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Managerial Opportunism And Earnings Management Behaviour: A review

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Abstract

In this study we describe the review of earlier studies of opportunistic and efficient earnings management. There are various studies done in developed countries and few studies happened in emerging economies to examine whether managers use their opportunism on the shoulders of investors and stakeholders. We used content analysis to review earlier studies to find the behaviour of managers in choosing between opportunism and efficiency. From the review we understood that the prime intention of managing earningsis not the welfare of investors; but at the same time the overall findings interpret that earnings management is not fully injurious to the investors' welfare. The study further examined the factors that can curtail the opportunistic behaviour of managers in reporting earnings. It is then finds evidence that presence of institutional investors, large proportion of promoter share capital and external finance help to reduce the managerial opportunism.

Keywords: Earnings Management, Opportunistic Earnings Management, Efficient Earnings Management, Income Smoothing, Informativeness.

Introduction

Investors are the main stakeholders of any business, so their interest and rights are to be protected. Even though there are various Acts and regulations exist across the world to protect the interest of the investors and stakeholders,theycannot notsuccessfullymake it beneficial. At the same time sophisticated techniques introduced by the managers for manipulating the interest of the investors. Presently managers are widely use earnings management practices for theirpersonal benefits at the expense of investors.

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Earnings management has become widely discussing research topic in accounting and finance after big corporate scandals happened across the world. It can be an accounting gimmick through which corporates make managerial gain. El Diri (2017) defines "….within GAAP management discretion over external financial reporting by abusing some contracting deficiencies, stakeholders' bounded rationalities, and information asymmetry in the market, through some economic decisions, a change in the accounting treatment, or other sophisticated methods. The purpose of management is to present earnings in a way different (up or down) from what is known to them to achieve private benefits while misleading the stakeholders; although such discretion may not always be harmful to them." Simply it is "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say, merely facilitating the neutral operation of the process)...." Schipper (1989).

Previous studiesoffer evidencesof earnings management practices among the corporates in India (e.g., Agrawal and Chatterjee 2015; Das and Jena, 2016). Ajit et al. (2013) conducted a study on behalf of Securities Exchange Board of India (SEBI) and find an average earnings management of 2.9%, near to the global level. For a layman earnings management may seems to be a fraudulent activity. But the nature of activities involved, it can be distinguished from fraud. Earnings management does not ultra vires the Generally Accepted Accounting Principles (GAAP). However, managers have the discretion to make use of flexibility provided by GAAP to indulge in earnings management practices.

Even though earnings management is found to be not a fraud, there is a scope for managers to make it use unethically or opportunistically. Earnings management behaves in two ways: opportunistically and efficiently. The opportunistic manipulationhappens when managers select accounting choices and estimates purposefully to maximize their welfare (Healy and Wahlen, 1999). It becomes efficient when it enhances the informativeness in conveying private information to stakeholders.The behaviourof earnings management (opportunistic or efficient) is worth to know since it affects investors and other stakeholders seriously. The very purpose of the study is to summarize the behavior of earnings management activities based on the findings of extant literature. The study reviews a wide range of empirical

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evidences of the behavior of earnings management activities of corporates in both developed and emerging economy.

Earnings Management: Fraud or not?

Most of the researchers describe that earnings management happens at the fiscal year end by using accounting choices within GAAP (known as accrual earnings management, AEM). It also happens through some economic decisions during the fiscal period to influence the cash flow, known as real earnings management (Roychowdhury 2006).Accounting fraud always violates the provisions of GAAP or other regulations. Literally earnings management is a legal activity that does not violate the principles of accounting. However,earnings management may be an aggressive choice of accounting estimates that results harmful impact on the stakeholders' wealth (e.g., Ronen and Yaari 2008; Walker 2013). In short, earnings management can be considered as the within GAAP choice of activities even though they are actively mask the real economic face of a firm. Though earnings management is legal, to some extent it is leaning towards unethicalends. The common manifesto of managers is recognized asmanagers are actively involved to increase or decrease earningsopportunistically for the better advantage of themselves by squeezing out the pocket of other stakeholders (e.g., Balsam et al., 2002; Leuz, et al., 2003; Rosner 2003; Dechow et al. 2011; Li et al. 2011; Shette et al.,2016).

Efficient V/s Opportunistic Earnings Management

Academicians and regulatory authorities are disagree that the managers use their discretionary power in accounting choices for maximizing the firm's value. Managers choose the accounting estimates and principles either efficiently to maximize firm's value or opportunistically to make private gains at the expenses of other stakeholders (Holthausen, 1990). The Agency Theory infers that conflicts among shareholders and managers lead to managerial opportunism. The managers' choice of accounting is depends on the accounting procedures accepted under various contracts(contracting based accounting theory). Since future is uncertain it is optimal to allow the managers, who has specialized knowledge in accounting choice, to use the discretion of future choice of accounting estimates (Demski et

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al. 1984). So, transfer of wealth among the contracting parties in the future is more depend on such managers' choice between opportunism and efficient managerial actions.Christie and Zimmerman (1994), finds that efficient managerial action increases the aggregate wealth of the contracting parties when opportunism increases only the managers' wealth.

Evidence of opportunism

As mentioned above, earnings management behavior of corporates may be opportunistic. Numerous evidences are available on opportunistic use of earnings management activities. However, most of them are basedin developed nations. Burgstahler and Dichev (1997) place evidence of opportunistic use of earnings management among US firms. They find that firms having small positive or slight negative pre-managed earnings opportunistically apply their discretionary power to report improved earnings or positive earnings respectively. Balsam et al., (2002), examined the quarterly earnings announcement among 366 US firms to test whether AEM affects pricing of earnings information. They observe that AEM is more leaning towards opportunistic behaviour.

Teoh et al. (1998) find that firms undertake opportunistic earnings management during the period of going public. A consistent evidence is produced by Dechow et al. (2011) in their study on firms charged by the SEC (Securities Exchange Commission, USA) for financial statement misstatements. They find that these firms are engaged in earnings management opportunistically to keep share price overvalued and maximise the proceeds from new issue. In a similar study, Shette et al. (2016) examine the impact of opportunistic earnings management during the IPO year on long-term performance. Their study,on150 book-built IPOs of Indian corporates during 2001-2006, finds that the quality of earnings during IPO period is less than the post IPO period. They further find that earnings management during the period of IPO has a negative impact on the long-term performance, which is suggested as an evidence of opportunistic earnings managementin India.

Leuz, et al. (2003) study the extent of earnings manipulationof 31 countries separately during the period 1990–1999. They find an association of poor investor protection with highearnings

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management. This association reflects the existence of opportunistic manipulation in countries with inferior investor protection.

In the context of managerial compensation, Hanna (1999) posits that managers are frequently record excess provisions for low-persistence special items since their bonuses are not affected by such provisioning. He finds that this provisioning is opportunistically used by managers due to two benefits, that, it will not affect the managerial bonuses and also helps to increase future earnings through excessive provisioning.There is also evidence that the bankrupt or stressed companies manage their earnings more opportunistically than unstressed firms (e.g.,Rosner 2003; Li et al. 2011). The findings of extant literature point that the eventualdisappointment of opportunistic earnings management vest with investors since the managers holdown interest and give more preference for their welfare and remuneration.

Evidence of efficient earnings management

Extant literature have evidence for efficientearnings management from both rational and behavioral perspective. Earnings management can be informative to the rational investors. According to Wang and Williams (1994), smoothing improves informativeness the reported earnings because it enables to transmit inside information about the future earnings performance, that in turn more helpful for the potential investors. Following this, Tucker and Zarowin (2006) argue that in an efficient market the reported earnings will create increased level of share return when income smoothing boost the competency to read future earnings (discretionary accruals used efficiently). They findthat high income smoothing is results inmore share return, consistent with efficient earnings management behavior.

Bowen et al. (2008) study the relationship between quality of corporate governance (CG) and managers' discretionary choice of accounting among firms in USA. The study finds a negative relation among quality of CG and managerial discretionary power. Further, the study investigates how managers use their discretion, whether opportunistically or in a good way. To observe this they relate firms' future performance and quality of CG. It is finds that when managerial accounting discretion is more, due to poor GC, the relation is zero or slightly positive. They interpret this finding as evidence of efficient earnings management; that is,

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managers use accounting discretion to communicate their expected future performance to the market.

Similarly, Das et al. (2009) examines the earnings reversal pattern (i.e., firms that reported good or bad earnings over Q1, Q2 and Q3 but reported reversed earnings in the Q4) of a large sample during 1988-2004, collected from COMPUSTAT. They reported that firms with earnings reversals show a significantly higher earnings response coefficient (ERC) in Q4. The higher ERC in Q4 indicates that investors viewed this pattern reversal as an efficientearnings management.

Siregar and Utama (2008) find evidence of informative earnings management in their study on Indonesian firms over the period 1995-2002. Consistentfinding isgivenby Rezaei and Roshani (2012) on Iranian firms that managers use their discretion to communicate private information about the profitability of the firm. Similarly, Francis et al. (2005) studied a large sample of U.S firms over the period 1970–2001. They claim that managers use discretionary accruals to covey inside information to market. They report that market reacts positively towards larger accruals since these accruals spread good information.Their finding, on average, supports the efficient earnings management.

Koonce and Lipe (2010) invoke on behavioural theory to examine whether investors value the “earnings consistency”. They argue that “consistent” information is much easy to analyse and understand than “inconsistent” information. They find that consistent earnings patterns make investors more confident about the future performance of the firm and will increase integrity of the management.

Factors restraining the opportunistic earnings management

Chung et al. (2002) find a negative relationship between the presence of institutional ownership and the use of discretionary accruals. They end up with a conclusion that opportunistic earnings management is less when more institutional investors own the firm. De Bos and Donker, (2004) also find a consistent evidence that more share of institutional investors in the capital structure inhibits the opportunistic behavior. They also find that

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presence of large outside shareholders and management shareholdings restrain the managers' to engage in opportunistic or voluntary accounting choices.

Summary and Conclusion

Extant literature presents evidence of efficient and opportunistic behavior of earnings management. The relevance of examining opportunism and efficiencyin accounting discretion lies on the conflict of interest among the investors and management. Due to the reasons like, ignorance of accounting knowledge, lack of expertise in analysis of financial statement, inability to gatherinside information etc., investors are getting exploited by the managers. Managers are opportunistically create earnings to maintain overvalued share, maximize proceeds of IPO, etc., thus the investors are seriously affected. The investors are the most affecting party when managers use opportunistic earnings management. Since earnings management is highly difficult to detect and quantify by unsophisticated and common investors, managers are widely using this strategy for their benefit.

Even though there is presence of factors curtailing opportunism like institutional investors, large proportion of promoter share, external finance etc., we find evidence of opportunism while reporting the earnings. We further find that incorporation of corporate governance practices also cannot fully preclude this evil effect.Itbecomes an issue and challenge to the policymakers as well as regulators since opportunism is not punishable. This raise the importance of new and sophisticated regulations.Even though we find the evidence of both opportunistic as well as efficient earnings management the overall evidence shows that earnings management is not fully detrimental to the investors' welfare. The study also finds that since opportunistic earnings manipulation is not able to penalize, it is much difficult to eradicate.

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