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# Earnings Management and Earnings Quality in Emerging Financial Markets: A Theoretical Discourse

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***ABSTRACT***

*Net cash flows generated from a firm's operations periodically is statement enough of its financial performance. Though net cash flows and earnings are and ought to be identical, in practice they are not. This gap inversely reflects on earnings quality. Earnings are created through accounting efforts while cash flows are real. Through earnings management boards have discretion accorded by accounting standards to determine what and how to report. The paper deliberates on interactions between earnings management and quality motivations thereof. By considering attendant theories of proprietary; agency and political costs we lay a theoretical basis for such interactions hence laying a foundation for empirical analysis on the subject in emerging markets. Two fundamental issues in corporate financial management: financial reporting and firm asset valuation depicted as changes in prices of stocks is addressed. A nexus between accounting and finance practice and the transmission of information derived from these interactions to investors is clarified.*

***Keywords:*** *Earning quality; Earnings management; Management motivation; proprietary agency and political costs.*

***Jel Classification****: G1, G14, G32.*

***Gelişmekte olan Finansal Piyasalarda Kazanç Yönetimi ve Kazanç Kalitesi: Teorik Bir Açıklama***

***ÖZET***

*Bir firmanın faaliyetlerinden periyodik olarak elde edilen net nakit akışları, finansal performansından yeterince açıklanmaktadır. Her ne kadar net nakit akışı ve kazançlar özdeş olmak zorunda olsalar da pratikte değildirler. Bu boşluk, kazanç kalitesine ters olarak yansıyor. Nakit akışı gerçekken, muhasebe çabalarıyla kazanç elde edilir. Kazanç sayesinde yönetim kurulları, neyin ve nasıl rapor edileceğini belirlemek için muhasebe standartlarına göre takdir yetkisine sahiptir. Rapor, kazanç yönetimi ve bunun kalite motivasyonları arasındaki etkileşimleri tartışmaktadır. Özel mülkiyet teorilerini göz önüne alarak; Ajans ve politik maliyetler, bu tür etkileşimler için teorik bir temel oluşturur; bu nedenle, gelişmekte olan pazarlardaki konuyla ilgili ampirik analizler için bir temel oluşturur. Kurumsal finansal yönetimde iki temel husus: Finansal raporlama ve hisse senedi fiyatlarındaki değişikliklerle gösterilen firma varlık değerlemesi ele alınmaktadır. Bu çalışmada, muhasebe ve finans uygulamaları ile bu etkileşimlerden elde edilen bilgilerin yatırımcılara aktarılması arasındaki ilişki açıklığa kavuşturulmuştur.*

***Anahtar Kelimeler:*** *Kazanç kalitesi; Kazanç yönetimi; Yönetim motivasyonu; tescilli ve acentelik maliyetleri.*

***JEL Sınıflandırması:*** *G1, G14, G32.*

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## 1. INTRODUCTION

Amount of net cash flows generated from a firm's operations periodically is statement enough of its financial performance. In ideal economic situations at the level of the firm, net cash flows and earnings are and ought to be identical. Practice however has shown they are not the same. Earnings are created through accounting efforts hinged on disclosures, measurements and treatments which are fairly subjective to say the least. On the other hand, cash flows are realand cannot be estimated (Dechow and Schrand, 2004:6).Earnings quality therefore is a measure of the extent to which reported earnings reflect net cash flows.

The Generally Acceptable Accounting Practices (GAAPs) which guide the development of accounting standards, has been entrusted globally to provide a framework through which earnings are reported. This means that as long as are a firm binds itself to GAAPs then the reported earnings is the fundamental means of transmitting value hence a sound basis of investor decision makingYaping, (2005:32). Investors therefore have a basis of setting their expectations.

Yet this is not a straight forward deposition as it looks. Accounting and corporate finance scandals such Enron – 2001; WorldCom -2002; Tyco International 2002; Olympus 2011 and Tesco -2015 have made a global infamous marks and challenged the wisdom of relying on the GAAPs. The Kenyan corporate environment and by extension the capital market has not been spared with the most visible incidences being MumiasSugar Company and HacoIndustries in which the auditors and managers have taken the blame in equal measure. In addition, recent receivership of some commercial banks by the central bank of Kenya could intimate underlying accounting and corporate finance scandals. Back on the heels of the 2008 financial meltdown corporations were paying huge bonuses to executives out of reported profits only to benefit from public bailout much to the chagrin of tax payers.

The flexibility and discretion accorded to management by accounting standards to determine what to report and how to report it has come to be referred to as earnings management (EM). According to Healy and Wahlen (1999:370) 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. Field et al. (2001:262) recon that earnings management occurs when managers exercise their discretion over accounting numbers, with or without restrictions. These definitions have both positive and negative undertones a fact which is not lost to Dechow and Skinner (2000) who refer to the earnings management and fraud continuum in the same breath, underscoring the thin line between the two end points. In this paper however, despite the contention, the fraud component of earnings management has not been pursued.

EM has received very close attention in the recent past among scholars, practitionersand regulators. Vladu and Cuzdriorean (2014) performed a meta-analysis covering the period 2003-2013 on the top 5 accounting journals globally and found that 77 articles were dedicated to detecting EM practices among firms in various jurisdictions around the world. This shows a huge effort in trying to understand the concept. EM consideration has further developed because it has been attributed as a single most contributor to poor quality earnings reported by firms (Kalgo et al, 2016;Enomoto, et al 2015; Bozzolan et al, 2015;

Vladu and Cuzdriorean 2014; Ball and Shivakumar 2008).

Low quality earnings in the short-run may deliver an enhanced firm value and higher prices of stock on listed firms but the effect is largely superficial. Dechow and Schrand (2004:100) indicated that earnings quality has deteriorated over time as evidenced by the deteriorating relationship between stock prices and earnings. Indeed, Muchina, et al (2015) reported negative relationship between earnings volatility and stock price volatility for companies listed on Nairobi Securities Exchange (NSE) a position attributed to low earnings quality.

Questions which abound and intended to be answered by this discourse are: What motivates corporate managers to practice EM and are there any theoretical underpinnings which could help explain, determine or predict management behaviour towards practice of EM or otherwise? In addition, this paper will provide an analytical framework which may be used to pursue and sustain a subsequent empirical discourse.

## 2. VALUE OF STUDY

The value of this paper exists in the fact that over and above the building of the premises on the interactions between EM and EQ and management motivations thereof, this paper will lay a theoretical framework to explain such interactions. This platform is severely lacking even in respected works on the subject such as Dechow and Schrand (2004); among others. By doing so this, the paper will compliment similar work by Ronen and Yaari. (2008). In addition, this paper will build a foundation for future applied research and empirical analysis on the subject in Kenya and beyond. Lastly, this paper by extension deal with two fundamental issues in corporate financial management: financial reporting and firm asset valuation depicted as changes in prices of stocks. The paper thus forms a very important nexus between accounting and finance practice and the transmission of information derived from these interactions to investors.

## 3. MOTIVATIONS FOR EARNINGS MANAGEMENT PRACTICE: A THEORETICAL PRECEPT

It is reasonable to attribute the practice of EM to Proprietary Costs Theory by Verrecchia,(1990); Wagenhofer, (1990); Agency Theory by Jensen and Meckling (1976); and Political Costs Theory by Watts and Zimmerman (1990) and Milne, (2002) .This paper considers each of these theories and attest the extent to which their propositions would hold for the purposes of empirical considerations on the matter.

The interaction between reported earnings and stock prices can indeed push management towards earnings management. Kim and Yi (2006) find that discretionary accruals for publicly traded firms are greater than those for privately held firms by a magnitude of 1.2 percent of lagged total assets. This result supports the notion that stock markets create incentives for public firms to engage in earnings management.

Prior investigations of capital market incentives are typically concerned about these four main issues: (1) incentives for managers to meet stock market participants' expectations; (2) incentives for managers to manipulate earnings before initial public or seasoned equity offerings; (3) tests of whether investors are deceived by earnings management; and (4) evidence on the capital market consequence of earnings management. There is paucity of empirical evidence to indicate whether managers in emerging financial markets engage in such acts and their motivation thereof. As such, this paper makes due considerations as under.

### 3.1. Stock Market Incentives: Proprietary Costs Theory

Firms are expected to provide financial information which meets the information expectations of investors over and above other stakeholders coalesced together as stock market participants. Divergences arising from this position thereof as is the case with EM can be explained using Proprietary Costs Theory.

Proprietary Costs Theory as espoused by Verrecchia(1990), Wagenhofer, (1990) posit that there is the potential for companies to not participate in a full disclosure strategy because of the existence of disclosure related costs, or in other words, proprietary costs. These proprietary costs exist because there are the initial costs of preparation, then the costs of dissemination, but then most importantly there are also the costs of disclosing the information. There are many possible causes for this latter category of costs to arise. It follows that if proprietary costs rise in proportion to investors' expectations, then firms will more likely practice EM and vice versa.

To explain this phenomenon further, let's consider the difference between circumstances in developed and emerging security markets. In developed exchanges such as the London stock exchange, widespread share ownership is observed coupled with high liquidity and efficiency. Investors in such markets often rely on the forecasts of stock market analysts to put together a portfolio of potentially successful firms. Meeting the analysts‟ expectations is important as firms that meet or beat expectations generate higher returns, even when it is likely that this is achieved through earnings management (Bartov, and Cohen 2007.). On the other hand, missing an earnings benchmark has considerable negative implications for stock returns (Matsunaga and Park, 2001).

Thus, meeting or beating the analysts‟ forecasts to attract potential investors is considered highly important, and may encourage companies to engage in EM. If pre-managed earnings are below the forecast, managers could use income-increasing earnings management and when pre-managed earnings are higher than the forecast, managers might use income-decreasing earnings management to defer these returns to future reports hence higher proprietary costs.

Recent research also considers earnings management in specific stock market situations, such as an initial public offering (DuCharme et al., 2001). Companies that make an initial public offering do not have a previous stock price and their initial stock prices are mainly based on their financial performance before going public. Therefore, managers of 'going public' firms have an incentive to manage their earnings before their initial public offering in order to receive higher prices for their stocks.

The opposite of an equity offering, a share repurchase, can also incentivize managers to engage in earnings management. Bens et al. (2003) find that corporate managers use stock repurchases as an earnings management tool when earnings are below the level required to achieve the desired growth of earnings per share.

In relation to incentives for managers to meet stock market expectations, accounting earnings tend to be managed towards expectations in general, and towards earnings forecasts in particular. In this respect, the US evidence indicates that managers attempt to meet or beat four main earnings benchmarks. These earnings benchmarks are: meeting analysts' forecasts, reporting positive profits, sustaining last year's performance, and meeting management's expectations.

Payne and Robb (2000) study the effect of analysts' forecasts on earnings management, hypothesizing that managers have incentives to use their discretion over accounting accruals to eliminate negative earnings surprises. They find that managers manage earnings upwards when pre-managed earnings are below analysts' forecasts. However, when pre-managed earnings exceed analysts' forecasts, managers either keep discretionary accruals for future periods by employing an income-decreasing strategy or preserve a positive earnings surprise with the aim of achieving a favourable share price reaction.

Abarbanell and Lehavy (2003) use financial analysts' stock recommendations of buy, hold or sell to predict the direction of earnings management. They find that firms that receive "buy" recommendations are more likely to manage earnings to meet or exceed analysts' forecasts, while firms that receive "sell" recommendations are more likely to engage in income-decreasing earnings management, suggesting that these firms have more incentives than other firms to create accounting reserves using earnings baths.

In terms of stock market incentives to report positive profits and maintain last year's performance, Burgstahler and Dichev (1997) examine the distribution of reported earnings around incentives to avoid reporting losses or a fall in earnings. They find that using earnings management to avoid annual losses and earnings decreases is common. More specifically, they find that 30-44 percent of firms with small pre-managed losses manage earnings to raise reported net income to a positive figure. Similarly, Degeorge et al. (1999) find that managers avoid losses but, once profitability is reached, they attempt to meet analysts' earnings forecasts.

Holland and Ramsay (2003) examine whether listed Australian companies manage earnings to report positive profits and to maintain the previous year's profit, and they find evidence of discontinuities in the distribution of reported earnings and changes in earnings. Overall, it would seem that, for any specific period, managers prefer to manage reported earnings or to reduce analysts' earnings expectations with the intent of beating these expectations, rather than reveal disappointing earnings (Soffer et al., 2000).

In line with the foregoing discussions, then it would be in order to posit that since in emerging markets managers are not bound to follow analyst forecasts, then the stock market is not an incentive to practice EM. The proprietary costs on the other hand are relatively low and inverse to the practice of EM. This leads us to the first proposition stated as:

**Proposition$_1$:** *In the absence of analysts' forecasts driven stock expectations as assumed in emerging markets managers are not incentivized to practice EM but will likely practice EM in stock market special situation such as initial public offers.*

### 3.2. Management Compensation Contracts Incentives: Agency Theory

The studies have also put a case for incentives for managers to engage in earnings management to meet or beat expectations therefore influencing stock prices. This type of opportunistic behaviour may be even more likely when managers have pecuniary interest from the firm's financial performance.

Therefore, it is argued that, in order to reduce agency costs and align shareholders 'interests' with managers 'objectives', managers will enter into monitoring and bonding contracts which will help to align the interests of managers and shareholders. An example of such contracts is the management compensation plan which ties part of the management's rewards to its reported earnings.

In this respect, financial reports are usually used to establish the covenant conditions of compensation contracts and to monitor whether or not these conditions are breached. Watts and Zimmerman (1990) argue that managers in firms with earnings-based compensation contracts have incentives to report earnings results that maximize the value of their bonus awards.

A seminal investigation on the impact of executive compensation plans on accrual decisions and accounting choices was conducted by Healy (1985). This study found that managers have a pecuniary inducement to manipulate earnings in order to increase their cash bonuses. The study further concluded that there is a strong association between accruals and managers' income-reporting incentives under a management bonus plan, meaning that a bonus becomes a pre-existing condition for EM practice under such circumstances.

Leuz et al. (2003) examine varying categories of managerial opportunistic behaviour such as excessive compensation for managers. They affirm that such behaviour ultimately presents in the firm's earnings. If compensation, stock option, bonus and other performance related payments are tied to earnings, there is an incentive for managers to manipulate earnings and an information asymmetry problem is created by offering unreliable and irrelevant financial statements. This scenario creates agency costs and leads to opportunistic management behaviour, such as earnings management.

The association between earnings management and insider trading is documented by Beneish et al (2012), Park and Shin (2004) and Cheng and Warfield (2010). Other studies, such as those of Baker et al (2003) and Bartov and Mohanram (2004), document the association between earnings management and management compensation using stock options.

Whereas it is not very clear whether management compensation presently different based on level of market development, management compensation is an overt activity in developed markets as opposed to developed markets. Whereas compensation of managers in the post 2008 financial crisis has received very harsh criticism from investors and general public in equal measure, it can be argued that in covert compensation environment that is the emerging market, managers in this markets are more likely to be incentivized towards the practice of EM. Hence the second proposition:

**Proposition$_2$:** *In the absence of analysts' forecasts driven stock expectations as assumed in emerging markets managers are not incentivized to practice EM but will likely practice EM in special situation such as initial public offers.*

### 3.3. Debt Contracts Incentives: Agency Theory

In addition to possible conflicts of interests between shareholders and managers, there can also be a conflict between the interests of shareholders and those of debt holders; decisions that consider shareholders' interests, for example large dividend payments, are likely to jolt debt holders.

Thus, this conflict can cause agency costs of debt. Jensen and Meckling (1976) argue that these costs can be borne by shareholders/managers if no action is taken to reduce them by monitoring and bonding contracts. It is assumed that managers have incentives to enter into monitoring and bonding contracts in order to reduce these agency costs of debt. Writing restrictive covenants in debt agreements is an example of these costs.

In this respect, information contained in the financial statement will used to establish the covenant conditions of debt contracts and to monitor whether or not these conditions are breached. This implies that accounting policies that generate the accounting numbers are selected as a part of the wealth-maximizing process. Therefore, managers' wealth could be affected by any changes in the accounting policies and, hence, there are always incentives for managers to use specific accounting policies which enhance the firms or their own future cash flows. Kasanen et al. (1996) examine whether firms close to violating their dividend covenant restrictions change their accounting techniques to increase those limits. They find evidence of dividend-based earnings management in Finnish companies that have owners who prefer stable dividends.

The main purpose of management compensation contracts is to limit management's ability to benefit investors over creditors. Therefore, debt contracts often contain restrictive covenants to limit potential conflicts of interest between shareholders and debt holders. These covenants normally restrict the ability of management to pay dividends or issue new debt, or give debt holders the right to demand early repayment of the debt issue if minimum accounting numbers are not achieved.

Some other prior research investigates the impact of accounting restrictions in debt contracts on the managers' choice of accounting techniques. However, Fields et al. (2001:275) review the empirical research on accounting choices and conclude that the evidence on whether accounting choices are motivated by debt covenant concerns is inconclusive.

Hunt (1990) examines the debt covenants for a random sample of 187 firms and reports that more than half of the sample have a dividend covenant, about one third have a working capital covenant, 28% have a debt-equity ratio covenant and 18% have a stockholders' equity covenant. Therefore, using dividend covenants in debt contracts suggests that bondholders believe that, without this covenant, managers will not cut dividends to protect bondholders' interests.

Furthermore, Beatty and Weber (2003) provide convincing evidence on the effect of debt contracts in borrowers‟ accounting choices. They document that borrowers are more likely to make income increasing rather than income-decreasing changes. Additionally, DeFond and Jiambalvo (1994) find that their sample firms accelerated earnings one year prior to the covenant violation.

Emerging markets are characterized by a lean span of debt contractual covenants. For example, as at January 2017, the Nairobi Securities Exchange had only four corporate bonds counters meaning that a negligible size of market players will be influenced by open market debt covenants. Further, even if borrowing contracts exists, they are diminutive to the bonds and may not receive similar overt treatment. In light of these observations the study makes the third proposition as:

**Proposition$_3$**: *In the absence bond contractual covenants restraining payment of dividends emerging markets managers are not incentivised to practice EM.*

### 3.4. Political and Regulatory Requirements Incentives: Political Costs Theory

In addition to earnings management in order to influence shareholders' opinions and decisions, managers can also manage reported earnings in response to other stakeholders‟ concerns. Banking and governmental regulations that are based on accounting numbers, and tax laws, may be considered as possible sources of motives for earnings management.

Regulatory rules can put pressure on firms that would make them more prone to earnings management practice. For example, Haw et al (2005) investigated income-increasing earnings management in China as a response to governmental regulations demanding a minimum of 10% return on equity (ROE) for firms that desire to offer shares or issue bonds, and find a strong motivation for earnings management practice.

Johnston and Rock (2005) document evidence of income-decreasing earnings management in companies threatened by the Superfund Act. Moreover, D'Souza, Jacob and Ramesh (2000) present evidence for firms using earnings management to reduce labour renegotiation costs.

In terms of industry regulations, Key (1997) studies the role of accounting information in the political process surrounding regulation of the cable television industry. He investigates whether cable TV managers select accounting choices to mitigate congressional scrutiny and potential regulations and he find that such political costs can motivate earnings management practice.

In addition, Han and Wang (1998) provide evidence that oil companies used income-decreasing accounting policies during the Gulf War to avoid the political consequences of showing a higher profit from increased retail prices. In terms of regulated financial institutions, prior research documents that managers have several incentives to manage earnings such as matching financial reporting with regulatory constraints. For example, Beaver and Engel (1996), and Liu et al. (1997) indicate that banks which are very close to minimum capital competence requirements are likely to manipulate accruals.

Jones and Sharma (2001) compare old economy firms and new economy firms listed on the Australian Stock Exchange over a ten-year period. They employ four different accruals proxies for earnings management and find that new economy firms have significantly less earnings management than old economy firms. They attribute this result to the stringent disclosure regime imposed on new economy firms by the Australian Stock Exchange Listing Rule 4.713, which requires a detailed quarterly cash flow statement under the direct method. In emerging markets however, most firms are bound to qualify as new firms as per the perspective of Jones and Sharma. This premise is multifaceted. On one hand the new firms in emergent markets can be presumed not to be practicing earnings management only if the rules are stringent enough. The latter remains to be seen.

In the same respect, Black et al. (1998) examined the effects of accounting regulation on the level of earnings management in Australia, New Zealand and the UK. They find no evidence of earnings management in Australia and New Zealand; in contrast, they find strong evidence of earnings management in the UK before the change in the accounting standard on asset revaluation. Thus, managers may find deficiencies in the regulations as an incentive for earnings management.

This study opines that while emerging markets are not as heavily regulated as their developed counterparts, there is pressure to improve the regulation environment. As such political costs towards compliance to the ever changing legal environment are inherent and equally pervasive. Which would lead to motivation for a manager in this market to practice EM? This leads us to the final proposition:

**Proposition$_4$**: *In the presence of tightening regulatory environment emerging markets managers are not incentivized to practice EM.*

## 4. CONCLUSION

It is clear from the above discourse that though all financial markets are faced by the EM challenge irrespective of level of development, theoretical considerations do point to the issues that are unique to emerging markets. In which case a foundation has been laid for subsequent investigations of whether in an emerging market environment, incentives for managers to meet stock market participants' expectations; incentives for managers to manipulate earnings before initial public or seasoned equity offerings; investors are misled by earnings management; and eventually map out market consequence of earnings management.

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