



The relations among accounting conservatism, institutional investors and earnings manipulation



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ABSTRACT

Most scholars have indicated corporations using accounting conservatism to reduce earnings manipulation, although certain scholars believe that firms have more incentive to increase earnings manipulation. Institutional investors play an important external monitoring role, and affect firm's earnings manipulation. Previous studies adopted accruals as an earnings manipulation proxy to detect the relationship among accounting conservatism, institutional investor shareholdings, and earnings manipulation. We further investigate the relationship among accounting conservatism, institutional investor shareholdings, and earnings manipulation by using Benford's law. Our results indicate that firms with more conservative financial reporting have less probability of engaging in earnings-manipulative activities. We also find the negative association between earnings management and institutional investor shareholdings. However, if corporate financial statements tend toward conservatism, institutional investor shareholdings could increase managers' incentive to manage earnings. Our findings have important implications for investors to make investment decisions.

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1. Introduction

Earnings management increases outsider uncertainty and potentially leads to information asymmetries among firm managers, resulting in decreasing investment efficiency. In prior studies, accounting conservatism was shown to reduce the adverse effects of existing information asymmetry between outside investors and managers by restricting managerial accounting manipulation (LaFond and Watts, 2008). Accounting conservatism is a measure to limit the amount of financial statement risk. This study introduced a measure to examine the association between accounting conservatism and earnings management, and determine whether accounting conservatism reduces earnings management in the enterprise.

Numerous studies have examined the relationship between accounting conservatism and earnings manipulation. Certain scholars have provided evidence of the negative association between accounting conservatism and earnings management; however, others argue that the relation is positive. Managers also have the opportunity to

misappropriate enterprise assets. Numerous factors have directly and indirectly affected the serious financial distress of recent years, resulting from a combination of complex factors, including real estate bubbles that have burst, fiscal policy selections related to government expenses and revenues, and methods enterprises used to report earnings numbers.

Outsiders doubt the reliability and neutrality of financial statements. Famous companies in the United States such as Enron, Fannie Mae and Freddie Mac, WorldCom, Arthur Andersen, and Lehman Brothers have incurred serious financial distress, in addition to the European debt crisis and the burst of Japan's stock and real estate bubble in the 1990s. The bubble burst and the subsequent collapse, which has lasted more than a decade, is known as "the lost decade." Because of the financial crisis in Europe caused by crushing debt and bank distress, countries such as Spain, Greece, and Ireland face continuing recessions.

Companies under financial distress are likely to take different measures to relieve the stress, including window-dressing financial statements, in which managers select business accounting methods and attempt to engage in earnings manipulation to mislead outsiders regarding financial statements (Xiong, 2006). Kury (2010) argued that agents are more likely to engage in enterprise decisions or management compared with outsiders. Consequently, receiving more enterprise information could result in agency problems. Managers have incentives to enable smooth earnings growth or particularly notice publicly reported earnings, and adopt improper means for manipulating earnings and window-dressing financial statements because of personal benefit. Ewert and Wagenhofer (2011) concluded that managers

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manipulate earnings to increase short-term company market values and manipulate earnings to promote stock prices to meet analyst expectations or to maintain stock prices during financial distress.

Managers typically exaggerate profits or underestimate debts to window dress firm financial statements; thus, investors may invest in those distressed firms unwittingly, resulting in significant losses. Financial reporting reliability has recently become a severe problem. From a prior study, Ball and Shivakumar (2005) showed that accounting conservatism can be used to reduce opportunist motives for managers when disclosing optimistic results. Consequently, we explore the relation between accounting conservatism and earnings manipulation.

Institutional investor shareholdings affect the earnings manipulation in firms and involve holding or investing money in firms such as insurance firms, pension funds, and banks. Roychowdhury and Watts (2007), Farooq and Jai (2012), and Pound (1988) proposed that institutional investors have greater expertise and can monitor management at a lower cost than individual shareholders, which may reduce the level of earnings management. Accordingly, financial distress motivates us to explore the relation between accounting conservatism, institutional investor shareholdings, and earnings manipulation. Foreign and domestic scholars have recently identified data sets that follow Benford's law to detect fraudulent data. Benford's law is a regulation that demonstrates that the expected distribution of naturally occurring numbers is skewed toward one for the first digit (zero cannot be a first digit) and zero for the second digit. Durtschi et al. (2004) argued that Benford's law provides a useful tool for auditors. Because digit analysis based on Benford's law does not use amounts, all digits can be used in particular accounts. After developing its use in the financial area, several empirical studies have mentioned that it can investigate window-dressing behavior among firms (Nigrini, 2001).

Prior studies between accounting conservatism, institutional investor shareholdings, and earnings manipulation have adopted accruals as a proxy of earnings manipulation. Whether higher accounting conservatism limits earnings manipulation opportunities is important to know. This study used Benford's law to investigate the earnings management of net income numbers reported by publicly listed Taiwanese firms adopting a high degree of conservatism. Benford's law is the empirical observation that digits 1 to 9 are not equally likely to appear at digit in numbers; Benford's law has been proven to be effective in finding out unnaturally-behaving data. Manipulated numbers usually do not follow Benford's law. This law is more scientific than other ways because of using real data sets. Such as Vocht and Kromhout (2012) thought that Benford's law is a straightforward and easy to implement analytical tool to evaluate the quality of data sets.

Accounting conservatism has two important characteristics. First, accounting conservatism is the consequence of the asymmetric verifiability requirements for recognizing profits and losses in firm financial statements. Second, assets are understated because of systematic conservative statement assets (Givoly et al., 2007; Roychowdhury and Watts, 2007). Therefore, accounting conservatism refers to a manager's tendency to require a higher degree of verification for recognizing assets than debts in financial statements. Recent studies have noted that accounting management reflects economic losses in a timelier manner than do profits that reduce earnings manipulation (LaFond and Watts, 2008; Watts, 2003).

We investigated the relation between accounting conservatism, institutional investor shareholdings, and earnings manipulation. In the context of higher accounting conservatism, we further explore the relation between investor shareholdings and earnings manipulation. Most scholars have indicated that firms could use accounting conservatism to reduce earnings manipulation; however, certain scholars believe that firms have more incentive to increase earnings manipulation. Consequently, investigating the relationship between accounting conservatism and earnings management is important to provide evidence concerning the ability of accounting conservatism to limit the manipulative earnings behaviors of managers. We argued that institutional

investors have strong incentives to monitor managers by reducing their opportunistic manipulation of earnings, and could impose pressure on managers, who are likely to manage earnings toward market expectations.

However, certain scholars have provided evidence that investigating the positive relationship between institutional investor shareholdings and earnings management is also important among firms. Benford's law has been promoted as a tool for the auditor to easily and effectively detect fraud (Durtschi et al., 2004). Consequently, we investigated the relationship between accounting conservatism, institutional investor shareholdings, and earnings manipulation using Benford's law to explore whether financial reporting complies with Benford's law at different levels of accounting conservatism and institutional investor shareholdings. Companies adopting lower accounting conservatism recognize that revenue could contain financial statement risk, which exposes investors to risk. Therefore, we assist investors in analyzing financial statements for decision-making. To assist investors in obtaining knowledge regarding the influence of accounting conservatism on earnings manipulation, this study explores the relation between investor shareholdings and earnings manipulation. Firm managers with lower institutional investor shareholdings and defective external monitoring mechanisms have more incentive to manipulate earnings. Therefore, this study assisted investors in knowing the influence of institutional investor shareholdings on earnings manipulation.

The main purpose of this study has two aspects. First, Benford's law has been widely employed in the finance field. Scholars have agreed that Benford's law is applicable to accounting audits and when examining whether enterprises manage earnings. In recent studies, numerous scholars have employed Benford's law to investigate earnings management in enterprises. In addition, scholars have varying opinions on the relationship between accounting conservatism and earnings management. Therefore, we used Benford's law to explore the relationship between accounting conservatism and earnings management; that is, whether data deviating from Benford's law is enhanced in enterprises adopting low accounting conservatism than enterprises demonstrating high accounting conservatism. Second, compared to typical investors, institutional investors possess abundant financial resources and expertise in investing and financing. Thus, numerous scholars have conducted research to explore the relationship between institutional ownership and earnings management. Velury and Jenkins (2006) asserted that institutional ownership is positively correlated with the information quality of corporate financial reports. However, when institutional ownership exceeds a certain proportion, this factor begins to negatively affect the information quality of corporate financial reports. Unlike earlier studies, we used quartiles to distinguish the various levels of accounting conservatism and then used the median to distinguish the different levels of institutional ownership. Therefore, we examined the influence that the interaction between accounting conservatism and institutional ownership has on earnings management. Benford's law was employed to analyze whether the financial data of enterprises deviated from Benford's law when enterprises exhibited various levels of accounting conservatism and different proportions of institutional ownership.

This paper made three contributions to the literature. First, most relevant studies have explored the relationship between accounting conservatism and earnings management or the relationship between institutional ownership and earnings management by using accruals or actual earnings-management models, respectively. Recently, a growing number of scholars have been adopting Benford's law when assessing whether enterprises managed earnings. For example, Guan et al. (2006) collected 182,278 positive quarterly earnings and 103,470 negative quarterly earnings from U.S. listed companies between 1993 and 2003 as the study sample and analyzed them according to Benford's law. Benford's law has not been used by previous studies for assessing the relationship between accounting conservatism and earnings management or for assessing institutional

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