A Review of Earnings Management

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1. Introduction

Managerial opportunistic behaviors regarding reported earnings have received considerable attention from regulators and practitioners, since the recent accounting scandals by giant companies such as Enron, WorldCom and Xerox (Levitt, 1998). Following Healy and Wahlen (1999), earnings management is defined as the *"alteration of firms' reported economic performance by insiders to either mislead some stakeholders or to influence contractual outcomes"*.

Insiders' incentives to misrepresent the reported performance potentially derive from the conflicts of interest between insiders (controlling shareholders or managers) and outsiders (usually minority shareholders). In contrast to Berle and Mean's (1932) image of widely dispersed corporate ownership in the U.S. and U.K., recent literature (Shleifer and Vishney, 1997; La Porta, Lopez-de-Silanes and Shleifer, 1999; Claessen, Djankov and Lang, 2000; Claessen and Fan, 2002; Claessens, Djankov, Fan and Lang, 2002) suggest that, even in developed countries, ownership is relatively concentrated to the degree that one owner possesses effective control over the firm. Meanwhile, divergence exists between control rights and cash flow rights through pyramidal structure, cross-shareholdings and dual-class shares. Under these circumstances, insiders are released from disciplinary governance mechanisms (Shleifer and Vishny, 1997; La Porta et al.,

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1999; Johnson, La Porta, Lopez-De-Salinas and Shleifer, 2000; Fan and Wong, 2002; Liu and Lu, 2007) and motivated to extract private benefits of control at the expense of minorities' wealth (Claessens et al., 2002; Lins, 2003; Denis and McConnell, 2003; Leuz, Nanda and Wysocki, 2003).

If these benefits are detected from financial reports, outside intervention and heavy penalty would be imposed on insiders. Therefore, insiders have incentive to conceal their value-decreasing behaviors by managing reported earnings (Kim and Yi, 2006; Leuz et al., 2003; Fan and Wong, 2002). For instant, insiders can use accounting discretion to overstate earnings and conceal poor performance. In well-performing years, insiders can also exert reporting discretion to understate earnings and create reserves for future. In either case, insiders are capable of concealing their evidence of expropriation by manipulating the level and variability of reported earnings.

This paper reviews the existing literature in term of earnings management around the world and summarizes the determinants of earnings management. These factors are extensively studied in single country analyses as well as in international setting.

Accounting standards will determine the degree of managerial discretion on revenue and loss recognition and thereby affect the level of corporate earnings management. The introduction of International Financial Reporting Standards (IFRS) offers researchers an appropriate opportunity to investigate whether accounting standards affect the degree of earnings management as well as raises the question of whether IFRS improves earnings quality uniformly around the world. Barth, Landsman and Lang (2008), Barth, Landsman, Lang and Williams (2012), Liu, Yao, Hu and Liu (2011) and Cormier, Demaria, Lapointe-Antunes and Teller (2009) suggest earnings quality increases with the adoption of IFRS. In contrast, He, Wong and Young (2012), Rudra and Bhattacharjee (2012) and Callao, Jarne and Lainez (2007) find that earnings management increases after the introduction of IFRS in China, India and Spain.

Numerous studies have also investigated the relationship between corporate governance structures and earnings management. Early studies focus on a single country (typically the US or other OECD countries) and generally find a negative impact of the efficiency of firm-level governance devices (such as ownership structure, board of directors and audit quality) on earnings management.

Meanwhile, the noble survey by Dechow, Ge and Schrand (2010) suggests that recent literature pays increasing attention to cross-country variation in earnings management and its relation to country-level legal systems. These studies generally document a negative association between country-level investor protection and earnings management (Leuz et al., 2003; Haw, Hu, Hwang and Wu, 2004; Shen and Chih, 2005; Burgstahler, Hail and Leuz, 2006; Lang, Raedy and Wilson, 2006). Strong legal systems allow minority shareholders to effectively prevent controlling shareholders from extracting private benefits (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1998; Nenova, 2000; Claessens et al., 2002; Dyck and Zingales, 2004). As a result, controlling shareholders have a weak incentive to manage reported earnings in those countries.

To date, the survey on earnings management is extremely limited. The purposes of this paper are to review the literature of earnings management in both single-country and cross-country settings and to provide readers with an integrated perception about the determinants of earnings management. This is especially important for researchers who intend to review the results of the effect of a specific determinant on earnings management.

The rest of the paper is organized as follows. Section 2 presents analysis of accounting standards and earnings management. Section 3 discusses corporate governance and earnings management. Previous literature on legal protection and earnings management is shown in Section 4. Section 5 concludes this study and presents suggestions for future research.

2. Accounting standards and earnings management

The market globalization which has been accelerated during the past few decades generates huge demands among investors for international harmonization in financial reporting process (Barth et al., 2012; He et al., 2012). Accordingly, accounting regulators, namely the International Accounting Standards Committee (IASC) and its successor the International Accounting Standards Board (IASB), attempt to increase the compatibility and value relevance of earnings information by developing an internationally acceptable set of financial reporting standards (Ashbaugh and Pincus, 2001; Daske, Hail, Leuz and Verdi, 2008; Liu et al., 2011). IFRS is a typical of such accounting standards. Following the attempt to converge accounting information across countries in the European Union, IFRS has been adopted by over 100 countries and regions. The introduction of IFRS provides us with an appropriate opportunity to examine whether accounting standards significantly affect the level of earnings management.

The intended objective of IFRS is to provide *"a high degree of transparency and comparability of financial statements and hence an efficient functioning of the community capital market and of the internal market"* (European Communities, 2002: Art.1). To achieve this goal, IFRS embraces principle-based standards (Ashbaugh and Pincus, 2001). IFRS also requires accounting measurements that better reflect underlying performance and that provide investors with informative accounting information for their decision-making (IASC, 1989). However, previous studies regarding the impact of IFRS introduction on earnings quality present mixed results.

Ewert and Wagenhofer (2005) theoretically model the economic effects of tightening accounting standards. By providing clear rules and limiting the impact of judgment by managers (or auditors), tighter accounting standards tend to increase earnings quality measured by the variability of reported earnings as well as the association between reported earnings and the market price reaction (value relevance of earnings).

Barth et al. (2008) conclude that firms adopting the International Accounting Standards (IAS) from 21 non-US countries manage reported earnings less than matched firms applying domestic standards. Barth et al. (2012) show similar evidence that the implementation of IFRS by non-US firms generates accounting amounts which are comparable to those deriving from the adoption of US Generally Accepted Accounting Principles (GAAP) by matched US firms. Less earnings smoothing, less accruals and more timely loss recognition are the potential sources of increased comparability.

Liu et al. (2011) indicate that accounting quality of Chinese listed companies has improved with decreased earnings management and increased value relevance of accounting measures since the mandatory implementation of IFRS-convergent new accounting standards in 2007. Similarly, Cormier et al. (2009) find that the first-time adoption of IFRS by French firms is associated with increased quality of financial statement. Clarkson, Hanna, Richardson and Thompson (2011) provide evidence that difference in value-relevance of earnings between Common and Code law countries disappears after the adoption of IFRS, suggesting that IFRS implementation enhances the comparability. Djatej, Gao, Sarikas and Senteney (2011) find that the quality of public information increases due to the implementation of IFRS in both Eastern and Western European firms.

In contrast, He et al. (2012) address the unintended consequences of mandatory IFRS adoption by investigating China's adoption of IFRS-convergent new accounting standards since 2007. They report that the adoption of fair value accounting (a vital feature of China's new accounting standards) motivates firms to smooth reported earnings by selling available-for-sale security. The results suggest that the unintended effect of IFRS implementation likely exists in countries where reported earnings' contracting role is more important than their information role, and that China's institutional environments are incompatible with the adoption of IFRS.

By examining how accounting standards and insiders' incentives affect earnings management in China, Zhang, Uchida and Bu (2013) show that the magnitude of earnings management significantly increases after the introduction of IFRS-convergent new accounting standards. The results provide consistent evidence with He et al. (2012) that the adoption of IFRS-convergent new accounting standards potentially increases managerial discretion on financial reporting.

In like manner, Jeanjean and Stolowy (2008) investigate the effect of mandatory implementation of IFRS on earnings management in three first-time adopters (Australia, France and the UK). The results show that the level of earnings management does not decline after the adoption of IFRS, even increases in France. This supports the conventional wisdom that managerial incentives and institutional environments play more important roles in determining the quality of financial reporting compared to accounting standards alone.

Similar evidence is also found in Germany which has a Code-law system and provides low investor protection. Tendeloo and Vanstraelen (2005) examine whether German firms voluntarily adopting IFRS prior to 2005 tend less to manage earnings compared to those reporting under German GAAP. They show evidence that IFRS-adopted firms do not present different earnings management behavior relative to firms under German domestic GAAP. The results imply that high quality accounting standards are not sufficient or effective in countries with weak investor protection.

Callao et al. (2007) focus on the impact of IFRS on comparability and relevance of accounting information in Spain. They find that comparability of financial reporting becomes worsen if the IFRS and local GAAP are simultaneously adopted in the same country at the same time. Besides, there is no improvement in relevance of financial reporting to stock market after the implementation of IFRS. In summary, the results suggest that IFRS introduction does not improve the quality of financial reporting in Spain. Rudra and Bhattacharjee (2012) also provide Indian evidence that firms adopting IFRS are more likely to engage in earnings management (income smoothing) compared to non-adopting firms.

3. Corporate governance and earnings management

Denis and McConnell (2003) define corporate governance as *"the set of mechanisms that induces the self-interested controllers of a company (those that make decisions regarding how the company will be operated) to make decisions that maximize the value of the company to its owners (the suppliers of capital)."* Well-designed corporate governance structures are an effective way to mitigate expropriation problems and earnings management (Shleifer and Vishny, 1997; La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2000a; Klapper and Love, 2004; Gillan, 2006; Liu and Lu, 2007).

3.1 Ownership structure

Corporate ownership structure is the most important source of agency conflicts (Claessens and Fan, 2002; Shleifer and Vishny, 1997; Liu and Lu, 2007).

A few insiders who own the majority of shares of a company will be released from disciplinary mechanisms (Shleifer and Vishny, 1997; La Porta et al., 1999; Johnson et al., 2000; Fan and Wong, 2002; Liu and Lu, 2007). Consequently, concentrated ownership structure would give insiders more power to expropriate minority shareholders' wealth, namely entrenchment effect. Additionally, divergence between control and cash flow rights can exacerbate the entrenchment effect caused by concentrated ownership structure. Pyramids, cross-shareholding and dual-class shares, which decrease the cash flow investment needed, are typical sources of such control divergence. In this circumstance, insiders are motived to extract firm wealth and enjoy the entire benefits but only bear a limited fraction of cost due to their low cash flow ownership (Claessens et al., 2002; Lins, 2003; Denis and McConnell, 2003; Leuz et al., 2003). In either case, insiders are likely to distort financial reports in order to conceal evidence of their value-destroying behaviors and to avoid potential outside interventions. For example, insiders can easily adopt their discretion on reporting and incorporate wealth effects of their expropriation activities in the aggregate earnings numbers without reporting them as separate income statement items.

Fan and Wong (2002) investigate the relation between ownership structure and earnings informativeness in 7 East Asian countries. They find that voting rights level of ultimate controllers is negatively associated with earnings informativeness, which is consistent with the entrenchment effect. Their evidence also shows that after controlling for the level of voting rights, control divergence significantly weakens the informativeness of earnings.

Haw et al. (2004) investigate the relation between income management and ownership structure in 9 East Asian and 13 Western European countries, and find that high income management is associated with the increased divergence between controlling shareholders' voting rights and cash flow rights.

Gopalan and Jayaraman (2012) examine earnings management of insider-controlled firms and non-insider-controlled firms across 22 countries, and show evidence that insider-controlled firms with greater divergence between control rights and cash flow rights engage more in earnings management.

Based on data from a large cross-section of Chinese listed firms from 1998 to 2003, Firth, Fung and Rui (2007) find that ownership concentration significantly weakens earnings quality (lowers the earnings-return relation and increases discretionary accruals), and the proportion of non-tradable shares over total outstanding shares is positively related to earnings management[1). Jiang and Habib (2012) present similar evidence that there is a positive and significant relation between non-tradable shareholding and earnings management during 2001 to 2004 (before the split-share structure reform).

Differently from controlling shareholders, foreign investors are subject to severe information asymmetry and have only limited opportunity of private benefit extraction (Brennan and Cao, 1997; Kang and Stulz, 1997; Choe, Kho and Stulz, 2005). Financial statements are an essential measure for foreign shareholders to prevent controlling shareholders from expropriating their

1) Non-tradable share holdings allow Chinese majority shareholders to retain strong control power on the company. Meanwhile, they neither benefit from capital gains nor bear losses from stock price reductions. As a result, there is a divergence between control rights and cash flow rights that gives majority shareholders an incentive to extract private benefits at the expense of minority shareholders' wealth.

wealth. Consistent with this idea, Leuz, Lins and Warnock (2010) find that foreign (US) investors have high equity stakes in firms that engage less in earnings management. Aggarwal, Klapper and Wysocki (2005) show evidence that in emerging markets US mutual funds invest mainly in firms with high accounting transparency. Bradshaw, Bushee and Miller (2004) show that US institutional investors tend to invest in firms that conform with US GAAP. These studies suggest that high earnings quality invites ownership by foreign shareholders who have an opposite characteristic to controlling shareholders. Once foreign investors buy shares in a company, they are likely to require the firm to disclose information that is more transparent.

3.2 Board of directors

Corporate boards are an important governance device that is expected to monitor insiders' behaviors. Numerous studies have investigated whether board characteristics affect earnings management and earnings informativeness (Beasley, 1996; Vafeas, 2000; Klein, 2002; Park and Shin, 2004; Ahmed, Hossain and Adams, 2006; Firth et al., 2007; Dimitropoulos and Asteriou, 2010; Xie, Davidson and DaDalt, 2003; Wang, Liu and Lu, 2007; Liu and Lu, 2007; Lo, Wong and Firth, 2010).

Large board tends to have much expertise that increases the ability of detecting insiders' wrong behaviors. Coles, Daniel and Naveen (2008) find a positive relation between board size and performance of complex companies. This idea suggests that earnings management decreases with board size. In contrast, large board is subject to free-riding problems and high coordination costs among board members (Vafeas, 2000). Indeed, some previous studies show evidence that large board is associated with low firm performance (Bennedsen, Kongsted and Nielsen, 2008; Eisenberg, Sundgren and Wells, 1998; Yermack, 1996). Therefore, large board is less effective than small board (Jensen, 1993; Lipton and Lorsch, 1992). Indeed, Vafeas (2000) and Ahmed et al. (2006) find a negative and significant relation between board size and informativeness of earnings.

Outside directors are likely to bear substantial reputation costs if they fail to effectively monitor management (Fama and Jensen, 1983; Srinivasan, 2005). It is also a common idea that outside directors have more incentive to protect investors' (especially minority shareholders') interests than inside directors do (Fama and Jensen, 1983; Vafeas, 2000; Brickley and James, 1987; Byrd and Hickman, 1992; Xie et al., 2003). Thus, more outside-oriented board makes it difficult for insiders to expropriate minority shareholders' wealth and manage earnings. Liu and Lu (2007) suggest that discretionary accruals are negatively related to the proportion of directors who receive no compensation from the firm over board members. Lo et al. (2010) show that in China, board independence is negatively related to the level of transfer pricing manipulations. Similar results are also found in U.S. and U.K. companies by Klein (2002), Xie et al. (2003) and Peasnell, Pope and Young (2005). By contrast, Vafeas (2000) and Park and Shin (2004) find that the proportion of outside directors is generally unrelated to the informativeness of earnings and abnormal accruals, suggesting that increasing outside directors on board may not achieve improvement in governance practices by itself.

Additionally, corporate governance researchers investigate how the dual role of board chairman and CEO affects firm value and managerial behaviors (Forker, 1992; Jensen, 1993; Dechow, Sloan and Sweeney, 1996; Raheja, 2005). When board leadership and CEO power are vested in one person, the CEO is able to exert strong power and board members will find it difficult to oversee managerial behaviors (Jensen, 1993; Raheja, 2005). Forker (1992) and Dechow et al. (1996) find that firms that manipulate earnings are more likely to have a CEO who simultaneously serves as chairman of board.

3.3 Audit quality

DeAngelo (1981) define audit quality as the joint probability that an existing material error is detected and reported by an auditor. Auditors can mitigate the intentional and unintentional misstatement of client firms, and therefore determine firms' reporting behaviors. Audit quality potentially depends on auditors' efforts and effectiveness.

Caramanis and Lennox (2008) adopt the hours spent auditing as a proxy for efforts/effectiveness, and find that lower auditing hours increase the extent to which manager aggressively reports high earnings.

Industry expertise is another typical proxy for audit efforts/effectiveness. Compared to non-Big X auditors, international Big X auditors are perceived to enforce high earnings quality since they bear relatively high cost of reputation-destroying if their client engages in misreporting. Besides, Big X audit firms are likely to have well-educated and sophisticated staffs who have high ability to detect earnings management (Krishnan, 2003).

Krishnan (2003) examines the relation between audit quality and pricing of discretionary accruals. Results show that the linkage between market stock return and discretionary accruals is much sensitive for firms audited by international Big 6 auditors than for firms audited by non-Big 6 auditors. It suggests that auditing plays a crucial role in mitigating agency problem through limiting managerial discretion in reporting process. Iatridis (2012) shows evidence that client of big auditor exhibits lower discretionary accruals in both Common-law South Africa and Code-law Brazil.

4. Legal protection and earnings management

Recent law and finance literature suggests that the degree of legal protection is associated with various aspects of corporate finance and governance, including ownership concentration (La

Porta et al., 1999), dividend policy (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2000b), foreign listing (Doidge, Karolyi and Stulz, 2004), group affiliation (Kali, 1999), bankruptcy (Claessens, Djankov and Klapper, 2003) and so on. An underlying idea of these studies is that legal protection effectively mitigates agency problems between controlling shareholders and minority shareholders (Type II agency problem), which are especially evident in firms with concentrated ownership structures. A developed legal system imposes high risk of future litigation and significant costs of damaged reputation on corporate insiders who extract private benefits (La Porta et al., 1998; Claessens et al., 2002; Dyck and Zingales, 2004). Therefore, earnings management decreases with legal protection.

Leuz et al. (2003) measure country-level earnings management by using aggregate score which incorporates four individual measures of earnings management: smoothing reported earnings using accounting accruals, correlation between changes in accounting accruals and operating cash flows, the magnitude of accounting accruals and small loss avoidance. Adopting the aggregate score, they investigate earnings management across 31 countries worldwide and demonstrate that earnings management decreases with strong investor protection, strong legal enforcement, developed stock markets and dispersed ownership.

By examining the properties of reported earnings of both private and public firms in the European Union, Burgstahler et al. (2006) provide evidence that earnings management is more pronounced in countries with weaker legal system and enforcement. Their measures of earnings management are similar to those adopted by Leuz et al. (2003), but are constructed at the industry level.

Haw et al. (2004) find that income management arising from the divergence between control rights and cash flow rights of ultimate owners is significantly limited in countries with high legal protection (e.g. tradition of legal system, protection of minorities' rights, efficiency of judicial system) and effective extra-legal institutions (such as effectiveness of competition laws, diffusion of the press and tax compliance).

Compared the U.S. firms' earnings with reconciled earnings for non-U.S. firms that are cross-listed in the U.S., Lang et al. (2006) find that earnings management (proxied by smoothness, tendency to report small profits and ERC) is more evident in cross-listing non-U.S. firms where domestic legal environments are less protective and managerial incentives to manipulate earnings are relatively stronger.

Francis and Wang (2008) demonstrate that earnings quality (measured by the level of discretionary accruals, tendency of reporting a loss and timely loss recognition) is greater in regimes with stronger investor protection, but only for firms audited by Big 4 auditors. The results suggest that investor protection affects earnings quality through the incentives of Big 4 auditors.

In addition to investor protection, legal protection of intellectual property rights also affects the level of earnings management. Precise disclosure of proprietary information (such as profitable technology or R&D information) can adversely affect firm value if that information induces unwanted political/social scrutiny or competitors acquire that information to the detriment of disclosing firm. Therefore, firms with proprietary knowledge have an incentive to adopt opacity (less transparency) in order to prevent technology spillovers to public and potential competitors (Fan and Wong, 2002). This is especially true for firms located in regions with weak legal protection of intellectual property rights. Consistent with this idea, Fan, Gillan and Yu (2013) show evidence that income smoothing of Chinese firms is negatively related to provincial legal protection of intellectual property rights.

5. Conclusions and suggestions

We emphasize following conclusions based on review of the earnings management literature that (1) corporate insiders have incentive to expropriate wealth from firms they control to benefit themselves at the expense of outsiders, and therefore engage in earnings management to conceal their value-decreasing behaviors; (2) the adoption of internationally acceptable accounting standards (e.g. IFRS) can mitigate insiders' earnings management by enforcing firms to provide earnings information with compatibility and value relevance. However, unintended effect of IFRS adoption exists in countries where institutional environments are incompatible with the implementation of IFRS; (3) concentrated ownership structure and divergence between voting rights and cash flow rights exacerbate corporate insiders' extraction of private benefits and thus boost their needs to manage reported earnings; (4) however, other well-designed corporate governance mechanisms can limit expropriation problems and earnings management, such as existence of foreign ownership and high audit quality; (5) protective legal environment imposes high future litigation risk and significant reputation-destroying costs on corporate insiders, and therefore effectively attenuates agency problems and earnings management.

Most of previous literature focuses on the single determinant of earnings management. However, extremely limited studies pay attention to the comparable or interactive effects among different factors on earnings management. For example, how do accounting standards and corporate governance mechanisms affect earnings management? In addition, another potential direction of future research could be that whether individual firm-level governance still matters on earnings management after controlling for country-level legal protection, or whether firm-level governance devices substitute for or complement country-level investor protection in mitigating earnings management.

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