownership affects both the informativeness of earnings and the magnitude of discretionary accounting accrual adjustments. Their results show that managerial ownership (i.e. owner controlled firms) is positively associated with earnings’ explanatory power for stock returns and inversely related to the magnitude of accounting accrual adjustments. Their findings provide evidence that managerial ownership is related to the magnitude of accounting interventions and is consistent with higher levels of earnings management in management controlled firms to mitigate contractual restrictions.

The role of shareholders
In the Netherlands, the role of shareholders in (management controlled) firms depends on the question whether the firm is a large firm (in the meaning of section 153 BW2). This is the case when the firm meets the following criteria:
1. Issued capital and reserves amount to minimally €25,000,000.
2. The firm, or one of her subsidiaries, has, pursuant to legal requirements, established a works council.
3. The firm employs, together with her subsidiaries, in general at least 100 employees.

Since listed firms usually will fulfill these requirements, or will otherwise opt for being a large firm in this respect, the role of shareholders will be discussed only for large firms. One of the most important consequences of being a large firm is that a supervisory board is compulsory. The members of the supervisory board usually are a coherent group with experience of management in general and of the firm specifically and with advantageous
access to resources of the firm. Shareholders usually are a disparate group. Under these circumstances it is not surprising that direct shareholder influence is limited and that successful shareholders revolts are scarce. Although shareholders have little direct influence, they have a simple alternative when the firm is listed, since shareholders can vote with their feet. If the performance of the board of managerial directors is poor the share price will suffer. Hence, incumbent management will be encouraged to pursue value-maximizing policies. Value-maximizing policies do not only regard real business policies but accounting policies as well. Although direct shareholder influence is limited and institutional shareholders, such as insurance companies and pension funds, are reluctant to become involved in the management of the firm, there is a tendency for institutional shareholders to take a more proactive role towards their investments in general. The largest pension fund in the Netherlands, the ABP, for example argued with IHC Caland N.V. that they should adapt a code on human rights after the company received an order from Birma (De Telegraaf, 1999a) and with Baan Company N.V. about their new option plan (De Telegraaf, 1999b). A proactive role of large institutional shareholders may affect the objectives of income strategies and earnings management since the board of managerial directors will preferably keep these (important) shareholders satisfied.

The supervisory board

In the Netherlands a dual tier executive board governs firms. The members of the supervisory board are nominated by a system of controlled co-optation. This means that the members of the supervisory board are co-opted, the supervisory board fills the vacancy, with a right of recommendation for the works council and a clausured veto-right for the annual meeting of shareholders. The influence of shareholders on appointments to the supervisory board is thus limited. The supervisory board’s primary task is to monitor and advise the board of directors (section 140 BW2). In order to fulfill this task properly the supervisory board should be a homogeneous group and its members should not feel called to serve a specific interest, but should be independent and serve the interest of the firm in general, taking into account the interest of all stakeholders (Van Schilfgaarde, 1992, p. 321). For large companies the supervisory board’s powers are extended to appointing new members of the supervisory board.
(section 158 BW2)\(^{61}\), appointing and dismissing members of the board of directors (section 162 BW2), deciding on the financial statements (section 163 BW2) and approving certain managerial decisions (section 164 BW2). Given the independent nature of the supervisory board, the board should take the lead when potential conflicts of interest arise between the firm and members of the board of directors. However, the supervisory board can only bring an independent judgement if the majority on the board is independent of the firm. Independence relates to the remuneration of the members of the supervisory board as well as the practice of many firms in the Netherlands to appoint former members of the board of directors to the supervisory board. The effectiveness of the supervisory board is further buttressed by its structure. One aspect of structure is the appointment of committees of the supervisory board, such as the audit, remuneration and nomination committee. Since 1978, the NYSE has required all listed firms to have audit committees and the Treadway Commission concluded in 1987 that audit committees have a critical role to play ensuring the integrity of US firms’ financial statements. The audit committee normally is involved with the auditor selection process, review the annual and interim reports before submission to the supervisory board, discussions with the external auditor about the audit process and the review of the management letter and the auditors report (in the meaning of section 393 BW2). Since the audit committee offers the auditor a direct link to members of the supervisory board the position of the auditor is strengthened. Further, the audit committee may create a climate of discipline and control that may reduce opportunistic managerial behavior and ultimately may increase public confidence in the credibility and objectivity of financial statements.

Beasley (1996) examined the relation between board of director composition and financial statement fraud in a US setting. In the US, the board of directors is made up of a combination of executive directors and outside, or non-executive directors (i.e. a single tier executive board). The role of outside directors is comparable to the supervisory board in a dual tier system. Results indicate that non-fraudulent firms have boards with significantly higher percentages of outside members than fraudulent firms.

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\(^{61}\) The Social and Economic Council in the Netherlands reached an agreement on October 19, 2000 on the appointment of members of the supervisory board. The proposal to the Government reduces the number of members of the supervisory appointed by the supervisory board to one-third. In the proposal the other members of the supervisory board are equally appointed by shareholders and the works council.
Additionally, Beasley found that when outside director ownership in the firm increases (i.e. outside directors have a monetary interest in the firm) or when the number of outside directorships in other firms held by outside directors decreases (i.e. outside directors can spend more time on the firm), the likelihood of financial statement fraud decreases. From this research it may be concluded that adequate monitoring by the supervisory board (or outside board members) may limit accounting interventions beyond GAAP. Dechow et al. (1996) found that firms manipulating earnings are:
1. More likely to have boards of directors dominated by management;
2. More likely to have a CEO who simultaneously serves as Chairman of the Board;
3. More likely to have a CEO who is also the firm’s founder;
4. Less likely to have an audit committee;
5. Less likely to have an outside blockholder (a party with active control and 10 percent or more of the voting stock and/or a party with 20 percent or more of the voting stock).

Peasnell et al. (1998) tested for empirical evidence on an association between the composition of the board of directors and earnings management. They reported evidence of a significant negative association between income-increasing discretionary accruals and the portion of outside board members. From their result it may be concluded that effective supervisory boards may constrain discretionary accounting interventions. Wild (1996) provides empirical evidence on the association between earnings quality, i.e. the informativeness of earnings, and audit committee formation. His results show a significant increase in the market’s reaction to earnings reports subsequent to the formation of the audit committee. The market’s reaction to earnings reports is more than 20 percent greater after the formation of an audit committee than before. Beasley (1996) however found no relation between audit committee formation and financial statement fraud. From these researches it may be concluded that, although audit committee formation may not prevent fraud any better than a supervisory board without an audit committee, an audit committee does increase public confidence in the credibility and objectivity of financial statements. Audit committees offer auditors a direct link with members of the supervisory board, potentially increasing their independent position. The next paragraph discusses auditing as a constraint on managerial influence over accounting income.
Internal control structure

A firm’s internal control structure is part of its governance structure. Internal control is broadly defined in the COSO report\textsuperscript{62} as a process, effected by a firm’s board of managerial directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial statements.
- Compliance with applicable laws and regulations.

The reliability of financial statements can only be assured if the firm’s accounting and internal control systems are sufficient. In general, in a sufficient system all transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with an identified financial accounting framework. A sufficient internal control structure will limit earnings manipulation. However, due to inherent limitations such as the possibility for management to override the control systems conclusive evidence cannot be provided. The “control environment” which means the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the firm is especially important in this respect. Further, the internal control system will not limit opportunistic accounting interventions within GAAP (earnings management) since this will be within the firm’s financial accounting discretion.

From the discussion above it may be concluded that no governance structure can be totally bullet proof against earnings manipulation. In a sufficient governance structure however earnings manipulation is discouraged and can be brought to light. It can also be concluded that the firm’s governance structure, especially the level of managerial ownership and the diffusion of ownership, is likely to affect the objectives of accounting interventions. Further, it can be concluded that the supervisory board has an important independent monitoring function, especially when an audit committee is active. A supervisory board, especially when an audit committee is active, may limit opportunistic accounting interventions, within GAAP.

as well as beyond GAAP, since members of the supervisory board should take the interest of all stakeholders into account.

4.4 Auditing

Managers typically own no more than a small portion of their firm's equity shares and management may have incentives to allocate resources in ways that are non-value maximizing for the firm or shareholders. Even when managers do own a large portion of their firm's equity shares (i.e. owner controlled firms) they may have incentives to allocate the firm's resources in ways that are not necessarily consistent with the interest of other (outside) shareholders. A function of financial accounting is to report on the control and use of resources by management to those to whom they are accountable. Managers are entrusted with the task of preparing the financial statements because they have private knowledge of their business activities. They are in the best position to summarize the business activities by estimating the future cash consequences of these activities. Due to the separation of ownership and the possible incentives for management to allocate resources in ways that are not necessarily consistent with the interest of other (outside) shareholders, shareholders feel the need for verification of financial statements by independent experts. The audit provides an external and objective check on the manner in which financial statements have been prepared and presented. According to section 393, subsection 1 Title 9 BW 2 the financial statements must be audited and pursuant to section 394, subsection 1 Title 9 BW2 the financial statements must be filed at the chamber of commerce within eight days after adoption. Law thus extends the accountability resulting from stewardship to all stakeholders and all stakeholders gain from this verification by independent auditors. Audits are a reassurance to all stakeholders having an interest in the firm.

According to section 393 Title 9 BW2 the legal person shall give instructions for the audit of financial statements to a registered accountant or to an accountant-administrative consultant with annotation (hereafter both are referred to as "auditor"). The general meeting of shareholders is empowered to give such instructions. If no such instructions are given by the meeting, the supervisory board, or if this body fails to do so, the management shall be
empowered to do so. Auditors must examine whether the financial statements provide the view required by section 362, subsection 1 Title 9 BW2. They must also ascertain whether the financial statements satisfy the requirements set by and pursuant to the law. The auditor must report on this audit to the supervisory board and the firm’s board of managerial directors. The auditor must set out the result of his audit in an auditor’s opinion as to whether the financial statements give a true and fair view and he must report any shortcomings that have appeared to him. Section 362 Title 9 BW2 states that the financial statements, prepared in accordance with GAAP, must provide such a view as enables a sound judgement to be formed of the assets and liabilities and result of the legal person and, insofar as the nature of the financial statements permit, of its solvency and liquidity. The legal person may not apply the special provisions of Title 9 BW2 to the extent necessary to provide such view and the reason for not applying such provisions must be set out in the notes (“true and fair view override”, section 362, subsection 4 Title 9 BW2). GAAP in the Netherlands originates from fundamental business economics and has been influenced by political and cultural influenced business law and accounting regulation. According to Bindenga (1994, p. 158) this has resulted in inherently subjective financial accounting. As stated in paragraph 4.2 there is no objectively existing “economic reality” of which financial statements should give a true and fair view. Accounting income results from the application of GAAP in the Netherlands and these conventions can be applied to produce a range of different accounting income numbers. With respect to the accuracy of financial statements, the EU “Greenbook”63 on the role and position of auditors in the EU, states that financial statements cannot be exact in a sense that only one series of figures exists that will present the firm’s performance and position correctly. Bindenga (1994, p. 159) also states that stakeholders should realize that accounting income results from subjective views of management and that due to accounting choices the view required in section 362 Title 9 BW2 is not a unique one.

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Auditor's general financial accounting responsibilities

The auditor's principal function is to carry out, in a professional capacity, an audit for the purpose of assessing whether the financial statements prepared by a firm give a true and fair view. The objective of an audit is to provide a (comparatively) high level of assurance to the public financial statements. It is essential for the adequate performance of an auditor that the public has confidence in the effectiveness of audits. In order to secure this confidence the professional bodies of auditors in the Netherlands, Royal NVRA and NOvAA, have adopted a “Code of Ethics”. Central ethical principles are integrity, objectivity, professional competence and independence. In the Netherlands the compliance with ethical standards by auditors is secured by disciplinary rules.

While the auditor is responsible for forming and expressing an independent opinion on the financial statements, the responsibility for preparing the financial statements is that of the board of managerial directors. The audit does not relieve management of this responsibility. In addition to auditing in the public interest, the auditor also acts as an auditor and advisor to the management of the firm. When during the performance of the audit function the public interest conflicts with the auditor’s advisory role, the public interest prevails because auditors must be independent from their clients and from the parties on whose activities they express an opinion (Rules of Professional Conduct and Practice of Registeraccountants 1994, section 24, subsection 1)64. By implementation of quality control policies and procedures the auditor should ensure that all audits are conducted in accordance with Generally Accepted Auditing Standards (GAAS). When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud and error. Fraud may involve intentional misrepresentation of results in order to manipulate share prices or to influence decisions of the users of financial statements. Apart from weakness in the design of the accounting and internal control systems, conditions or events which increase the risk of fraud and error include: questions with respect to the integrity or compliance of management; unusual pressures within or on a firm; unusual transactions and problems in obtaining sufficient

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64 The Limpert Institute (1987) initiated research on this subject and found that two out of three respondents agreed with the suggestion that in practice auditors primarily serve the interest of their clients. This research thus indicates a potential problem in relation to the perceived general functioning of auditors.
appropriate audit evidence (Netherlands Standards on Auditing\textsuperscript{65} 240, section 2, 3 and 8). Auditors thus should consider management’s incentive structure discussed in chapter 3 in the audit process and it should be noted that the accounting and internal control system may not be so effective when management is in a position, and it usually is, to put this aside. Further, when setting materiality auditors should be careful with rules of thumb since certain elements of the incentive structure relate to specific levels of accounting numbers and ratios (Emanuels, 1997, p. 11)\textsuperscript{66}. The responsibility for prevention and detection of fraud and error rests with management through the implementation and continued operation of adequate accounting and internal control systems. However such systems reduce, but do not eliminate the possibility of fraud and error. The auditor is not and cannot be held responsible for the prevention of fraud and error. The fact that an annual audit is carried out may, however, act as a deterrent (NSA 240, section 5 and 6).

\textit{Auditor’s specific financial accounting responsibilities}

As stated above the auditor’s principal function is to carry out in a professional capacity an audit for the purpose of assessing whether the financial statements prepared by a firm give a true and fair view. Since this view is not provided when accounting income is manipulated the auditor is responsible for detecting accounting interventions beyond GAAP. However, due to inherent limitations of an audit, the auditor cannot be held responsible for material misstatements when the audit is properly planned and performed in accordance with GAAS. The audit gives a comparatively high level of assurance, but is no guarantee. According to GAAS in the Netherlands the auditor should perform appropriate modified or additional procedures upon indications of fraud, regardless of its potential effect on the financial statements. When fraud is suspected or detected the auditor should report to management and the supervisory board as indicated by NSA 240, section 19 and 20. To the users of financial statements the auditor should express a qualified or an adverse opinion when he concludes that the fraud or error has a material effect on the financial statements. From the discussion provided above it can be concluded that auditing will limit earnings manipulation.

\textsuperscript{65} The Royal NIVRA has determined to adopt International Standards on Auditing issued by the International Federation of Accountants as Netherlands Standards on Auditing (hereafter referred to as NSA).

\textsuperscript{66} For example a near debt covenant violation or a cap in managers compensation contract.
Paragraph 4.2 stated that in general most auditors will accept the notion that management exerts influence over accounting income. Although it is not for the auditor to morally judge the motives behind this influence, the difference between managers who exert influence with opportunistic or efficient contracting and signaling motives should influence the auditor's risk assessment since it may affect the firm's control environment. From an ethical point of view auditors should advise clients how, in their professional and independent opinion, GAAP in the Netherlands should be applied in order to provide a true and fair view. However, auditors cannot stand firm against a particular accounting treatment if it is permitted within the law. When the auditor is of the opinion that GAAP is applied correctly but more information is desirable, he can only advise his client to provide this information. Apart from the law, the auditor must rely on his persuasive powers when discussing alternative accounting approaches with clients (Zeff, 1992, p. 267). He cannot force his client to do so because this is the competence of the regulator (Van Manen, 1990, p. 528). From an ethical point of view auditors should not advise or train clients in the (opportunistic) optimal use of their accounting discretion because this is against public interest\textsuperscript{67}.

Auditors in the Netherlands are expected to comply with NSA. According to NSA 120, section 3, financial statements need to be prepared in accordance with GAAP in the Netherlands. However GAAP in the Netherlands can be applied to produce a range of different accounting income numbers. Users may believe that auditors guarantee the accuracy of financial statements and users may not realize that accounting income inherently results from subjective views of management (see for example Van Manen, 1990 and Bindenga, 1994). This (potential) conflict between financial statement users and auditors may arise because users base their confidence on unrealistic expectations or because auditors sometimes fail to meet warranted expectations. This so-called "expectation gap" is damaging not only because it may reflect unrealistic expectations of audits, but also because it may result in unwarranted litigation.

Due to the inherent subjectivity in preparing financial statements, earnings management as such cannot be classified as misleading and is not by definition unethical. Earnings

\textsuperscript{67} See Izeboud (1992) for an example of this practice.
management does not violate GAAP and as for the true and fair view auditors are the final arbiters before financial statements become public information. Because the distinction between interventions within and beyond GAAP is sometimes hard to make auditors should be careful and not take a rule-based approach to financial accounting. Auditors should base their judgement on the impact of the intervention on decision-making by stakeholders. According to Weisfelt and Brugman (1995, p. 703) this principal level of reasoning is not common practice among auditors. According to their research, auditors, especially when working at large accounting firms, tend to take a rule-based approach to dilemmas. When there is a strong pressure on auditors to accept interpretations of accounting standards which conform with the interest of management rather than the “spirit” of the standard, the rule based approach will result in auditors approving the interpretation. In addition to the principal and conventional level of reasoning Weisfelt and Brugman (1995) found that some auditors base their decisions on egocentric arguments. In this line of reasoning the chance of getting caught and the consequences of getting caught are crucial since the auditor must perceive the expected gains from this egocentric behavior to exceed the expected costs. Theoretically it may well be possible that giving an unqualified auditor’s opinion, when there are reasons for giving a modified auditor’s report, will not be noticed by the stakeholders. Only when there is a going-concern problem or a serious antithesis between stakeholders, the auditor’s opinion may be that important that stakeholders will spend money on their own investigation⁶⁸. In all other cases it is not likely that stakeholders will take the effort. Getting caught⁶⁹ however can have severe consequences for auditors. First, according to the disciplinary rules in the Wet op de Registeraccountants and the Wet op de Accountants-Administratieconsulenten failure to follow the rules of conduct can eventually result in expulsion from the Royal NIVRA or NOvAA. Apart from the financial consequences, this is certainly a weighty social sanction and can have liability consequences under civil law. The second consequence is the liability to the client when the auditor is in default.

⁶⁹ Getting caught means that financial statement users become aware of the fact that the auditor fails to follow the rules of conduct or that the auditor issues an erroneous audit opinion as the result of an underlying failure to comply with the requirements of GAAS.
Examples include claims for inappropriate withdrawal from an audit, failure to discover a defalcation and breaching the confidentiality requirements. Thirdly, an auditor may be liable to third parties if a loss was incurred by the claimant due to reliance on misleading financial statements. Under civil law in the Netherlands this may only be the case when the auditor commits a wrongful act. Last but not least, under criminal law, it is a criminal offense to defraud another person by being knowingly involved in preparing false financial statements.

In auditing dilemmas two aspects are especially important: the relationship between audit pricing and auditor independence, and the position of the auditor when management is threatening to switch to another auditor. Since qualified audit opinions may affect the stock market price of firms and therefore manager’s compensation, there is concern that managers can pressure auditors into giving clean opinions by threatening to switch to another auditor. In order to limit auditor changes motivated by management opportunism GAAS and the rules of conduct have additional requirements for audit engagements. The Rules of Professional Conduct and Practice of Registeraccountants 1994 (GBR-1994) section 31 requires the proposed auditor to communicate with the current auditor. In addition, NSA 240, section 26, states that the current auditor should advise whether there are any professional reasons why the proposed auditor should not accept the appointment. When informing the proposed auditor, the current auditor will mention the reasons for the auditor change. If the reasons for such a change is fraud or misleading financial statements, the proposed auditor is informed about its nature and extent. The proposed auditor should not accept the engagement if the effects have not been resolved and have not been properly reflected in the financial statements. This does not however mean that the proposed auditor cannot have another professional opinion on the possible specific reasons for a qualified opinion. Beckman (1994, p. 391) states in this respect that views on providing the true and fair view can diverge between firms and auditors as well as among auditors themselves. This may also hold for specific disputes.

In respect of the relationship between audit pricing and auditor independence, the SEC has expressed concern that price competition among auditors may lead to an overproduction of dishonest reporting. In particular the SEC is concerned that situations where the auditor
agrees to fees less than normal in order to obtain the client (hereafter referred to as “low balling”) may lead to less independence, or to put it differently may stimulate auditors in basing their decisions on egocentric arguments70. “Low balling” only presents a threat to independence if auditors disagree among themselves as to the appropriateness of the accounting policy desired by the client. If all auditors agree that the accounting issue can be regarded as an audit failure, then “low balling” should not cause an auditor to compromise on egocentric arguments. From this it can be concluded that auditor independence is easier to maintain when GAAP leaves less room for disagreement among auditors (Magee and Tseng, 1990, p. 316). From the discussion above it may also be concluded that auditing will limit earnings manipulation and may limit earnings management when, taking a rule based approach, the intervention is justifiable, but is not in the public interest.

Research on the relationship between auditing and earnings management
This section discusses existing research on the relationship between auditing and managerial influence over accounting income. The relevant research is divided into two groups. In the first group a number of papers on the effect of audit quality on earnings management are briefly discussed. In the second group a number of papers on the motivation of auditor replacement and auditor changes are discussed.

DeAngelo (1981a) argues that audit quality is not independent of audit firm size. In particular she concludes that when incumbent auditors earn client-specific quasi rents, auditors with a greater number of clients have “more to lose” by failing to report a discovered breach in a particular client’s records. This collateral aspect increases the audit quality supplied by larger audit firms. Francis et al. (1996) found for a large sample of NASDAQ firms that the likelihood of hiring a Big 6 auditor is increasing in firms’ propensity to generate accruals. Firms with greater accruals also have greater opportunities for earnings management and therefore have an incentive to hire a more credible Big 6 auditor as an external monitor to provide assurance that opportunistic earnings management does not occur. Further, they found that the consequence of hiring a Big 6 auditor is decreased discretionary accruals, which is evidence of less earnings management behavior. Becker et al. (1998) also examined the

relation between audit quality and earnings management. They also assumed that Big 6 auditors are of higher quality than non-Big 6 auditors and hypothesize that clients of non-Big 6 auditors report discretionary accruals that increase income relatively more frequently than the discretionary accruals reported by clients of Big 6 auditors. The hypothesis was supported by evidence from a sample of 12,558 firms. They also found, consistent with earnings management, that the mean and median of the absolute value of discretionary accruals are greater for firms with non-Big 6 auditors. Although Weisfelt and Brugman (1995) found that auditors working at large accounting firms in the Netherlands tend to take a rule based approach to ethical dilemmas, the evidence above suggests that Big 6 auditors are of higher quality than non-Big 6 auditors. The findings can be explained by the fact that, although a rule based approach may not be optimal from an ethical point of view, it results in a basic quality level. For smaller auditing firm it is assumed that the audit quality is less homogeneous. Langendijk (1994) found that the audit market for listed firms in the Netherlands has a very high level of concentration, and is even higher when taking industry concentration into account. From this it may be concluded that in the Netherlands it is difficult to investigate the effect of audit quality on earnings management based on the distinction between Big 6 and non-Big 6 firms.

DeAngelo (1981b) demonstrates, contrary to the SEC claims mentioned above, that “low balling” does not impair independence, but that it is a competitive response to the expectation of future quasi-rents to incumbent auditors. “Low balling” in the initial period is the process by which auditors compete for these advantages. Critically, initial fee reductions are sunk in future periods and therefore do not impair auditor independence. Chow and Rice (1982) focussed their study on the influence of qualified opinions on auditor switches. Results support the contention that firms switch auditors more frequently after receiving qualified opinions. Craswell (1988) reached the same conclusion for the Australian practice. Schwartz and Menon (1985) examined the motivations for failing (bankrupt) firms to change auditors. Their research findings strongly support their prior expectations that failing firms have a greater tendency to switch auditors than healthier firms since factors that could influence auditor switching such as audit qualifications, accounting disputes, management changes, audit fees and insurance needs are different for failing and healthier firms. Dye (1991) found
support for the hypothesis that there may be informational motives for clients to replace their auditor. An auditor is more likely to be replaced when management’s perception of the firm’s financial condition is more favorable relative to the auditor’s perception and this lower perception is reflected in the auditor’s opinion. Auditors will not be replaced when the firm’s management and the auditor possess common information and the financial statements reveal this information. Based on Dye’s hypothesis DeFond and Subramanyam (1998) tested whether auditor changes are motivated by divergent beliefs between the auditor and management concerning the appropriate application of GAAP and more specifically the auditor’s preference for conservative accounting choices. In a sample of 503 firms with auditor changes, they found that discretionary accruals are income decreasing during the last year of the former auditor and generally insignificant during the first year of the successor. Consistent with their expectations, they found that negative discretionary accruals are concentrated among the sample partitions that are expected to pose the greatest client litigation risk threat to the auditor. Specifically, they found that discretionary accruals are more negative for clients that receive a modified opinion from the predecessor auditor, have a Big 6 predecessor auditor and change to a non-Big 6 auditor. These findings are consistent with managers dismissing incumbent auditors in the hope of finding a more reasonable successor. However, they did not rule out financial distress as mentioned by Schwartz and Menon (1985), as a potential alternative explanation for their results. Krishnan and Krishnan (1997) also tested the hypothesis that auditor litigation risk motivates auditor resignation. They found that resigning firms differ from firms that are dismissed along dimensions that capture the probability of litigation: financial distress, variance of abnormal returns and a modified opinion. Apart from the influence of qualified opinions, financial distress and litigation risks, auditor changes may also be made for efficiency reasons. Johnson and Lys (1990) argue that audit firms achieve competitive advantages through specialization and that clients purchase audit services from the least cost supplier. Based on a sample of 600 voluntary auditor changes they found that these changes can generally be attributed to cross-sectional changes in client characteristics and differences in audit firm cost structures. According to Langendijk (1990) listed firms in the Netherlands are very loyal to their auditors, and only sporadically change their auditor. From this it may be concluded that it is difficult to investigate the reasons behind auditor changes in the Netherlands.
4.5 The probability of observation, legal constraints and market forces

A variety of factors may limit managerial influence over accounting income. The previous paragraphs discussed the role of managers' ethical standards, the firm's governance structure and auditing. This paragraph discusses some of the remaining factors may be considered in this respect: the probability of observation, legal constraints and market forces.

The probability of observation

The probability that accounting interventions will be observed matters because costs can be imposed by the firm's stakeholders when accounting bias is revealed (Jiambalvo, 1996, p. 42). The relevance of observability depends on managers' objectives to influence accounting income. When managers influence accounting income in order to provide better information about future cash flows it does not matter whether the interventions are observed by stakeholders, observability may even contribute to the effect of the signal. When managers bias accounting income opportunistically, costs can be imposed by firm stakeholders since opportunism means that wealth is transferred from stakeholders to managers and this managerial action is by definition unexpected (Christie and Zimmerman, 1994, p. 541). Costs can for example be imposed by litigation or due to price protection by stakeholders in future contracts. When managers influence accounting income for efficiency reasons the relevance of observability is uncertain. If the outcome obviously increases the wealth of all stakeholders observability does not matter. However, when this is not the case costs can be imposed by stakeholders who do not benefit from the accounting interventions. For example, accounting interventions to avoid violation of a debt covenant may result in a wealth transfer from debtholders to stockholders. If this is observable to the debt market, higher future debt-financing costs may result. However, if the violation is incidental, the violation may impose costs to the firm that would not have occurred by avoiding the violation with accounting interventions. If the (potential) debt covenant violation is against the spirit of the covenant, accounting interventions may be efficient and debtholders may not impose higher future debt-financing costs on the firm.

71 By definition because if it is expected that managers bias accounting income opportunistically, accounting interventions that result in the expected bias are efficient.
When stakeholders approve the accounting intervention, observability is less important. Accounting interventions beyond GAAP are an economic crime and generally perceived unethical. Interventions within GAAP are more likely to be observed by the firm’s stakeholders than interventions beyond GAAP. Management will cover up interventions beyond GAAP for auditors and stakeholders because these interventions will result in high costs when observed. The probability that accounting interventions within GAAP will be observed varies widely and depends on the disclosure requirements under GAAP. While some interventions such as accounting changes and extraordinary items must be disclosed under GAAP in the Netherlands, other interventions such as non-material changes in accounting estimates or real decisions are not disclosed and thus far more difficult to observe. But even when the intervention is disclosed it is often hard to quantify the effect of the interventions for the current and future accounting periods.

The costs imposed by stakeholders can be divided in two groups, litigation costs and reputation costs. Litigation costs are incurred due to legal constraints. Generally, costs incurred when non-GAAP interventions are revealed are higher than costs incurred when interventions within GAAP are revealed. Observed non-GAAP interventions may impose litigation costs where interventions within GAAP usually do not. Reputation costs are incurred due to market forces. Because market forces usually react more vehemently to non-GAAP interventions higher costs are also imposed from this perspective.

*Legal constraints*

Legal constraints depend on the status of a country’s accounting standards and the enforcement of these accounting standards. In the US for example, the Financial Accounting Standards Board (FASB) issues Statements of Financial Accounting Standards, Statements of Financial Accounting Concepts and Interpretations. Although the FASB is a private sector body, the FASB standards are officially recognized in the US as authoritative by the SEC. The SEC enforces the standards for SEC-registered firms.

The boundaries of accepted accounting policies and estimates in the Netherlands can be found in the Civil Code and the Guidelines of the CAR. A distinction should however been made
between the Civil Code and the CAR Guidelines for Annual Reporting. The special provisions in the Civil Code are law and cannot be departed from. The true and fair view override (section 2:362, subsection 4 BW) however leaves room to depart from these special provisions if this is necessary to provide the view the law requires. The Guidelines do not have the same status. The authoritative statements in the CAR Guidelines are generally conductive to provide the view the law requires, they are not expected to be departed from without good reason. The recommendations and opinions in the CAR Guidelines on the other hand only give support and direction, they can be departed from without good reason. The methods to influence accounting income and the boundaries of GAAP in the Netherlands are discussed in more detail in chapter 5. In case of an accounting dispute regarding financial statements, stakeholders have the possibility to complain to the Enterprise Chamber of the Court of Justice in Amsterdam. The Enterprise Chamber has the exclusive right to judge these disputes, with an appeal possibility to the Supreme Court. The auditor has the right to be heard in this procedure. When the Enterprise Chamber grants the claim, the firm is given an order to change the financial statements. A decision by the Enterprise Chamber can also have consequences for other legal proceedings by supporting the claim that the financial statements give a misleading representation of the firm’s performance and/or the assets and liabilities. As stated in the previous section complaints on financial statements are very scarce since only when there is a going-concern problem or a serious antithesis between stakeholders, the financial statements may be that important that stakeholders will make the effort for these time and money consuming procedures.

Apart from the internal liability where directors and members of the supervisory board are liable to the firm in case of mismanagement, directors and members of the supervisory board are also liable to third parties (stakeholders). When the firm gives a misleading representation of the firm’s performance and/or the assets and liabilities the firm is liable under civil law for stakeholders’ claims when the firm has committed a wrongful act. Stakeholders have the burden of proof. Proof may for instance be given in the form of an Enterprise Chamber’s decision. Not only the firm, but also the directors and members of the supervisory board are

72 According to the Standards on Auditing in the Netherlands (RAC Guideline 120; Framework of Standards on Auditing) financial statements in the Netherlands should be prepared in accordance with the authoritative statements included in the CAR Guidelines for Annual Reporting.
liable for providing misleading information. This is not the case when the directors and/or members of the supervisory board can prove that he is not to blame for this misleading representation. Finally, under criminal law it is a criminal offence to defraud another person by knowingly being involved in the falsification of financial statements. Although the procedures mentioned above are scarce in the Netherlands, liability will have a prohibitive effect on accounting interventions beyond GAAP. With respect to interventions within GAAP liability will however not have this effect since these are not classified as misleading by the Enterprise Chamber. Apart from the direct financial consequences that may result from liability, liability will also result in loss of reputation for the firm, directors and members of the supervisory board.

Market forces
Reputation costs are imposed on the firm due to market forces. A loss of reputation may be a consequence of accounting bias within as well as beyond GAAP. The stock market for example may react when the financial accounting quality is perceived below average because there is no perfect substitute for accounting data and the risk of the investment is increased. Dechow et al. (1996) for example documented a nine percent decline in equity value when the stock market learns of an allegation of earnings manipulation for firms that are subject to an SEC investigation for violation of GAAP. Foster (1979) found that firms criticized by Briloff suffered on average a price drop of approximately 8 percent after the companies' accounting practices were criticized. More recently shares of BAAN Company N.V. fell heavily after two US analysts published serious doubts about the application of US GAAP (De Telegraaf, 14 May 1998) and IBM shares dropped 5 percent after an analyst report criticized the computer maker's accounting practices regarding the unusual treatment of one-time gains (Reuters news, 25 December 1999).

As stated in paragraph 4.3 the stock market will also react when management's own (accounting) objectives are below average aligned with shareholders' objectives. If the performance of the firm is perceived as poor due to opportunistic managerial behavior the share price will suffer and the reputation of management will be harmed. This will not only have its effect on the market value of management on the managerial labor market, but will
also weaken management's position within the firm. It is likely that managerial competition within the firm will control opportunistic behavior. Not only competition from within the firm may control opportunistic behavior. When the firm's earnings and stock-price performance is poor, shareholders may also want to replace management. A proxy contest is a political campaign in which shareholders who disagree with managerial policies seek election to the firm's board of managerial directors or to the firm's supervisory board. In the Netherlands the dispute between Nedlloyd and Hagen in the 1990s is a scarce example of a proxy fight. Further, when management is responsible for the value of the firm being less than under value-maximizing management there is an incentive for a take-over. Because members of the board of managerial directors are likely to be replaced after the take-over this may control opportunistic accounting interventions. It should however be noted that in the Netherlands a hostile take-over has never been successful. From this it may be concluded that in the Netherlands there hardly is a market for corporate control and take-over threats will have little effect on managerial behavior.

Opportunistic managerial behavior may also cause stakeholders other than shareholders to react. For example, when opportunistic accounting interventions result in higher director's pay, labor unions and employees may demand higher wages because they do no longer feel the need for moderate wage claims. When debtholders learn about opportunistic accounting interventions they may expect higher future opportunism in financial statements. When the interventions are within GAAP this may result in higher future debt-financing costs, but when the interventions are beyond GAAP it is likely that providers of debt are reluctant to provide any debt at all in the future. Finally, customers and suppliers decisions may also be affected by a damaged reputation. This will especially be the case when the firm's prospects are affected or when the firm's behavior is such that other firms don't want to be associated with the firm.

4.6 Summary and implications for this study

Manager's ethical standards, the firm's governance structure, auditing, the probability of observation, legal liability and market forces constrain managerial influence over accounting
income. The likeliness of the constraints to reduce the probability of certain accounting interventions depends however on the objectives as well as the methods used to influence accounting income. Income strategies may be motivated to provide better information, be motivated by efficient contracting reasons or may be opportunistically motivated. Different methods may be used to implement the income strategy and exert influence over accounting income. Apart from real transactions, accounting income may be influenced through pure accounting decisions within GAAP and beyond GAAP. The boundaries of GAAP in the Netherlands are discussed in the next chapter.

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Table 4.1 Constraints on managerial influence over accounting income (adapted from Jiambalvo, 1996).

Table 4.1 provides a summary of the factors that constrain managerial influence over accounting income. All constraints are likely to reduce the probability of accounting interventions beyond GAAP and may reduce the probability of accounting interventions within GAAP. For example, auditing is likely to reduce the probability of earnings manipulation, but is it likely to reduce the probability of earnings management? Similarly, ethical standards are likely to reduce the probability of earnings manipulation, but are they likely to reduce the probability of earnings management? The likeliness of constraints
reducing the probability of accounting interventions within GAAP depends on the objective of the intervention.

All the factors mentioned in table 4.1 are relevant for the empirical part of this study. However, there are implementation difficulties for all of them:

- **Ethical standards** range widely and it is difficult to assess whether the perspective of management is opportunistic, efficient or aimed at providing better information;

- **Ownership structure, shareholders, supervisory board and internal controls** are difficult to test for because the sample of firms in this study is too homogeneous in this respect (the number of owner controlled firms and the number of firms with audit committees for example are very small) or because the required information is not available in the public domain;

- The **probability of observation, legal constraints and market forces** have with no doubt relevance, especially for accounting interventions beyond GAAP, but one needs a pre-selected sample of firms to study this relevance.

Auditing is the only constrain that is taken into account in the empirical part of this study. As discussed in this chapter existing research in this respect concentrates on audit firm characteristics (Big 6 versus non-big 6) and auditor changes. Although publicly available there are some difficulties regarding auditing research in the Netherlands. According to Langendijk (1994) the audit market for listed firms has a very high level of concentration and listed firms are very loyal to their auditors in the Netherlands.

A number of firms do however report auditor changes and it is expected that firms with auditor changes report less conservative than firms without auditor changes. Furthermore, since nearly all listed firms are audited by Big 6 audit firms one can only assess whether there are quality differences among Big 6 audit firms. Although it is not expected that there are quality differences among (Big 6) auditors of listed firms in the Netherlands the empirical part of this study tests for differences in (Big 6) audit firms.