Earnings Management: A Literature Review in the Actual Debate

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Abstract

Over the last years, earnings management came to light as a phenomenon which gathers numerous evidences from all over the world. It is actually one of the main topic in academic research on accounting.

Adopting a content analysis approach, the paper offers a synthetic review of academic literature and empirical evidences all over the world on earnings management. First, the contribute takes place in considering the phenomenon looking at the various definitions and techniques. Secondly, it considers the earnings management policy and the differences between earnings management, creative accounting and fraud. The evidences gathered allow to state that the topic is still widely opened to further research. In synthesis, the paper contributes to highlight the earning management topic relating to different perspective of analysis.

1. Introduction: Presenting the Background

Over the last twenty years, the world economic system has been shaped by multiple and rapid changes. Among them, *globalization* enhanced by the birth of the European Union and the creation of a single European market and the development of Emerging Countries; *American market-based system*, which involves a rapid growth of the stock market, prevalently with the growing importance of the derivatives (linked to the market value, or to the firm's performance); *growth of internet-based business*, which allows management to handle free information and to develop network in the world, implying a boost in exchanging information; lastly, important *changes in the job market*, due to the prevailing diffusion of bonus-related payment for top managers linked to firm and market performance.

All these factors have led to the development of many earnings management actions, which wants to misuse the discretion of the regulatory system in order to gain personal advantage. But where does this concept born? When was it coined?

2. The objective

The objective of this paper is to analyze the state of the art about earnings management and creative accounting, which are their influencing variables and components, throughout a literature review on these topics. Regarding to the methodology, we construct a content analysis model of main literature focusing on last five years main contributions published.

3. Earnings Management: A Definition

Earning is an accounting measure and its quality is crucial to the usefulness of the decision. Qualitatively high earnings reflect fairly the firm's performance and they can be considered a good measure to evaluate short and long term performance. Earnings are very important in the calculation of income since they take into consideration the influence of accruals.

Arthur Levitt, (1998) in its speech "*The numbers game*" underlined that the growing diffusion of earnings management actions have lead to earnings quality worsening, stating that this phenomenon can be linked to different factors:

- the growing firm complexity, which involves a more difficult control process by the internal and external audit committees;
- the evidence that the accounting principles are not fully able in following this changing process in the economic system (the accounting principles framework is changing, but this development is not so fast as the economy's expansion);
- a more aggressive behavior of the top management.

Earnings management is one of the most important veins of debate over the last twenty years.

There is no unique definition, s that we could refer to three main contributes that can be considered as "milestones" on the field:

- Davidson, Stickney and Weil (1987)
- Schipper (1989)
- Healy and Wahlen (1999)

Firstly, Davidson, Stickney and Weil (1987) stated that earnings management is "the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported earnings".

Then Schipper (1989) which defines the earnings management phenomenon as "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain".

Lastly, Healy and Wahlen (1999) underlines 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".

In synthesis, Earnings management is the accounting manipulation in order to represent a specific earning level, it changes costs and revenues with the aim of influencing the shareholders perceptions and of increase the market value of the shares. There are many ways that managers can exercise their power to influence financial reports: this power is required to estimate future economic events which have an abutment on financial statement (expected lives of assets, deferred taxes, losses from bad debts), manager can also choose among different accounting methods for reporting the same economic event (LIFO, FIFO); this discretion leave space to the possibility of earnings management.

3.1 Creative accounting vs earnings management

A close definition of earnings management is *creative accounting*. This term came to light in 1986 in the Ian Griffith's work titled "*Creative Accounting*". The author objective was to demonstrate that most UK companies were indulging in creative accounting: he stated that UK top management were using accounts to serve managerial purposes rather than offering a "true and fair view" of the company results to shareholders.

Oxford dictionary of English describes creative accounting as “The exploitation of loopholes in financial regulation in order to gain advantage or present figures in a misleadingly favourable light”.

Jones (2011) gives a formal definition of the creative accounting’s phenomenon through the analysis of the major literature contributes. It is a : management behavior of using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of the accounts so that they give primacy to the interest of the preparers, not the users; the exploitation of expedients in order to gain advantage or present figures in false favorable light.

3.1.1 Differences and analogies between earnings management and creative accounting

Firstly, it is possible to stated that both earnings management and creative accounting are two methods used in order to represent something that is not true. They both portray a better company situation which is different from the real.

Their main difference coincide with the technique used in order to reach their mutual result. On the one hand earnings management make the company more attractive for investors manipulating accountings in their value or using different accounting methods which exploit the financial report’s discretion. On the other hand creative accounting manipulates accounting in their presentation in order to stress good news and to hide bad news.

3.1.2 The phenomenon of Earnings Quality

Differently from earnings management and creative accounting, earnings quality is a growing importance necessity for the annual financial report. This is a strategically important attitude adopted by the healthy firms, because a qualitatively valid earning stresses a solid business management which will support the company’s competitiveness; moreover, this earnings is valued by analysts as a true and fair representation of the company’s performance. So the earnings quality has an informative value: it is a good medium/long term performance indicator. Unfortunately, earnings quality has deteriorated due to the diffusion of earnings management policies. This fact involves the reduction in the ability of earnings to represent the market trend.

3.2 Something to know about earnings management

EARNINGS MANAGEMENT TECHNIQUES 1. increasing income, in order to maximize revenues (premature sales recognition, inclusion of non operating profits…); 2. decreasing expenses, it involves an automatic increase of profit (capitalization of expenses, lengthening of depreciation lives…); 3. increasing assets (enhance goodwill, enhance other intangibles, revalue tangible fixed assets…); 4. decreasing liabilities (remove liabilities from the balance sheet when the firm is in danger to breaching its loan covenants, reclassifying debt as equity); 5. increase operating cash flow (bank loans were treated as operating cash flow);
VARIABLES INFLUENCING EARNINGS MANAGEMENT 1. Normative system; 2. Market capital (coinciding with incentives for the execution of the accounting policies which derive from market); 3. System of corporate governance (the presence of independent or non independent admin may prevent earnings management actions); 4. Cultural or ethical factor (cultural level and firm's problems knowledge);

EARNINGS MANAGEMENT INCENTIVES 1. Personal incentives (increasing salaries, bonus related pay, personal satisfaction…); 2. Market incentives, in order to make profit coinciding with analysts' expectations (the trade of firm's shares on the stock market in order to influence the share price and to gain personal advantage, the achieving of some profitability thresholds);

3.3 Earnings management and fraud: differences

Creative management and earnings management are not fraud; the first is a behavior within the regulatory framework, the latter represent a knowing misrepresentation of the truth a material fact to induce another to act to his detriment, a violation of the regulatory system, a knowing misrepresentation of the truth of a material fact to induce another to act to his detriment, a voluntary misstatement or omission of amounts in the financial reporting.

The phenomenon of fraud gains a growing importance with the expansion of the emerging countries, because in these contests there is a less rigid control by the government about the sources of firms' growth.

The main operations under which are hidden frauds are:

- Misappropriation of assets (or management embezzlement), this action may be done either by employees and directors. Which assets can be misappropriated? Inventory or cash.

- Fictitious transactions, it is individuate as the creation of a particular activity which doesn't exist. What kind of transactions may be invented? Sales; cash or inventory, so management invest false incomes and then diverted the money into his own account.

3.3.1 Reasons to commit fraud

There are some reasons for which managers and employees commit fraud, which can be divided into three groups:

1. Pressure factors with financial contents (show up when people are in need of cash);
2. Opportunity factors (which directly involve top management and owners of the business providing the opportunity of committing fraud);
3. Justifications to commit fraud ("I had borrowed the money, I would pay back");

3.3.2 When was the term born?

In 1939, Edwin H Sutherland, in his speech to the American Sociological Association, coined the term White Collar Crime, as "approximately as a crime committed by a person of respectability and high social status in the course of his occupation." It is a synonym of fraud, and explains the fact that, over the last years, most of the fraudulent practice were not committed by total strangers to companies, but were done by them who were given the stewardship role to steer the corporate managers.

Public listed companies have taken a series of actions to fight against internally committed fraud, as the Sarbanes-Oxley act in 2002; as the corporate scandals have demonstrated the inadequacies of the audit process carried out by external auditors and demonstrated the need for an urgent change in order to restore confidence, the sox law were included all the most important accounting regulations and institutional principles. Which regulations were introduced by this act? Firstly, the necessity for company's financial statements to be approved by the board of directors; then the onus for the firm's management to establish an effective internal control structure.

Which is the biggest problem that determines the presence of fraud? It is the fact that firms from all over the world have not taken enough steps to install the necessary protection

required, due to the absence of legislation, the lack of expertise in the corporate management when it is indispensable to put in place the inspection mechanism.

This phenomenon is really diffused in the developing countries, due to financial malpractices.

AN EXAMPLE OF FRAUD: SATYAM COMPUTERS' SCANDAL

One of the most important evidence about corporate fraud in one emerging country is Satyam computers' scandal. This fraud was detected by the SEBI (the Indian SEC) in 2008 , when the president of Satyam's board of directors resigned and accompanied these resignations with a letter to the board of directors, which stresses the main problems of the Indian listed company: inflated cash and bank balances; a non-existent accrued interest; an understated liability on account of funds; an overstated debtors position.
The difference from real profits and the one reflected in the financial report was accentuated by the fact that the company had to carry additional resources and assets to justify higher levels of operations, increasing the cost. These are the findings which the SEBI identifies:

- exit strategy, a well organized scheme for moving out from the industry gradually;
- financial logic, in order to inflate false revenues and show false profits, inventing false receivables on real clients;
- fictitious accounting, creating fictitious customers and services;
- false and inflated pay rolls: Satyam had inflated by 13000 units his headcount and had managed as many salaries accounts withdraw cash from them every month for several years;

This demonstrates how fraud is different from earnings management, but also demonstrates how easy it is to pass from one to another

4. Literature review

Over the last twenty years earnings management topic has gained increasing attention from academics and professionals all over the world.

First of all, three different approaches can be recognized in the accounting literature:

1. Earnings management
2. Creative accounting
3. Earnings quality

4.1 Earnings management literature

Main studies are based on the analysis of accruals in the financial statement, trying to understand the level of manipulation of managers.

Trueman and Titman (1988) established that earnings management occurs over the form of income smoothing. Managers want to smooth reported income to influence shareholders perceptions of the firm's performance. So that, earnings management incentives are more probable to arise when managers might gain from share price rises, as in case of stock option based payment.

Other studies are focused on the behavior of management in satisfying analysts' forecast on earnings and performance. Kasznik (1999) investigated on managers adopting discretionary accruals on the base of the analysts' forecasts. He provided evidence that "*managers use positive discretionary accruals to manage reported earnings upwards when earnings would otherwise fall below management's earnings forecasts*". The author concludes that this action has a positive effect on the stock price, increased by market analysts' consensus.

Bartov, Givloy and Hayn (2002) studied the rewards of the management behavior of meeting the analyst's forecast. They found that companies have dampened down earnings expectations.

Another vein of research focuses on the maximization of management bonuses, that implies that managers are rewarded with bonus once reached particular level of earnings. On the same field, Healey (1985) tried to answer to a specific research question that is "when managers have no incentives to manipulate earnings?". The author found that managers have not incentive in earnings manipulation when bonuses are fixed and not related to improvements in profit performance.

Regarding to debt covenants policy, Defond and Jiambalvo (1994) analyzed a sample of US firms that violated the covenants. Firms subscribe debt covenants in order to protect the lenders against the borrower getting into difficulties, so they have many incentives to avoid breaching the loan incentives. The authors stressed the link between the violation of debt covenants and the manipulation of accruals findings that earnings management policy is more frequent in the year before the violation of the covenant.

Murphy and Zimmerman (1993) investigated about the relation between changes in management and incentives in earnings management. They stated that there are incentives for managers to paint the outgoing managers in as black light as possible. Where the CEO's departure is preceded by poor performance, authors found that incoming managers adopt earnings management policy, in particular adopting the "big bath" accounting techniques. The incentives are particularly great when the departing managers are reporting a loss; in this case, the incentives for the incoming managers is to make that loss as big as possible, so they will make the incoming management's intended improvements even better than the reality.

Erickson and Wang (1999) explored the acquisitions of 55 US firms in the 1990's. When a firm tries to take over another one, there are incentives for both firms involved in the deal for earnings management policy, in particular for the target company that would show higher earnings. The effect on the acquisition price is a arising for both companies. Authors found evidence that, in the period before the acquisition, the acquiring firms manage their earnings upwards in order to reduce the number of shares to issue to acquire the target company.

4.2 Creative accounting literature

Many contributes about the origin of the term creative accounting.

In a book published by Ian Griffiths ("Creative Accounting", 1986) the author coined a specific definition of earnings management. He stated that: "*Every company in the country is fiddling its profits. Every set of accounts is based on books which have been gently cooked or completely roasted. The figures which are fed twice a year to the investing public have been changed in order to protect the guilty. It is the biggest con trick since the Trojan horse. Any accountant worth his salt will confirm that this is no wild assertion. There is no argument over the extent and existence of this corporate contortionism, the only dispute might be over the way in which it is described. Such phrases as 'cooking the books', 'fiddling the accounts', and 'corporate con trick' may raise eyebrows where they cause people to infer that there is something illegal about this pastime. In fact, this deception is all in perfectly good taste. It is totally legitimate – it is creative accounting*".

The author describes perfectly his vision after a deep analysis of the UK economic system. He concluded that most UK companies use creative accounting manipulating accounting numbers in order to serve managerial purposes. The expression "creative accounting" will raise in importance with the cases of Worldcom and Enron, because the findings in the accounting investigation stress the author's definition, opening a debate on the variables influencing the phenomenon.

In 1991, County Natwest Woodmac published "*Company pathology*", a study which studied 45 listed companies on Third Market, which is the trading of exchange-listed securities in the OTC (over the counter) market; these trades permit institutional investors to trade securities with no help by the dealers. Its aim was to to identify lacks in the UK financial reporting. The authors stated that only three of the 45 report were qualified, the others presented a lack in order to paint a favorable situation of the company. The paper underlines areas which identified as questionable accounting practices really frequent in accounting policy:

- Capitalizing interests and other costs;
- Classify or excluding from profits extraordinary items when they are normal operating costs;
- Classify leasing as operating rather than as financial;

Trevor Pijper (1993) in the book "*Creative accounting*" analyzed some main accounting scandals in the UK at the start of 1990's. He found that the stock market seems unconcerned about changes in borrowing levels for as long as companies were able to report healthy increases in earnings and dividend per share.

Mulford and Comiskey (2002) in "*The financial numbers game*", observing the pre-Enron economic system and collecting both earnings management and fraud evidenced, offered a wide definition of creative accounting in order to include accounting techniques that were within and beyond the regulatory framework. The definition offered of creative accounting by the authors is the following: "*Any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, both within and beyond the boundaries of generally accepted accounting principles, and fraudulent financial reporting. Also included are steps taken toward earnings management and income smoothing*".

Authors summarized creative accounting techniques as follows:

- Recognizing premature and fictitious revenues: goods may be ordered but not shipped at the time of recognition so that companies will ship goods even when no orders are expected;
- Aggressive capitalization and extended amortization policies, in order to reduce expenses and boost profits;
- Misreported assets and liabilities;
- Problems with cash flow reporting, it is more difficult to manipulate than profit.

Michael John Jones in its work "Creative accounting, fraud and International accounting scandals" (2011) scored a study that encompasses all research fronts on earnings management. He analyzes all the major fraud-cases all over the world (Worldcom, Enron, Parmalat, and Satyam Computers) and collects all the literature evidences about earnings management, creative accounting and fraud. Its purpose is to explore the role of accounting, specially the one of creative accounting and fraud. The author focuses on the where creative accounting born, which are its components and variables; at last, he offers a portrait on all the most important cases of fraud, detecting its components and showing the difference from creative accounting.

4.3 Earnings quality literature

Annalisa Prencipe's work "*Earnings Quality*" (2006) introduces in Italy the debate about the quality of earnings linked to the diffusion of earnings management action. She moves from Arthur Levitt's speech "*The numbers game*" in which the author denounces a progressive worsening in the earnings quality due to the growing adoption of earnings management policies. Prencipe contribute offer a deep picture through statistical and accounting evidences underlining that earnings management policy are more frequent in some specific moments (IPO, signing of the debt covenants, M&A operations). The aim of this work is to give a first and general vision of which practices are more frequent in earnings management. About earnings quality and earnings management policy the literature is wide.

Burgstahler and Dichev (1993) found that the achieving of some thresholds of profitability is an inducement for earnings management policies. These thresholds are:

- The line that divides loss from profits: authors found that when the annual result is not so distant from zero, the firm tend to apply earnings management policies in order to manipulate it and make it positive;
- The previous year earnings level: in order to represent a steady growing pattern, listed companies usually manipulate earnings for representing small profits rather than small losses;

Degeorge (1999) contribute on the impact on earnings of specific accruals related to R&D costs, stated that the reporting on these kind of expenses can be highly influenced by accounting policies. Costs related to R&D may be capitalized only under specific requirements:

- The costs are measurable and identified;
- They are attributable to a specific project;
- They are recoverable through the future project incomes.

Nevertheless, the accounting rule on R&D capitalization is characterized by a big discretion regarding this capitalization requirement so that the decision to capitalize R&D costs can be highly influenced by earnings management policy. The incentives related are:

- Earnings smoothing, in order to represent a regular pattern of growth;
- Debt covenants, when the firm is contravening these provisions;
- Management bonus plan, when the adoption of earnings management techniques helps in maximize management remuneration.

5. Earnings Management in the Actual Debate

Earnings management is the manager's behavior of using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of the accounts in order to give primacy to the interest of the preparers, not the users of the financial report. It is also the exploitation of expedients in order to gain advantage or present figures in false favorable light. It is the policy of manipulating costs and revenues in order to achieve some profitability thresholds. Over the last twenty years the earnings management related topics have been analyzed under different aspects. Authors mainly focused on which are the factors influencing the probability of earnings management. This topic becomes more complicated due to the changes in the firm structure.

5.1 Earnings management: a corporate governance perspective

The first vein on debate is the link between earnings management and corporate governance. Kouki, Elkhaldi, Atri and Souid (2011) examine the influence of corporate governance mechanism on earnings management. They considered a sample of 171 US firms, finding that auditing committee independency, the separation between chairman and CEO and manager as a membership to nominating committee are the most significant constraints to earnings management. So there are many corporate governance instruments which can limit earnings management actions, these are: the auditing committee independency, the board size, the separation of function.

Seng and Findlay, (2013) using data collected from New Zealand listed companies for the financial year ending in 2005, conclude that the size of the Board of Directors is positively associated with earnings management, so larger boards seem to be ineffective in their oversight duties relative to smaller boards. Moreover, the independence of the Board of Directors, the independent role of the Board Chair and Chief Executive Officer, and the independence of Audit Committees are not significantly associated with earnings management.

Choi, Kwak and Choe (2014) examine 403 CEO turnovers and 806 non-turnover control firms during the period 2001-2010 in order to analyze the relation between Chief Executive Officer turnover and earnings management practices. After controlling for corporate financial performance and governance structure, they find that earnings management is influenced by the departing CEO only when the departure is forced and the new CEO is an insider.

Sarkar, Sarkar and Sen, (2008), using a sample of 500 large companies over a two-year period, examine the impact of board characteristics on opportunistic earnings management in India, a large emerging economy. They find that diligent boards are associated with lower earnings management, while boards that have directors with multiple appointments exhibit higher earnings management.

5.2 Earnings management and Sarbanes-Oxley act: influence on corporate governance

Sarbanes Oxley Act in USA stressed its effects on corporate governance, with high influence on earnings management practices.

Wang, Sheu and Chung (2011) explore whether the Sarbanes-Oxley Act of 2002 can be associated with the incidence of earnings management in a sample of the US firms. The authors found a significant reduction in abnormal accruals after the implementation of the SOX Act and an association between firms with high pre-managed earnings and fewer incidences of income-reducing earnings management behavior. Authors conclude that the SOX Act has contributed significantly to the integrity of financial statements.

Leventis and Dimitropoulos (2012) investigated the role of corporate governance in earnings management behaviour analyzing US listed banks during the era of the Sarbanes-Oxley Act. The authors examined accounting quality and corporate governance practices within banking corporations through the use of two different measures of earnings management. Findings show that banks with more efficient corporate governance mechanisms report small positive income to a lesser extent than banks with weak governance efficiency; well-governed banks engage less in aggressive earnings management behavior through the use of discretionary loan loss provisions and realized security gains and losses. The period analyzed is one of transition to an intensively legalized governance environment. Their conclusion was that the Sarbanes-Oxley Act constrains earnings management with the improvement of corporate governance.

Chang and Sun (2009), starting from the hypothesis that the Sarbanes-Oxley Act marks the beginning of the mandatory disclosure of audit-committee composition and other corporate governance information for cross-listed foreign firms, stated that the provisions of Sarbanes-Oxley Act improve the effectiveness of an independent audit committee and other corporate-governance functions in monitoring the earnings quality of cross-listed foreign firms. They adopted a cross-listed firms' earnings informativeness and earnings management to measure earnings quality. The authors found that earnings informativeness is significantly associated with Audit Committee independence as well as with board independence in the post-SOX period; on the other hand, they did not find a significant association between earnings informativeness and audit-committee independence in the pre-SOX period. In conclusion, authors stated that there is a negative association between earnings management and audit-committee independence after SOX, so that they conclude that the SOX provisions improve the effectiveness of cross-listed foreign firms' corporate-governance functions in monitoring the quality of accounting earnings.

5.3 Earnings management in family firms

An important topic is the relation between family firms and the influence of the family on the earnings management.

Prencipe and Bar-Yosef (2011), on the evidence that board of directors' structure improves the monitoring of managerial decisions, observed that earnings management in widely held public companies is less prevalent when there is a high level of board independence. However, there is less evidence regarding the effectiveness of board independence on earnings management in family-controlled companies. Examining a family firms sample, authors found evidence that the impact of board independence on earnings management is indeed weaker in family controlled companies.

Sue, Chin and Chan (2013), starting from prior research on the fact that family firms have better earnings quality than non-family firms in common-law countries and highly developed markets, examined financial reports both in family firms and non family firms. The authors doesn't find any difference between these two situations. They concludes that that the financial reporting quality of family firms is conditioned on the divergence between the controlling shareholders' voting rights and their cash flow rights, and the firm's reputation for integrity, while these two conditions do not explain the restatement likelihood for non-family firms.

Yang (2010) explored the relationships between insider ownership and earnings management in family firms and the impact of family versus nonfamily CEOs on earnings management. Author shows that the larger the level of insider ownership, the greater the extent of earnings management, supporting an entrenchment effect of family ownership. Moreover, other studies suggest that nonfamily CEOs show a greater tendency to manage earnings than do family CEOs. The author concludes saying that family firms should promote information transparency and quality of accounting reporting to avoid a negative image that suggests that family firms expropriate the interests of outside shareholders.

Hosseini and Abdoli (2012) analyzed the relationship and the effect of the ownership structure, family control and ownership type, and the board structure on the earnings management in the companies registered in Tehran Stock Exchange. They found evidences that both the ownership concentration and the earnings management are lower in the private companies and higher in the family firms.

Many researched investigated if third related party transactions, that seems to be more frequent in family firms, can influence the earnings management policy. Munir, Saleh, Jaffar and Yatim (2013) examined the effects of related-party transactions - typically associated with controlling shareholder expropriation activities - on the earnings quality of family firms in Malaysia. The authors concludes that, in the presence of a high level of family ownership, the negative effects of related-party transactions are likely to be more substantial and reduce the benefits of familial value. So certain firms are likely to report high earnings quality if they have small levels of family ownership despite low levels of investor protection in Malaysia.

5.4 Earnings management and accruals

Accruals are earnings components with no impact on cash flow. Their manipulation can help earnings management strategy. Accruals can be identified as *discretionary* and *non discretionary*; only these second one could measure the earnings management impact.

On the role of accruals in determining earnings quality from both a stewardship and a valuation perspective, Drymiotes and Hemmer (2013) concluded that the valuation and stewardship qualities of accrual accounting are maximized by an "aggressive" or a "conservative" accrual strategy.

Zang (2012) investigated on how managers use real activities manipulation and accrual based earnings management as substitutes in managing earnings. It states that managers trade off the two earnings management methods based on their relative costs and that managers adjust the level of accrual-based earnings management according to the level of real activities manipulation realized.

Ibrahim, Xu and Rogers (2011), starting from the statement that firms manipulate earnings through accruals to achieve certain reporting objectives and comparing firms in seasoned equity offerings, found evidences of income-increasing accrual and real manipulation for seasoned equity offerings n the year prior to the offering in the pre-SOX period. Moreover, he found evidence of a shift to real account manipulation post-SOX. So that, firms that engage in income-increasing earnings management are more likely to be sued when they engage in accrual manipulation while other forms of manipulation may be less understood.

5.4.1 May corporate governance influence the manipulation of accruals?

Ittonen, Vähämaa, E. and Vähämaa S. (2013) examine the association between accruals quality and the gender of the firm's audit engagement partner. Given the documented gender-based differences in diligence, conservatism, and risk tolerance, they postulate that female auditors may improve accruals quality. The results suggest that firms with female audit engagement partners are associated with smaller abnormal accruals, thereby implying that female auditors may have a constraining effect on earnings management. it seems that the behavioral differences between women and men may have important implications for the quality of auditing and financial reporting. The study of Salleh, Hashim and Mohamad (2012) confirms this result examining if the participation of women on audit committee boards enhances audit committee effectiveness to control earnings management practices. Findings suggest that the presence of women directors on audit committee boards reduces earning management practices.

In their work, Bekiris and Doukakis (2011) examined the association between corporate governance and accruals earnings management using a corporate governance index consisting of 55 individual corporate governance measures. Based on a sample of firms listed on the Athens, Milan and Madrid Stock Exchanges, they found an inverse relationship between corporate governance and earnings management. Corporate governance provisions seem to constrain the trend of management to manage earnings leading to higher credibility for financial statements. Additional tests suggest that the negative relationship holds for large and middle capitalization firms but not for the small capitalization sample. This study also stresses the importance of introducing corporate governance mechanisms in order to ensure the integrity of the financial reporting process.

5.5 Earnings management and stock price: evidences from all over the world

Lee, K.T., Lee, S.C. and Choi (2011) examined if executives manage accounting earnings to maximize their own gains around stock option exercises. They investigates the effects of two factors, which are the value of exercised executive stock options and the change in the value of stock options for a 1% change in the underlying stock price on the propensity of managers to engage in earnings management. Subsequently, they analyzed whether the relations between both the value and the price incentive of exercised stock options and earnings management are more affected by the level of information asymmetry. The paper, basing on some observations from Korea listed companies, finds that higher values and price incentives for executive stock options were associated with higher earnings management. These results imply that executives manage firms' reported earnings to maximize their own gains around stock option exercises. Finally, information asymmetry enhances the association between both the values and price incentives of exercised executive stock options and earnings management.

Beyer (2009) examines optimal earnings forecasting strategy and optimal earnings management policy in a setting where both the mean and the variance of the distribution generating the firm's cash flows are unknown. The model contains several predictions: the

manager manipulates earnings to reduce his forecast error at the earnings announcement date, the firm's stock price is more sensitive to the firm's actual earnings announcement than to the manager's forecast; a controlling for the level of reported earnings and the magnitude of the earnings surprise, the firm's price is higher when it has a positive surprise at the earnings announcement date than when it has a negative surprise.

The aim of Kamel and Elbanna's paper (2012) is to investigate the phenomenon of earnings management in Egypt regarding to the stock market Authors individuated some factors that are likely to weaken the effectiveness of internal corporate governance mechanisms in preventing the engagement in earnings management practices. The results indicate that Egyptian IPO managers have no incentive to affect the offering proceeds of their firms through exercising their discretion over the accounting accruals before going public.

Alves (2012), starting from previous evidences indicating that stock options may engender manager-shareholder conflicts and create incentives for earnings management, examined the implications of stock option grants on earnings management in order to answer the question "does stock options grant induce incentives for earnings management?". Using a sample of 33 non-financial listed Portuguese firms-years from 2003 to 2010, he found that managers are more likely to engage in earnings management when they hold stock options.

Basilico and Grove (2013) extend prior research on the relation between earnings quality assessed by accruals and future stock price returns and adds new research on the relationships between direct and indirect corporate governance mechanisms of control with accruals and future stock price returns. Authors found evidence that direct corporate governance control mechanisms, such as the existence of separate, independent and skilled audit committees, are related to higher earnings quality and higher future stock price returns.

5.6 Earnings management in the IPO

One important moment of the firm is the initial public offering (IPO). The authors debate on how earnings management can boost the stock price in the IPO.

Chen, Lin, Chang and Lin (2013) examined how information uncertainty surrounding IPO firms influences earnings management and long-run stock performance. The evidence suggests that managers in low-information-uncertainty firms tend to engage in earnings management for informative purposes, while managers in high-information-uncertainty firms engage in earnings' management for opportunistic purposes.

Nagata (2013) work's purpose was to understand the relationship between earnings management and under-pricing. The author found evidences on how earnings management leads to favorable price formation or further under pricing. Moreover, author stated that firms with aggressive earnings management during the pre-IPO period tend to be more underpriced than firms that use less aggressive accounting.

Shen, Coakley and Instefjord (2014) tested China market examining the impact of earnings management and investor sentiment on IPO anomalies through the use of a sample of 506 Chinese IPOs issued over the 1998-2003 period. They used a model which shows that the offer price can be below the fair price while the short-term equilibrium price in the aftermarket can be overvalued due to investor sentiment. The empirical results reveal a positive relation between the initial return and managed accruals and a negative relation between the long-term stock performance and the initial return. Earnings management appears to generate a pattern where the initial price following an IPO tends to be inflated by overreaction in the secondary market but adjusts to its fundamental level in the long run.

Miloud (2014) investigated the presence of earnings management in initial public offerings of French firms. Starting from the fact that earnings management's aim is to increase the attractiveness of the offered shares, it needs to go undetected by market participants. This need makes earnings management difficult to detect in the financial report,

so investors would benefit from other information that reveals the probability of earnings management. Managers' and owners' incentives for managing earnings are used to value the probability of using earnings management before the IPO. The results suggest that IPO firms with the highest discretionary current accruals significantly underperformed, compared to equivalent companies in the third year following the IPOs.

5.7 Impression management as an earnings management action

In order to show a different firm's performance, managers indulge in impression management with the use of a different financial statement presentation in the moment at an earlier time to IPOs.

Aerts and Cheng (2011) examined the association of earnings management and narrative impression management as reflected in properties of causal explanations of reported earnings in the prospectus of Chinese IPO firms. Anticipated earnings management concerns are argued to be a significant incentive for causal disclosures on earnings in order to rationalize and legitimize earnings outcomes. They fu evidence of close alignment of a firm's earnings management propensity and its use of tactical causal disclosures. Stronger earnings management is associated with more intense assertive causal disclosure. On the other hand, firms exhibiting stronger earnings management tend to avoid the use of explicit defensive causal disclosure tactics.

Beattie and Jones (2000), considering the financial graphs of the corporate annual reports of 300 companies in Australia, France, Germany, the Netherlands, the UK and the US, analyzed two important forms of impression management: selectivity and measurement distortion. They examine whether graphs of key performance variables, such as sales, earnings, earnings per share, and dividends per share, are more likely to be included when performance has increased rather than decreased, and whether measurement distortion of key performance variables graphs are likely to give a more rather than a less favorable portrayal of company performance. In conclusion they found evidences of selectivity in graph usage and of measurement distortion, although there is some evidence that impression management is greater in those countries with strong capital markets.

Clatworthy and Jones (2003) stated that accounting narratives are an increasingly important instrument of financial communication, playing a crucial role in the corporate annual report and allowing company management to present annual performance to users in a readily accessible manner. Unfortunately, accounting narratives are unaudited and thus may be subject to impression management. Focusing on the chairman's narratives of 50 listed UK companies ranked by percentage change in profit before taxation, authors examined whether companies with improving and declining performance report good and bad news in different ways. They conclude that both groups of companies stress the positive aspects of their performance; moreover they prefer to take credit for good news themselves, while blaming the external environment for bad news.

Guillamon-Saorin, Osma and Jones (2012) examine managerial disclosure practices in the headlines of press. Releases announcing annual results, a framing feature that is used to capture attention with the intention of affecting the thoughts of readers, thus influencing their opinions. The paper uses a large sample of Spanish listed companies for the years 2005 and 2006 in order to provide evidence of persistent impression management in press release headlines. Companies are inclined to stress good news and downplay bad news. Companies with very small profits report surprising amounts of good news. The authors conclude that companies are selective in the performance figures they include in the headlines of press releases, so the disclosure of profits or sales figures in press release headlines is also associated with earnings performance. Finally, they find evidences on that larger firms are

more likely to issue press releases than smaller ones, consistent with the theory that highly visible firms face a greater demand for information transparency.

5. Conclusion

6.

This literature review started from the first research on earnings management in 1980, in this first period was created a wide definition of earnings management: it is only an adjustment of financial report. With the progress of the economic system, this phenomenon gain its own importance and the authors debate branches in many topics. Earnings management debate is in continuous development and it is open to further research.

7. References

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