Earnings Management: Empirical Evidence on value relevance and Income smoothing.

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CHAPTER 1 INTRODUCTION

One of the most important numbers for investors in an annual report is the net earnings. It is this number that measures the overall performance of the firm over the past year. The outcome of the accounting process, the net earnings, is not only determined by the achievements and the state of the firm. It can also be influenced by discretionary adjustments in the numbers by management.

Law and regulations for external reporting in the Netherlands are flexible in the sense that they allow a certain extent of discretion in the application of accounting rules and regulations. The result of this flexibility, and the estimations that are made, is that there is a degree of latitude within which earnings can be reported. The term used for the adjustment of accounting earnings by management is earnings management.

Research on earnings management has to take into account that there are several interested parties that each have their own role in the numbers game. Regulators set the rules, auditors play referee, managers compose the financial statements and investors and other stakeholders, that do not have access to the internal information, read and assess the annual reports. All parties involved have different interests. These different roles make them regard earnings management differently. As noted by Dechow and Skinner (2000) there is a notable difference in views between various stakeholders.

Academics are more neutral in their positions then direct stakeholders, whereas regulators regard earnings management as pervasive and problematic. For investors the possibility of managed earnings also poses a problem. The interpretation of the annual report and hence the assessment of profitability of the firm becomes a
combination of assessing the state of the firm based on the reported numbers while allowing for possible adjustments in this reported state by earnings management. Even if it is obvious that earnings are managed, how should this be interpreted? Accounting adjustments do not have to be seen as a negative signal. They can also be seen as a signal from management about their expectations for the future. Understanding when managers implement an accounting policy, and how they make certain adjustments, whether this influences the value relevance of earnings and how this affects the inter-temporal earnings stream is of importance to preparers, users and regulators alike.

In the US earnings management is an active field of research. It was shown that there are reasons for management to engage in earnings management (bonus plans, for instance see Healy (1985)). Beaver and Engel (1997) have also done some work in the US setting on the effects of earnings management on the share price. The main finding in the US market context was that investors see through these adjustments to a certain extent.

Whether these results can be transferred to the Netherlands is not well known. In the Netherlands the regulation of accounting is far more flexible and therefore more open to the adjustment of earnings by management than in the US. Also, the financial markets in the Netherlands are smaller. The combination of more flexibility in accounting regulations and smaller financial markets could lead to a lesser degree of detection of earnings management. Whether this is indeed the case has not been investigated till now.

Investigating the effects of earnings management in the Netherlands will contribute to the accounting literature since knowing the effects of earnings management in this context provides an illustration of the consequences of the flexibility in our accounting regulation. Moreover, providers and users of financial statement information in general and investors and managers in particular will be interested in knowing the effects of earnings management. For management it could show the rationality of earnings management behavior, and for users it could help with the interpretation of financial statements.
1.1 CENTRAL RESEARCH QUESTION

While there seems to be general consensus that earnings management occurs quite frequently the motivations, value relevance effects and strategies are far from clear. This thesis attempts to contribute to further understanding the nature of earnings management. The general question for this thesis is formulated as:

*What are the causes and consequences of earnings management?*

The generally formulated research question will be divided into more specific questions that are open to hypothesis testing. The likelihood of occurrence of earnings management appears to be influenced by the performance of firms. Before examining the two main hypotheses of the thesis, earnings management will be examined in detail and related to the performance of the firm. Special attention will be given to high and low performing firms relative to average performers. Hence, the first research question is formulated as:

*Question 1: Is earnings management associated with the financial performance of a firm?*

If there is a linear relationship or some other connection between the performance of the firm and the incidence of earnings management this should be taken into account when interpreting results.

A central question in the discussion about earnings management for both regulators and users of financial information is whether it influences the relevance of annual reports. The second research question is therefore formulated as:

*Question 2: Does earnings management influence the value relevance of financial reports?*

This question will be examined both in a relative and incremental form. Examining relative information content is similar to asking the question: "Does earnings management add or delete information from reported earnings?" and examining the
incremental information content amounts to asking the question: "Does earnings management add information on top of the neutral outcome of the reporting process?"

Income smoothing is the reallocation of earnings across periods to reduce the volatility of the reported income. It can be argued that managers and shareholders reap rewards from smoothed earnings. Smooth earnings allow management to convey the expected long-run performance of a firm. This allows investors to better assess future performance. In addition, it could also be that management will aim at their forecast and use slack in the reporting process to improve on the predictability of reported earnings. The third research question thus becomes:

**Question 3:** Does earnings management increase the inter-temporal smoothness of earnings?

If there is empirical support for income smoothing in the analyses the interpretation is dependent on the outcome of the examination of earnings management in relation to the performance of firms and the value relevance findings from the first research question.

Both the examination of the earnings management proxies and the analyses of the research questions take into account that most research methodology is developed in a US setting. Since laws, regulations, economic structure, institutional settings and interests of stakeholders differ substantially between the US and the Netherlands the local setting is specifically taken into account.

The results that will be presented in the empirical analysis will examine whether earnings are managed to attain certain targets and if the outcome of the neutral reporting process relative to the desired outcome provides indications in which direction earnings are likely to be managed. In addition, evidence will be presented on the value relevance of earnings management. The association between earnings and returns is examined for the impact of adding discretionary components to earnings. Finally, the empirical analysis will investigate the association between earnings management and income smoothing.
Research program

One of the research programs of the Faculty of Economic Sciences and Econometrics at the University of Amsterdam is the program in Accounting, Organizations and Society. This dissertation is part of the sub program Financial Accounting and Assurance.

Field of research

In accounting research there is a specific area that deals with earnings. Earnings management is a subset of this research and it deals with the deliberate adjustment of earnings numbers with the aid of actual transaction or accounting methods in order to get a more desirable outcome of the reporting process. In the past such research has focused primarily on the factors associated with the incidence of earnings management and the way that adjustments in accounting data are effected. Current developments are moving in the direction of more interest in targets towards which earnings are managed and the effects on the value relevance of earnings management.

Methodology

This thesis uses survey data gathered from annual reports and DATASTREAM. The collected data is subjected to statistical analysis in order to answer hypotheses. This approach was chosen for the following reasons. Financial accounting is a research field that can use relatively large samples. The wide availability of market data and annual reports allow sufficient sample size for complex data analysis. In addition, the gathering of data by means of interviews or questionnaires introduces extra complexities on top of limited sample size. The nature of the topic introduces the likelihood that respondents are either unwilling to answer questions or answer questions which are hard to assess on their truthfulness.

1.2 SOCIETAL AND SCIENTIFIC RELEVANCE OF THE STUDY

Measuring the effects of adjustments in accounting earnings on the relevance of accounting information could help to interpret the informational quality of annual
reports. The meaning of accounting information is relevant for all stakeholders of the firm. Investors, financial analysts, banks, managers and others could benefit from better understanding of the cause and effect structure for discretionary decisions. Knowing more about the mechanisms that drive earnings management could help to increase the decision usefulness of annual reports. In addition, it could also help regulatory bodies decide what course to take and assess what degree of discretion should be allowed to managers when preparing financial statements. With the current international trend towards harmonization it becomes important to know more about the impact of discretion in accounting systems.

**Structure of the dissertation**

The remainder of the dissertation is organized in three parts. The first part consists of chapters 2-4 and introduces the prior literature on earnings management (Chapter 2), the institutional setting (Chapter 3) and the measurement of earnings management (Chapter 4). The second part (Chapter 5) contains the development of hypotheses and the empirical analysis. The third and final part consists of the summary and conclusion (Chapter 6) and a brief Dutch summary of the thesis (Chapter 7).