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# Real Earnings Management, Institutional Environment, and Future Operating Performance: An International Study

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## ABSTRACT

This paper investigates the association between firms' engagement in real activities manipulation (hereafter REM) on future firm performance in an international setting, and whether the association is conditional upon country-level institutional factor. Our inquiry is motivated by a paucity of research on the consequences of REM in an international setting. Using a large sample over the period of 2001 to 2015, we find that current-period REM is positively associated with future performance: a finding that is consistent with Gunny (2010) in the US. Importantly, we find that the positive performance effect is driven by firms operating in countries with strong institutional environments. Finally, we find that future operating performance improves when REM is undertaken by firms in strong institutional environments only during a non-economic crisis period, but not during an economic crisis period. The paper adds to the existing REM literature by showing a non-monotonic effect of REM on future performance that is conditional on the strength of a country's institution. We also contribute to the accounting information and crisis literature by documenting a time-variant effect of REM on future performance.

## 1. Introduction

This paper investigates the association between firms' engagement in real activities manipulation (hereafter REM) on future firm performance in an international setting, and whether the association, if any, is conditional upon country-level institutional factors. A sizable volume of academic research has shown that managers manipulate reported earnings by changing accounting methods or estimates (also known as accrual-based earnings management, hereafter AEM) (Dechow, Ge, & Schrand, 2010). However, the opportunistic reporting behaviour of firms is not limited to AEM alone. To boost short-term reported earnings artificially, managers also manipulate the timing or structure of real operations. Increasingly, recent REM studies in the US explore the mechanisms of REM (Roychowdhury, 2006); managerial trade-offs between REM and AEM (e.g., Cohen, Dey, & Lys, 2008; Zang, 2012); and the consequences of REM for firm operating performance (e.g., Ewert & Wagenhofer, 2005; Gunny, 2010).

A recent stream of research has started to investigate the determinants of REM in an international setting, incorporating legal regimes and country-level investor protections as likely determinants of the degree of REM activities, as well the extent to which REM substitutes for AEM (Braam, Nandy, Weitzel, & Lodh, 2015; Choi, Choi, Kim, & Sohn, 2012; Enomoto, Kimura, & Yamaguchi, 2015; Ipino & Parbonetti, 2017). However, the consequence of REM for future performance internationally has remained unexplored, and this is the focus of our study.

Competing hypotheses exist regarding the association between REM and future firm performance. On one hand, engagement in

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REM can impact firms' long-term productivity and performance adversely, because these practices deviate from normal business operations, alter firm's future cash flow patterns, and may hamper innovation (Roychowdhury, 2006). For instance, cutting R&D expenditure, a major means of REM, boosts earnings temporarily but harms the firm's long term competitiveness and is detrimental to its performance in the long run. On the other hand, firms may conduct REM strategically to avoid both immediate loss and failure to reach the current period's earnings targets, thereby signalling the firm's potential for better performance in the future. Thus, REM can be associated with relatively better subsequent performance (Gunny, 2010). Using US data, Gunny (2010) finds evidence consistent with this hypothesis. Zhao, Chen, Zhang, and Davis (2012) find that, although abnormal real activities in general are associated with a weaker future performance, abnormal real activities intended to just meet earnings targets are associated with a higher future performance.

We propose that the investigation of the performance effects of REM internationally is very significant, given the wide variation in country-level institutional features, e.g., investor protection, enforcement of law, and ownership concentration. Specifically, we argue that strong institutional factors inhibit value-destroying REM activities and discipline managers to conduct REM more efficiently, resulting in enhanced future performance. As an additional test, we also examine whether the association between REM and future operating performance, conditional on institutional features, responds to changes in business cycles (contraction versus expansion cycle). We undertake this analysis in order to complement a growing literature that investigates the effect of the business cycle on various facets of financial reporting in a single country setting (e.g., Ahmad-Zaluki, Campbell, & Goodacre, 2011; Jenkins, Kane, & Velury, 2009; Saleh & Ahmed, 2005).

We choose four common proxies used by international studies to measure the strength of institutional environment. First, a country's legal origin has strong ramifications for financial development, including development of an efficient accounting regime (Ball, Kothari, & Robin, 2000; Habib, 2008). It is postulated that accounting information produced in common law countries is of higher quality, as manifested in earnings management lower than that produced in code law countries. This is because the common law countries enforce rules and regulations aimed at protecting minority shareholders' interests, encouraging corporate managers to provide value-relevant information to market participants (Ali & Hwang, 2000; Ball et al., 2000; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002; Leuz, Nanda, & Wysocki, 2003).

Strong investor protection and legal enforcement give rise to high quality accounting information by mitigating the opportunities for corporate insiders to expropriate minority shareholders' interests (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998; Bushman & Smith, 2001). Legal enforcement also protects investors' rights through regulations and laws on accounting and disclosure rules. Finally, another country-level institutional variable, ownership concentration, is reported to be inversely associated with the quality of a country's information disclosures (Bushman, Chen, Engel, & Smith, 2004; La Porta et al., 1998). Managers would have more opportunities to expropriate outside investors via earnings management when insiders have higher private benefits of control made possible through concentrated ownership (e.g., Sanchez-Ballesta & Garcia-Meca, 2007). Although the above studies find that a strong country-level institutional environment constrains opportunistic AEM, this does not necessarily imply lack of earnings manipulation. Indeed, existing research finds that managers switch to REM in countries with strong institutional environments (Choi et al., 2012; Enomoto et al., 2015).

Using 158,587 firm-year observations from 29 countries over the period of 2001–2015, we find evidence that current-period REM is positively associated with future performance: a finding that is consistent with Gunny (2010) in the US. Importantly, we find that the positive performance effect is driven by firms operating in countries with strong institutional environments. The sub-sample analysis on the effect of REM on future performance between countries with strong vs. weak institutional environments reveals a significantly positive effect of REM on future performance from firms operating in strong institutional environments but an insignificant or negative effect of REM in weak institutional environments. Finally, we find that future operating performance improves when REM is undertaken by firms in strong institutional environments only during a non-economic crisis period, but not during an economic crisis period.

We contribute to the earnings management literature in an international context in a number of ways. First, we add to the REM literature by focusing on the consequence of REM. In comparison to the literature on REM determinants, the consequences of REM are under-studied. To our knowledge, this paper is the first to investigate the performance implications of REM in an international setting. Although there appears to be a belief that REM affects future performance favourably (Gunny, 2010), we posit that such an association could vary depending on the country-level institutional environment, as strong institutions motivate efficient use of REM. Second, we also contribute to the accounting information and crisis literature internationally by documenting a varying effect of REM on future performance during a non-economic crisis period vs. an economic crisis period.

The remainder of the paper proceeds as follows: Section 2 reviews the related literature and develops the hypotheses; the next section describes the research design and sample selection procedures. Section 4 provides descriptive statistics and presents a correlation analysis. The main test results are reported in Sections 5 and 6 reports additional test. The final section concludes.

## 2. Literature review and the development of hypotheses

In the field of accounting, real earnings management has attracted increasing attention as an alternative to accrual-based earnings management. REM has been defined "...as departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations" (Roychowdhury, 2006, p. 337). Graham, Harvey, and Rajgopal (2005) find that managers are willing to sacrifice long-term value by cutting down on discretionary expenditures in order to meet or beat analysts' forecasts. Although the underlying incentives for firms

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