



Accrual-based and real earnings management: An international comparison for investor protection



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ABSTRACT

This paper examines the differences in accrual-based and real earnings management across countries from the perspective of investor protection. Following prior research (Leuz et al., 2003), we hypothesize that accrual-based earnings management is more constrained by strict discipline in countries with stronger investor protection. For real earnings management in countries with stronger investor protection, we have two hypotheses. One is that real earnings management is more often implemented to substitute for accrual-based earnings management. The other is that real earnings management is less often implemented, as with accrual-based earnings management. Our examination uses data from 222,513 firm-year observations drawn from 38 countries covering 1991 to 2010. The results show that managers in countries with stronger investor protection tend to engage in real earnings management instead of accrual-based earnings management. We also find that real earnings management is constrained by analyst following. Our results are not affected by the control of audit quality or the calculation method used for earnings management measures according to country and year.

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1. Introduction

This paper examines the differences in accrual-based and real earnings management across 38 countries. Healy and Wahlen (1999, 368) state that earnings management occurs 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. Earnings management occurs through a change in the accrual process or a deviation from normal business activity, or both simultaneously; the former is called “accrual-based earnings management” (AEM) and the latter “real earnings management” (REM).

Earnings management is affected not only by the factors relating to each manager and firm but also by institutional factors such as laws, market mechanisms, and regulations (Wysocki, 2004). Institutional factors vary across countries. International comparative studies on earnings management have been very important and fruitful (Gordon et al., 2013; Wysocki, 2011). International comparative studies on earnings management have concentrated on AEM. Leuz et al. (2003) consider investor protection as an institutional factor influencing managerial behavior and investigate whether investor protection in various

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countries was related to AEM.¹ They examine the relationship between outside investor protection and earnings management in 31 countries from 1990 to 1999, finding that AEM decreases in countries with stronger investor protection.

Boonlert-U-Thai et al. (2006) also investigate the relationship between investor protection and earnings management using data from 31 countries covering 1996 to 2002, suggesting that earnings were smoothed in countries where investor protection was advanced. Shen and Chih (2005) show that earnings management declines in countries with stronger investor protection and more transparent accounting disclosure for banks in 48 countries from 1993 to 1999.

Most of the research uses accrual-based measures as key proxies of earnings management. Besides accrual processes, managers can also change real activities to manage earnings. Recent studies have examined REM as an important topic in research on earnings management (e.g., Roychowdhury, 2006). While REM could have a negative impact on firms' future value (e.g., Bhojraj et al., 2009; Cohen and Zarowin, 2010), neither regulators nor auditors can restrain firms from engaging in REM.² Scrutiny by regulators and auditors is weaker for REM than for AEM; thus, the costs of REM are lower (Francis et al., 2011).

Managers might choose cost-effective methods based on the features of AEM and REM; studies have analyzed the substitutability of the two types of earnings management. For example, Cohen and Zarowin (2010) and Zang (2012) present evidence on the tradeoffs between AEM and REM in U.S. firms. Zang (2012) finds tradeoffs between AEM and REM by focusing on their constraints. The results of their studies as well as those in Leuz et al. (2003) raise the questions of whether investor protection has an effect on REM in the international setting and whether substitution occurs between AEM and REM. In line with the focus on tradeoffs in REM research, we hypothesize that the level of investor protection in each country leads to such tradeoffs. Investor protection has developed globally, but national development levels vary; for example, the Sarbanes–Oxley Act is specific to the United States. Consequently, we can analyze the substitutability of the two types of earnings management at the international level. We predict that REM, rather than AEM, will be implemented in countries with stronger investor protection.

Managers might implement REM in order to bring earnings to a target level and conceal “true” firm performance and behavior, similar to the use of AEM. Additionally, REM could have a negative impact on a firm's future value and be undesirable for investors. For example, Cohen and Zarowin (2010) find that firms issuing seasoned equity offerings (SEO) engage in REM and that the decline in post-SEO performance due to REM is more severe than that caused by AEM. Kim and Sohn (2013) suggest that REM is positively associated with the implied cost of equity even after controlling for the effects of AEM. Thus, managers in countries with stronger investor protection might avoid REM as well as AEM. In this scenario, REM is less prevalent in countries with stronger investor protection.

Following Leuz et al. (2003), we measure AEM using three proxies: (1) the ratio of the standard deviation of operating income to that of operating cash flow, calculated with time-series data from each firm; (2) the correlation between changes in accruals and changes in operating cash flow computed from the pooled data in each country; and (3) the ratio of the absolute value of accruals to that of operating cash flow calculated in each firm-year. We measure REM employing two proxies: (1) the correlation between changes in sales and production costs and (2) the correlation between changes in sales and discretionary expenses.³

As investor protection variables, we use the strength of legal enforcement and the extent of outside investor rights under corporate and security law (La Porta et al., 1998, 2006). Furthermore, we treat disclosure regulations and the analyst's role as important investor protection factors, including the disclosure index and analyst following.

Our examination employs 222,513 firm-year observations from 38 countries covering 1991 to 2010. The results show that managers in countries with stronger outside investor rights tend to engage in REM instead of AEM and that REM is constrained by analyst following. This result is not affected by the control of audit quality or the calculation of earnings management measures according to country and year.

This paper offers two main contributions. First, most international comparative studies on earnings management (e.g., Leuz et al., 2003; Shen and Chih, 2005; Boonlert-U-Thai et al., 2006) have looked only at AEM. We also investigate REM based on the theoretical relationship between REM and AEM, finding a substitution effect between them regarding outside investor rights at the country level. However, the results also indicate that analyst following restricts REM. Taken together, the findings suggest that managers tend to apply REM where the legal environment constrains AEM and that the development of security markets increases the monitoring of managerial discretionary behaviors. Second, our results are much more reliable than those of previous studies because of our larger sample size and longer-term investigation.

The rest of this paper is organized as follows. Section 2 discusses AEM and REM and provides some institutional background. Section 3 shows our sample selection procedures and the measures of earnings management and investor protection. Section 4 presents the results on the relationship between earnings management and investor protection. Section 5 discusses some additional analyses, and Section 6 concludes the paper.

¹ Investor protection is the power to prevent managers from expropriating minority shareholders and creditors within the constraints imposed by law (La Porta et al., 2002; Leuz et al., 2003).

² Gunny (2010) suggests that REM makes a positive impact on the future value of firms.

³ The correlation between the changes in sales and cash flows from operations, employed in Roychowdhury (2006), is not included for the reason given in Footnote 7.

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