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Income smoothing by Dutch hospitals

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A B S T R A C T

Research indicates that hospitals manage their earnings. However, these findings might be influenced by methodological issues. In this study, I exploit specific features of Dutch hospitals to study income smoothing while limiting these methodological issues. The managers of Dutch hospitals have the opportunity not only to postpone revenues to future periods but also to choose the moment of recognition of the postponed revenue. These postponements and recognitions can be positive as well as negative and have to be disclosed in hospitals' financial statements. I show that the patterns found with respect to postponing revenue and the recognition of postponed revenue are consistent with the expectation that hospitals attempt to smooth their income.

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1. Introduction

Financial statements can be of great importance for the governance and funding of hospitals, depending on the specific institutional context and the funding arrangements in place. In the hospital sector, these statements are often used for accountability and funding decisions because they are expected to provide an objective view of the hospital's financial resources and performance. However, the objectivity of accounting numbers can be affected by a limited form of manipulation known as earnings management. Typically, accounting relies on estimates and managerial discretion which typically provides some scope for managing reported numbers within the confines imposed by a regulatory framework and a financial audit. As a consequence, earnings management can affect funding

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decisions that could result in the misallocation of funds and wasted resources. In turn, earnings management can lead to a loss in social welfare (Jegers, 2010).

Despite extensive research on the earnings management in for-profit enterprises (for a review see Healy and Wahlen, 1999; for a discussion of the commonly used research designs see McNichols, 2000), there is relatively little research on earnings management in nonprofit hospitals (see Ballantine et al., 2007, p. 421), or in the nonprofit sector in general (as concluded by Verbruggen et al., 2008, p. 17). The few empirical studies in this area investigate a diverse group of methods for earnings management. Blanchard et al. (1986) examine the effect of incentive schemes on the accuracy of hospital information in the state of Washington. The regulation in force at that time provided incentives to bias forecasts of costs and volume. They find that hospitals biased the budgeted data in line with the incentives. Eldenburg and Soderstrom (1996) extend the research carried out by Blanchard et al. (1986) and also find that hospitals bias information in line with the incentives.

More recent studies on earnings management at hospitals include those carried out by Leone and Van Horn (2005) and Ballantine et al. (2007). Both of these studies report evidence of earnings management, or to be more precise income smoothing by hospitals.[1] Eldenburg et al. (2011) extend the literature on earnings management by examining the real operating decisions of nonprofit hospitals.

Both Leone and Van Horn (2005) and Ballantine et al. (2007) use approaches that are problematic under certain conditions. Both studies find evidence that nonprofit hospitals smooth income to just above zero by using two widely applied research approaches to for-profit earnings management. One approach is to consider the shape of the frequency distribution of the earnings and to look for indications that the incidence of 'small losses' is unusually low. This approach has gained considerable popularity since it was first used by Burgstahler and Dichev (1997) but has since then lost favor following the fundamental criticisms by, among others, Durtschi and Easton (2005, 2009). The second and more traditional approach used by Leone and Van Horn (2005) involves making an estimate of the so-called discretionary accruals. Accruals are elements of profit that are not directly tied to cash flows, such as depreciation and provisions. Discretionary accruals are those accruals that are not simply mandated by accounting standards. While some depreciation is inevitable, the amount of depreciation expense recorded in a given year depends on the estimates of the useful life of the assets that are, within limits, discretionary. In this traditional approach, discretionary accruals are estimated by the researcher and subsequently 'backed out' of the reported earnings to estimate the 'unmanaged earnings'. Inferences about earnings management are made on the basis of the properties of the discretionary accruals and the unmanaged earnings that depend on the specific pattern of earnings management (i.e., maximizing, minimizing, or smoothing reported earnings) that is hypothesized in a specific setting.

While widely used, this 'backing out' approach is not without its problems, especially when used to investigate income smoothing, a type of earnings management that seems to be the most relevant for hospitals (Ballantine et al., 2007; Leone and Van Horn, 2005). In a critical review of the earnings management literature, Elgers et al. (2003, p. 406) state that:

> "... unmanaged earnings, defined as the difference between reported earnings and an **error-prone** (emphasis added) discretionary accrual estimate, creates patterns of measured discretionary accruals that appear to support the anticipatory income smoothing hypothesis, even in the absence of earnings management".

As I discuss in greater detail in Section 3, these problems are particularly acute in the investigation of income smoothing in a nonprofit setting. Although Leone and Van Horn (2005) try to mitigate this problem, I show that the possibility exists that their results are influenced by problems inherent in the 'backing out' approach. Consequently, their results therefore do not provide an unambiguous indication of income smoothing. In order to address these methodological issues, I use a specific discretionary item to calculate the amount of earnings management as well as statistical tests that are insensitive or less sensitive to estimation errors. In this paper, I study income smoothing at nonprofit hospitals in the Netherlands based on a specific element of the funding system and on the financial reporting requirements. On this basis, I find that hospitals smooth their income.

[1] Income smoothing is one of the patterns of earnings management (see Scott, 2012).

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