CORPORATE GOVERNANCE MECHANISMS AND EARNINGS MANAGEMENT: A STATE OF THE ART

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Abstract: *Extant research have for long identified that corporate governance has the potential to affect both financial performance and the opportunistic behavior of managers. Studies on the influence of corporate governance mechanisms on firm performance do not often assess the possibility that reported earnings can be misrepresented by managers with the scope of achieving various objectives. This paper examines the relationship between corporate governance mechanisms and earnings management practices. According to prior empirical studies in the field, corporate governance can reduce the extent of manipulative practices and increase the quality of financial reporting. As stated above, this study examined prior research investigating different corporate governance mechanisms that can have negative impact on earnings management practices. In this regard the legal system and the effects of takeover were examined as external mechanisms of corporate governance on manipulative behavior of managers. Internal mechanisms of corporate governance were also assessed. Board independence was found to enhance certain monitoring behaviors of managers while an audit committee can oversee the internal control for financial reporting and the quality of financial information. This paper contributes to corporate governance literature by providing detailed reviews of different corporate governance mechanisms on the most documented practice of creative accounting: earnings management. Limits of the current research are explored as well as the scope for future research.*

Keywords: corporate governance quality, creative accounting practices, quality of financial reporting, literature review

JEL classification: M41

1. Introduction

Earnings have the potential to influence a large category of users of financial information. Being a pivotal item in terms of decision making in the economic field, earnings have a powerful influence on the business activities and its management decisions. Given the fact that earnings can influence or impact contractual outcomes related to financial leverage or compensation of managers, a strong incentive to adjust it to a desirable level was documented extensively in the literature.

When incentives meet the flexibility of accounting regulation, earnings management practices arise (Healy and Wahlen, 1998).

In the light of previous accounting scandals documented in the literature, a large body of research assessed both corporate governance mechanisms and earnings management. The main idea approached in the literature in terms of corporate governance impact on earnings management practices is reflected in the assessment of the impact of the first on the latter. As such, the large majority of empirical studies documented so far that corporate governance mechanisms have the potential to decrease the scope for accounting manipulation.

The subject is timely and relevant for at least two arguments. First, in the light of former global crisis, a large body of literature started to focus extensively on corporate

governance mechanisms when arguing for demarches that have the potential to decrease the scope for earnings management activities. Second, given the current high uncertainty and divergence of interest, the economic environment is relying entirely on the quality of financial reporting.

Defined as "a deliberate intervention in the process of financial information presentation in order to capture personal gain" (Schipper, 1989), earnings management practices are a topic of high interest today. On the other hand, corporate governance mechanisms, board of directors and audit committee in particular, are responsible for monitoring managers on behalf of shareholders and overseeing financial reporting process by company law. Therefore, the mechanisms of corporate governance have the potential impact earnings management practices.

The objective of this paper is to examine some of the effects of some of the corporate governance mechanisms both internal and external on the level of earnings management as documented in the literature.

The remaining of this work is organized as follows. Section two reviews extant literature related to the objective of this study and presents prior results in the field, comprising also the research questions developed. In section three the main findings are presented, as documented in the literature in terms of the impact of corporate governance on manipulative practices. The latter section presents the main conclusions, the limits and scope for future research.

2. Revisiting prior corporate governance and earnings management research field

As stated above, this study is aiming to augment the literature by analyzing and summarizing the findings of the papers approaching the effect of corporate governance mechanisms on earnings management practices. By using a similar research method like in Webster and Watson (2002), a concept-centric rather than author-centric research was conducted. It is out of the scope of this paper to develop a theoretical framework for the relationship between corporate governance and earnings management, so the literature review process was not conducted with reference to such theoretical framework. Moreover, the current paper can serve as a starting basis for developing such theoretical framework.

As reflected in the literature, the act of managing earnings does not necessarily reflect the true performance of the company, case that may contribute to shareholders and investors taking inaccurate decisions in regard of the companies. On the other hand, effective board monitoring was documented as having an important impact on reducing the scope for manipulation.

Defined as the system by which business corporations are directed and controlled, corporate governance structure comprises the distribution of rights and responsibilities among different participants in the organizations such as, the board, managers, shareholders and other stakeholders. Including both internal and external mechanisms, such system is regarded today as one of the most important items responsible with the quality of financial reporting.

Broadly speaking, two types of earnings management were assessed and documented so far in the literature: real versus accrual-based earnings management (Kothari *et al.,* 2005). Real earnings management, regards the manner in which firms may structure transactions with their related parties in order to manipulate earnings (Cohen and Zarowin, 2008); accrual-based earnings management comprises estimations and judgments used on discretionary bases according to various incentives. As Kang and Kim (2011) asserted, management could influence reported earnings by making operating decisions discretionally. One of such discretionary decisions to manipulate reported earnings is imbedded in the accrual-based accounting that makes use of estimations and judgments to achieve desired goals.

Previous empirical studies that explored the relationship between corporate governance and firm performance, both in the developed and developing countries, approached as main objective the quality of financial reporting. As stated above, the large majority of such studies concluded that good governance mechanisms can impact on the discretionary behavior of managers (Klein, 2002).

As earnings management practices became more complex with time, the mechanisms of corporate governance were more and more approached and their role examined. As such, audit committee has also been discussed in relation to earnings management. It was argued that firms with large institutional shareholders are more likely to act in the interest of the investors, because large institutions have more resources and ability to monitor, discipline and influence managers (Hartzel and Stark, 2003). Remuneration committee was also assessed in the literature, when executive compensation was examined, given the cases documented when stock-based incentive lead to higher earnings manipulation and insider trading. This latter argument was empirically supported, among others, by the study developed by Cheng and Warfield (2005).

Most recent literature, turned to corporate governance aspects to explain the existence and magnitude of earnings management practices. At institutional level, Leuz *et al.,* (2003) examined the systematic differences in earnings management across a large number of countries. Their results documented that earnings management is expected to decrease as investor protection increases because strong protection limits insiders' ability to acquire private control benefits and reduces their incentives to mask firm's performance.

From international level, to firm`s level, authors tried to examined which dimensions of corporate governance can reduce the probability of restatement. Among the mechanisms documented, the incidence of independent directors with a background in accounting or finance on the board and/or audit committee, and the presence of the CFO on the audit committee was found to be significant (Xie et al., 2003; Agrawal and Chadha, 2005). Institutional ownership was also found to be significant given its impact on the on the informativeness of earnings and on discretionary accruals (Chung *et al.,* 2002). The main argument for this latter mechanisms proactive role in decreasing the scope for earnings management is that that higher institutional ownership reduces the agency cost of information asymmetry, and therefore reduce earnings management.

Given the scope of this paper and based on the above results, two research questions were formulated as following:

RQ 1: *What is the scholarship field of corporate governance mechanisms impact on earnings management research?*

RQ 2: *What is the future for corporate governance mechanisms impact on earnings management research field?*

3. Findings – Discussions based on relevant empirical work that documented the association of corporate governance and earnings management

This segment of the paper comprises the assessment of both external and internal corporate governance mechanisms impact on earnings management practices. In this respect such items as: board composition; duality; board size; number of board meetings; board gender ratio; audit committee; managerial ownership and concentrated ownership, were approached in connection with manipulative practices. In this regard, Table 1 and Table 2 comprises the main results documented in the literature.

a) External corporate governance mechanisms and earnings management:

Table 1: The legal system/Effects of takeover and earnings management

Authors/ Year	External corporate governance mechanisms	Results
Perry and Williams, 1994	Effect of takeover	Under management buyout, firms are more likely to manage earnings downward so that managers can purchase firm shares at a lower price.
Comment and Schwert, 1995	Effect of takeover	When firms face a higher probability of being acquired or losing control, they have more incentive to engage in practices to reduce this likelihood.
Wu, 1997	Effect of takeover	When dealing with management buyout companies are using earnings management practices in order to purchase firm shares at a lower price.
Shleifer and Wolfenzon, 2002	Legal system	It is likely for managers to divert earnings when there is greater legal protection.
Leuz et al., 2003	Legal system	Countries with lower investor protection usually have a higher magnitude of earnings management.
Ball et al., 2003	Legal system	Institutional arrangements of a country is the most important factor in controlling managers` self-interest, reducing opportunistic earnings management and improving the quality of financial reporting.
Burgstahler et al., 2006	Legal system	Countries with stronger legal systems have lower earnings management magnitude.
Chin et al., 2009	Legal system	Foreign-owned firms in Taiwan with stronger levels of investor protection have reduced earnings management to meet the target level of earnings from outsiders.
DeFond et al., 2007	Legal system	When dealing with weak investor protection rights the magnitude of earnings management are severe and the level of earnings informativeness is low.
Billet and Xue, 2007	Effect of takeover	When there is a higher probability of being acquired or soling control, companies tend to increase the levels of accruals.
Shen, 2007	Effect of takeover	It is more likely that firms would use more conservative accounting policies to reduce their takeover risk.
Braga-Alves et al., 2009	Effect of takeover	Companies would engage in earnings management practices upward to reduce or avoid the likelihood of a successful takeover.

Source: Author`s projection

Both legal system and effect of takeover were assessed, as mechanisms of corporate governance. When the institutional environment provides better legal protection managers'

self-interest can be controlled to a certain extent. In this regard, previous empirical studies documented that a strong legal system can deter manipulative practices. On the other hand, takeover force can put market pressure on managers to act in the best interest of the shareholders. The results documented in the literature so far linked both decreased and increased levels of accruals with takeover risk.

b) Internal corporate governance mechanisms and earnings management:

Table 2: The ownership structure/Composition of boards and earnings management

Authors/ Year	Internal corporate governance mechanisms	Results
Dechow et al., 1996	Composition of boards	Firms with extensive earnings management levels are more likely controlled by insiders than outsiders.
Peasnell et al., 2000	Composition of boards	Board independence can reduce the magnitude of earnings management practices.
Fan and Wong, 2002	Ownership structure	East Asian earnings informativeness measured by earnings return relation is related to ownership structure.
Anderson and Reeb, 2004	Ownership structure	Ownership structure can influence firm earnings quality.
Song and Windram, 2004	Composition of boards	Firms with large proportion of outside directors in the committee have less income increasing earnings management. Also, an increase in proportion of short term stock options held by directors in audit committee is more likely to reduce the effectiveness of monitoring managers to have high level of earnings management.
Abbott et al., 2004	Composition of boards	Audit expertise can control fraud and earnings restatements, which are measures that affect earnings management.
Bedard et al., 2004	Composition of boards	Audit committees with financial expertise can reduce earnings management.
Agrawal and Chadha, 2005	Composition of boards	When the CEO comes from the founding family, the firm tends to lack independence and have a higher probability of restatement of accounting information.
Ali et al., 2007	Ownership structure	Ownership structure has an impact on firm earnings quality.
Sánchez-Ballesta and García-Meca, 2007	Ownership structure	Lower level of insider ownership is associated with less earnings management.
Jiraporn and DaDalt, 2009	Ownership structure	Founding-family-owned firms have less incentive to manage earnings, as they do not have high pressure to meet or beat earnings expectations.
Turner and Vann, 2010	Composition of boards	Audit committee independence can reduce opportunistic earnings manipulation.
Srinidhi et	Composition	Female directors can improve board governance in

al. (2011)	of boards	terms of monitoring CEOs, improving board attendance, and improving communication; these aspects are likely to improve earnings quality.
Huson et al., 2012	Composition of boards	The results document that the compensation committee makes decisions regarding discretionary expenditure in the executive's terminal year when setting cash compensation for executives, and intervenes to reduce payments when managers make up accruals.

Source: Author`s projection

Internal mechanisms of corporate governance were also assessed in the literature in connection with earnings management practices. In this respect, the composition of the board of directors was expected to play an important role in converging the interest of managers and that of the shareholders. Also, it was documented as an important feature the role played by the non-executive directors that must comprise independent directors appointed on the basis of experience and competence. The main argument in favor was based on the fact that such directors are expected to act in such a manner that maximizes the value of the firm, being inversely related with earning management practices as empirical studies above documented it. Given the fact that independent directors do not pursue self-interests such as executive compensation and the misappropriation of assets, any pressure coming from shareholders to meet or beat expectations related to the performance of the firms cannot affect them. On the other hand, when such directors engage in manipulative practices, such demarches will negatively influences the performance of companies and a positive relationship can be documented.

Gender composition, as internal mechanism of corporate governance can also play an important role in terms of deterring earnings management practices. In this regard, prior empirical studies documented that female directors are more averse to the risk of litigation and reputation loss and they would choose and monitor internal and external auditors more closely. Empirical studies like those conducted by Srinidhi et al., 2011 tested whether the proportions of female directors, female non-executive directors, and female audit committee members are correlated with opportunistic earnings management and documented a significantly positive correlation.

The audit committee also was tested in prior research in connection to earnings management practices. Based on the fact that audit committees are filling various roles for the organization, management, shareholders, creditors, and other stakeholders, their role assessed extensively in the literature regards the enhancement of the credibility of financial statements. Audit committee has been explored in prior literature and how it relates to earnings management using various constructs of audit committee effectiveness such as size of the board (Xie et al., 2003) or composition and independence (Klein, 2002).

Compensation committee on the other hand, is one of the most important item of interest comprised in the assessment of board composition. Given the fact that compensation motivation is one of the most documented incentives for engaging in earnings management practices, such function was extensively approached in prior research. Since managers are willing to boost earnings in order to earn higher bonuses, accrual or real earnings management activities take place. That is the main reason why executive compensation and the discretionary behavior of managers is currently explored extensively in the literature. As such, prior research assessed the main function of the compensation committee in terms of incentives plan design viability for top managers (Cornett et al., 2009).

4. Conclusion, limits and scope for future research

Prior research documented that corporate governance can reduce the scope for earnings management practices and limit the manipulative behavior of managers. In this respect, various mechanisms of corporate governance were tested in connection with earnings management practices and both internal and external mechanisms were documented as having an effect on such unfair practices. For instance, an institutional environment that provides better legal protection can control managers' self-interest to a certain extent. Other external mechanisms, as the takeover force was found negatively associated with earnings management practices in most of the prior research.

Also, internal mechanisms of corporate governance as: board composition; duality; board size; number of board meetings; board gender ratio; audit committee; managerial ownership and concentrated ownership, were found as having a negative relationship with earnings management activities.

One of the most explored item in the literature was the board independence. In this regard it was found important in enhancing certain monitoring behaviors in managers, including the misappropriation of assets. Overall, board independence was found to constrain managers' opportunistic behavior. Part of internal mechanism of corporate governance board gender was also empirically tested in prior research. In this respect, female directors were found able to develop trust leadership, which requires managers to share information, being more likely risk averse to frauds and opportunistic earnings management. Audit committees can oversee internal control for financial reporting and increase the quality of financial information.

The main limitation of our study was the sampling of the literature. Since only the sources that were written in English language were used, this could results in an important limit. As further research, we intend to assess empirically the association of corporate governance both internal and external mechanism and earnings management practices in the Romanian economic environment since no study was been conducted so far in this respect.

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