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Associations between Earnings Management Manipulation Types and Debt Contracts, Political Costs and Characteristics of Board of Directors

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Abstract *Rapid growth in global economic environment has significantly elevated the importance of the study of earnings management (EM) due to increased need for reliable and transparent financial information. EM is efficient if managers signal financial information to external users to assist them to improve their understanding of company's upcoming performance. However, EM is opportunistic, if managers act creative with accounting numbers for purposes other than that of enhancing truthful reporting. In order to reduce the effects of opportunistic behavior on investors, it should be clear under which conditions managers are likely to behave opportunistically. The aim of this study is to investigate the practice of EM and its manipulation types, revealing the connection of debt contracts, political costs, and characteristics of board of directors by exhibiting conflicts of interests.*

Key words Earnings management, opportunistic behavior, efficient behavior, debt contracts, political costs

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1. Introduction

Users of financial information are able to make rational investment decisions only by eliminating manipulated financial statements. When financial statements are *"controlled or handled for one's own benefit",* especially in an unfair manner towards drawing a more positive and optimistic picture, earnings are simply managed (Spears, 2000). There is no precisely perceived definition for EM in the existing literature. However, the most commonly and generally accepted definition is '*…When managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers*' (Healy and Wahlen, 1999).

Briefly, EM is an act of manipulation to create a better image of the firm's performance as it occurs when the management has the opportunity to make accounting decisions that change reported income, and simply exploits those opportunities (Weil, 2009).

Managers engage in earnings management practices to increase, among other things, earnings per share and the value of the firm. Creating a better image of the firm's performance generate a positive perception for the users of financial information and in turn affects investment decisions. The line between appropriate earnings management techniques and "cooking the books" can be a blurry one, notwithstanding the plethora of detailed rules that are currently in place to deter malfeasance (Millstein, 2005)

The practice of EM is aligned with agency theory as it examines the conflict of interest between parties to a contract that comprises all co-operative arrangements; and suggests that there is an information asymmetry among managers and shareholders. Moreover, EM is concerned with signaling theory as well. Occasionally, managers signal financial information to external users to assist them improves their understanding of the firm's upcoming performance so as to yield them to make the right investment decisions. Such fashion is called as the efficient type of EM.

On the other hand, earnings management is opportunistic if managers play with the accounting numbers to maximize their own wealth or the firm's interest. This kind of practice manipulates the real financial performance and causes unreliable and non-transparent financial information, which lessen the quality of disclosed report thus confidence of investors.

This study covers two main motives of EM, which are debt contracts and political costs. Moreover, this study covers the two main characteristics of board of directors, namely the size and independency. In order to reduce the effects of opportunistic behavior on investors, it should be evident under which conditions managers are likely to behave opportunistically. Thus, this study considers the practice of EM manipulation types, revealing its association between debt contracts, political costs and characteristics of board of directors by thoroughly exhibiting the conflicts of interests.

Significance of this study is the scope of the topic, which covers both theoretical and practical concerns. From a solely academic viewpoint, alteration of financial reports to mislead stakeholders about the underlying economic performance of the company or to simply influence contractual outcomes depending on accounting numbers is an alarming act, which should be assessed in terms of ethics, manipulation, income smoothing, aggressive accounting, corporate governance, and all the way up to fraudulent practices. As for practical matters, audited financial statements are the gateway for investors. Once the statements are audited, they are deemed as trusted with no doubts under reasonable assurance (Kaya, 2012). However, EM may be practiced by managers in their own interest and still be undetected by both the internal and the independent audit.

In the light of both theoretical and practical concerns, this study sheds light on areas, which raise questions in terms of truthful reporting, thus is of interest for both academia and practice.

2. Types of Earnings Management

EM has two different types: Efficient if managers signal their reserved information to outside users to enhance their knowledge and help for the communication among stockholders, public and managers; Opportunistic if managers include their own judgment in accounting reports to maximize their utility (Siregar and Utama, 2008; Jiraporn *et al*., 2008).

Managers engaged in earnings management may be motivated by contractual, political and other reasons. For example, managers may opportunistically manage net income so as to maximize bonuses under bonus schemes based on current reported income (Healy, 1985). When managers employ accounting policies that are in their own best interests with regard to debt contracts and political costs, such behavior clearly represents an opportunistic conduct. In order to monitor such opportunistic behavior, well-established internal control system is the key to limit opportunism and motivate managers to select accounting policies that minimize the costs to the firm. This is the efficiency type of earnings management (Scott, 2008). The efficiency perception aims at explaining the application of different tools to reduce the agency cost to the firm as much as possible, particularly the costs related with allocating authority for decision making to the managers.

Holthausen and Leffivich (1983) expressed the concept of efficient earnings management for the first time. At this point, managerial preference is related with the disclosure of reserved information about the firm's future profitability to investors. Stockholders could make profit once the earnings management is practiced to signal private information of managers or to cut down political costs (Watts and Zimmerman, 1986).

On the other hand, the opportunistic perception takes certain assigned contractual engagements for a firm and search for explaining and predicting a particular opportunistic behavior that is likely to arise later on. Originally, the specific contractual engagements may have been assigned, since they were thought to be useful in supporting the benefits of different parties within the company (Deegan, 2006). In spite of this, it is not likely or effective to write down covenants that offer directions upon each accounting techniques to be employed for each situation. Therefore, managers are believed to always find room to behave opportunistically.

The practice of opportunistic earnings management leads to less reliable accounting information that affects the firm's actual financial performance. This practice also downgrades the quality of reported earnings and accordingly investor confidence by reducing its expediency for investment decisions (Dechow et al., 1995). Monitoring mechanisms should be established to increase the reliability and quality of accounting earnings and to reduce opportunistic behavior of managers.

Over the years, EM has become a substantial concern for regulators and agencies that protect investors, particularly having witnessed the failure of numerous global businesses in recent decades. To overcome EM practices, regulators have improved the philosophy of corporate governance and given importance to independent external auditors (Xie *et al.,* 2003). Primary objective of corporate governance as a monitoring system is to solve agency conflicts by supporting management's interests with shareholders, which lessens the executive's aptitude to manage earnings. EM is not exactly related with reported earnings; however there may be additional influence on different accounts. Therefore, EM might arise in financial ratios in place of earnings. Among other areas, EM is generally practiced by manipulating the timing of the incurred expenses; such as advertising or training, so the incurred expenses may then be reported in a non-matching period. Firms can adjust the recognition of revenues and expenses by moving forward the revenue recognition or postponing the recognition of losses. Additionally, EM is applicable in estimating the useful life of asset impairments and assets as well (Habbash, 2010).

2.1. Association between EM Types and Two Main Motives

2.1.1. Debt Contracts

More common conflict within the scope of the literature is between the interests of shareholders and managers. Nevertheless, conflict between the interests of shareholders and debt holders is noteworthy as well. The more recognized example of such conflict is an abundance of dividend payments, which is certainly not in the best interest of the debt holders. Therefore, this conflict creates agency costs for debt. Without the action of bonding contracts or monitoring, these agency costs cannot be reduced or disappeared (Jensen and Meckling, 1976). The common example for these costs is *"restrictive covenants in debt agreements".*

The debt covenant hypothesis is one of the main hypotheses of positive accounting theory (PAT) introduced by Watts and Zimmerman. PAT argues that the debt contracts have substantial influence in choosing accounting methods within the firm (Watts and Zimmerman, 1978). Watts and Zimmerman (1986) proposed that managers are prone to move profits from next period to current period if the firm is closer to a credit agreement.

From this point of view, accounting numbers are generally used to set up the covenant disorders of debt agreements and to monitor if these conditions are violated or not. This suggests that accounting methods with the objective of wealth maximizing (Habbash, 2010). Thus, the personal wealth of managers is vulnerable to the extent that managers are easily influenced by any variations in the accounting methods. Consequently, the continuous motivations exist for managers to select particular accounting methods, which will either increase their own wealth or that of firms. The majority of preceding research has concentrated on the contracting effects of compulsory changes in accounting methods.

Leverage naturally increases the opportunistic behavior of managers since the payments of debt cause a reduction in the amount of cash. Besides, highly leveraged firms face the strict inspection of investors and lenders (Ardison *et al*., 2013). If investors feel that the company cannot avoid debt covenant default, then there will be remarkable declines in future investments. Managers of firms with higher debt to asset ratio are more likely to manage earnings since they want to prevent debt covenant default. Debt to asset ratio measures firm's proximity level to debt covenant default and the cost of debt covenant default is high since it pushes up the cost of debt capital and induce significant decline in useful investments (Kim *et al.,* 2011).

Omid *et al*. (2012) and Waweru and Riro (2013) argue that there is a positive relationship between borrowing costs and EM. Subsequently, managers engage in manipulation of accruals to protect themselves and/or the company and choose more favorable accounting methods between depreciation methods or inventory valuation methods such as LIFO or FIFO and etc.

2.1.2. Political costs

Aside from debt contracts, EM is also applicable in such areas with weighty impact on other stakeholders. Political costs hypothesis is one of the main hypotheses of PAT and it holds a considerable place in EM research. Political cost declares that, ceteris paribus, the greater the political costs that the firm meets, more likely a manager to select accounting methods that postpone reported earnings from current to future periods. This is because high profitability can cause increased political attraction, new taxes and regulations (Scott, 2008).

According to Watts and Zimmerman (1986), volume of political costs deeply and strongly depends on the size of the firm, since larger firms attract more attention from regulatory bodies. This situation increases the opportunistic behavior of managers and is inclined to pick accounting techniques to decrease their reported earnings to lower the political costs and avoid tax burden (Tehrani *et al.,* 2011). They are motivated to choose the accounting methods in the best interest of the firm and maximize self-interest. It is strongly argued that there is a positive relation between firm size and opportunistic type of EM (Rezaei and Roshani, 2012; Charfeddine *et al.,* 2013). Thus, managers in large-sized firms are prone to choose accounting methods that shift earnings to future periods, since as the size of a company increase, the possibility of being exposed to pressure increases too. This inspires managers to select accounting methods that decrease earnings to lower political costs that are based on accounting figures (Watts and Zimmerman, 1978).

3. Association between EM and Board Characteristics

3.1. *Size of Board of Directors*

Board size is one of the most important components of board characteristics and has direct effect upon EM. It is imperative since it is counted as the part of monitoring. The right size for the board increases the ability to monitor management and manage the business activities effectively and efficiently and undoubtedly should neither be too large and nor too small to prevent conflicts. According to Fama and Jensen (1983), the central responsibility of the board of directors is to control managers. The efficiency of the board is based on board's structure and its size. Smaller boards are thought to be more effective, since they have less difficulty for monitoring, coordinating and managing issues (Fama and Jensen, 1983).

Likewise, Charfeddine *et al.* (2013) suggests that the efficiency of the board depends on its size; that boards with smaller number of members make more effective decisions than larger sized ones. Crowded boards are exposed to a higher degree of conflict between board's members. Thus, the board size increases the opportunistic behavior as it creates gaps due to lack of harmony in decisions.

3.2. Board independency

The board of directors must have independent non-executive members who have capability to perform their responsibilities independently. The independent members of the board are expected to be objective in decision-making process (Khalil and Ozkan, 2016). There is a definite need for independent non-executive board members to preserve the reputation of the directors and monitor them at the same time. For independent non-executive directors to be effective, they ought to obtain strong incentives and capabilities to monitor and detect earnings manipulation (Saleh *et al*., 2005). Numerous studies have revealed that independent non-executive directors are far more effective in detecting manipulation and monitoring management. Furthermore, companies with independent non-executive members are less likely to engage in earnings manipulation or report abnormal accruals (Xie *et al*., 2003; Peasnell *et al*., 2005; Adıgüzel, 2012). Thus, firms with lower proportion of independent non-executive board members are likely to practice earnings management opportunistically in order to increase earnings, since there is less monitoring on management. Such argument is in line with agency theory as well.

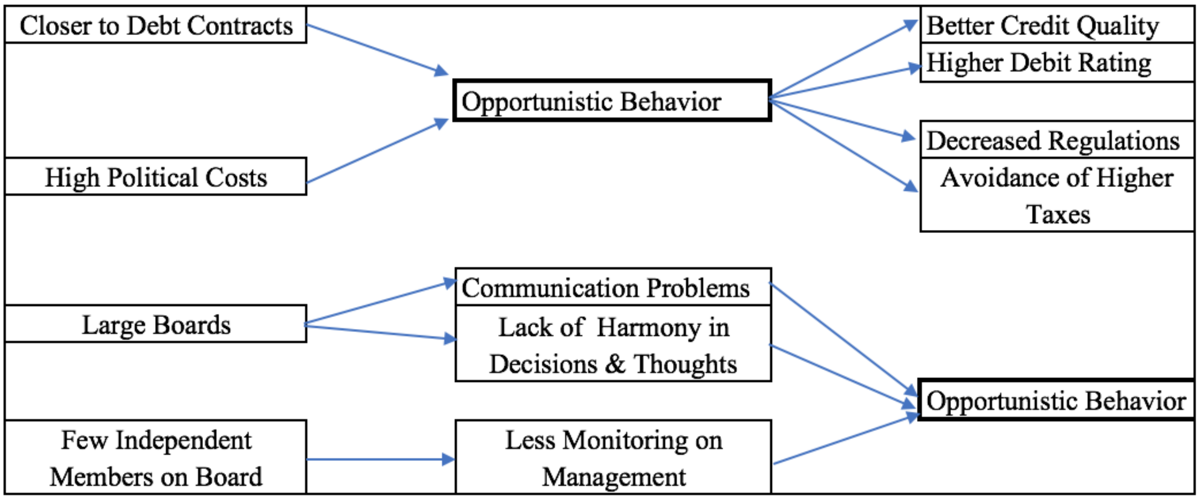
4. Conclusions

This paper acts as a guide to investors to exhibit management's ability to manipulate earnings for opportunistic objectives. Furthermore, by thoroughly outlining the different types of EM, reliability of financial numbers in terms of debt contracts, political costs, board size, and independency factors have been reevaluated.

Moreover, this study alerts decision makers to assess the effects of monitoring systems such as size and independency of board of directors. Likewise, guides shareholders to consider the role of these monitoring systems in improving the understanding of financial information quality. If shareholders are capable of acquiring reliable information about the firm's performance, then their financial decisions may turn out to be more accurate and effective.

The table below association of opportunistic behavior and debt contracts, political costs and characteristics of board of directors.

Figure 1. Association of Opportunistic Behavior and Debt Contracts, Political Costs and Characteristics of Board of Directors



In the light of the review of the subject matter, this paper has four main results. The first result indicates that firms with high debt ratio are more expected to manage their earnings. However, users of financial information should also take into consideration that debt creation might decrease opportunistic behavior of managers due to higher governance control. The second result indicates that firms that face high political cost are more expected to manage earnings. Political cost is related with the firm size and as the size increases, current assets increases and this creates a room for practicing earnings management relative to small sized firms. Large-sized firms may have stronger internal control systems, but the power of management is also strong and management may dominate the internal control system to practice earnings management. However, users of financial information should also take into consideration that large-sized firms allocate a great deal of reputation cost when manipulating earnings, since the cost of practicing earnings management will be higher for them in comparison to small-sized firms. Moreover, many larger firms are engaged in socially responsible activities, thus they have to disclose their financial information and present reliable and timely information more than smaller sized firms.

The third result indicates that firms that have few members on their board is more effective than abundant members since it is believed that conflict would arise between members as the size of the board increases due to communications difficulties. However, users of financial information should also take into consideration that as the number of director increases on the board, the knowledge, experience and external resources increase as well. They would have the balancing and harmonizing power within the board.

The final result indicates that firms with independent non-executive members are less likely to practice earnings management or to disclose abnormal accruals. Independent non-executive members are believed to resolve the agency conflict between managers and shareholders by monitoring opportunistic behaviors of members. As the number of independent non-executive members increase on the board, the quality of earnings increases as well and this allows investors to see transparent and reliable financial numbers. Independent non-executive members are effectual in detecting earnings manipulation and more successful in monitoring management. However, users of financial information should also take into consideration that independent non-executive members are not always effectual in detecting manipulation and monitoring the members, since they have limited accessibility of information within the level of independency. As stated, boards that have high independency levels are incapable to exhibit their know-how for the firm.

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