Earnings Management: An Analysis of Opportunistic Behaviour, Monitoring Mechanism and Financial Distress

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Abstract

The aim of this study is to analyze the relationship between opportunistic behaviors (free cash flow and profitability), monitoring mechanism (leverage) and pressure behaviors (financial distress) toward earnings management. There are indeed several factors that could motivate the managers to manage earnings. In this study, it is assumed that the management incline to manage earnings in order to avoid reporting losses or to avoid showing any decreases in the reported earnings. This empirical research with a sample of Malaysian public listed companies from year 2010 to 2012 shows that managers of the companies would engage in earnings management when the company is financially healthy and when the profit of the company is high. The result of this study would provide a valuable explanation on the relationship between variables, thus, would give relevant views to regulators in tightening the rules and regulation in order to promote public confidence in the reliability of financial reporting.

Keywords: Earnings Management, opportunistic behaviour, leverage, financial distress, monitoring mechanism

1. Introduction

The primary purpose of reporting financial statements is to deliver annual company’s financial information to both external and internal stakeholders in a reliable and timely manner. A major element of the report is accounting earnings, which are used to assist the users in developing corporate policies. Major decisions like capital raising,
debt covenants, executive remuneration, are shaped based on the available information reported in annual reports. For external investors, they basically can make more informed investment decisions based on the information acquired in the reports. Idyllically, the reported earnings should reflect a company’s underlying operating economics and simplify efficient resource allocation within the company. Nonetheless, given the control advantages that manager have in reporting and collecting firm specific information over external information users, manager have the opportunity to present the company’s earnings in a manner that is most suitable for the company or for themselves. Commonly known as earnings management (EM), this topic is of considerable interest to academics and practitioners (Hatam et al., 2013).

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” (Healy & Wahlen, 1999). Earnings information can be used by the managers to convey superior and useful information which they know about company performance to shareholders and debt holders. If this is the case, then, earnings management may not be harmful to the stockholders and the public. Nevertheless, the financial scandal at WorldCom and Enron changed the outlook of earnings management toward an opportunistic view. With regards to this view, managers manage earnings for their own private benefits rather than for the benefits of the stockholders (Watts & Zimmerman, 1986; Subramanyam, 1996; Holthausen, 1990; Healy & Palepu, 1993; Guay et al, 1996; Demski, 1998; Arya et al, 2003; Hao, 2010 & Jiraporn et al, 2008).

Unlike fraud, earnings management encompasses the selection of accounting and estimates that conforms to the generally accepted accounting principles (GAAP). This implies that companies that practice earnings management would manage their earnings within the limits of accepted accounting procedures (Rahman &Ali, 2006). However, certain monitoring mechanisms can prevent managers from inflating the earnings. The monitoring hypothesis acknowledge the impact of external monitoring (such as monitoring by creditors) on the practice of earnings management. Under constant monitoring, inflated earnings through management are likely to be detected and, therefore, unlikely to affect stock prices (Shih & Yueh, 2002).

Meanwhile, pressure from financial distress too has significant adverse effects of an economy, whereby investors and creditors could possibly suffer substantial financial loss. If the firm is in financial distress, managers would anticipate that having their bonuses cut, possibility of being replaced and suffer damage in their career, reputation (Liberty & Zimmerman, 1986; Gilson, 1989). Hence, for conservative management, managers would take opportunity to conceal such a deteriorating performance by choosing different accounting methods that increase income and could conceal the loss (Habib, Bhuiyan & Islam, 2013). Rosner (2003) reports that firms that become bankrupts ex post, but do not appear ex ante, engage in income-increasing earnings manipulation practices.

Therefore, the aim of this study is to analyze the relationship between opportunistic behaviors (free cash flow and profitability), monitoring mechanism (leverage) and pressure behaviors (financial distress) toward earnings management. The result of this study would provide a valuable explanation on the relationship between variables, thus, would give relevant views to regulators in tightening the rules and regulation in order to promote public confidence in the reliability of financial reporting. This study is also expected to provide useful information to current and potential investors as well as to regulatory authorities who are responsible in observing the quality of financial reporting of firms more closely.

2. Literature Review & Hypothesis Development

2.1 Earnings Management

From a broad perspective, accounting is all about the measurement and communication of economic information to the users of financial information. Depending on the type of the users of the information be it creditors, lenders, regulators or public at large, accounting is divided into internal and external accounting. While internal accounting is used for decision making within the firm such as project and profitability evaluation, external accounting is used to assist stakeholders in decisions concerning their relationship with the firm. Thus, external accounting should deliver useful information for investors, creditors, regulators, customers, suppliers and employees in their respective decisions regarding future investments, taxes, whom doing business and with whom to work for (Watts & Zimmerman, 1986; Spohr, 2005).
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