African Development Finance Journal http://journals.uonbi.ac.ke/index.php/adfj
August Vol 5 No.2, 2021 PP 15-24 ISSN 2522-3186

Earnings Management: A critical Literature Review

Mongeri Oruke[1], Cyrus Mwangi Iraya (PhD)[2], Nixon Oluoch Omoro (PhD)[3] and Luther Odhiambo Otieno(PhD)[4]

Abstract

Purpose: *The purpose of this study was to takes a critical literature review of earnings management with the aim of establishing research gaps and areas for further research.*

Methodology: *The study employed meta-analysis technique by relying on findings from prior studies to draw conclusion. The study reviewed empirical evidence from both international and local context covering the period 2014 to 2020.*

Findings: *The study established both accrual based and real earnings approach techniques were used in detection of earnings management. With majority of studies suggesting Jones modified model as the most accurate, in detecting earnings management. However, the studies were inconlusive on the motivation for earnings management. The results on the relationship between earnings management, corporate governance and modified opinion were mixed.*

Implications: *The findings that links earnings management, modified audit opinions and corporate governance will be of interest to policy makers and those charged with corporate governance on how it can be constrained.*

Value of Study*: The study contributes to litelature by evaluating theoretical and empirical evidence. The study also has helped to identify research gaps, how to operationalize and test variables.*

Key Words: *Earnings Management, Corporate Governance, Audit opinion*

[1] PhD Student, Department of Finance and Accounting , University of Nairobi, Email: mongerioruke@gmail.com, Tel: +254724668358

[2] Professor, Department of Finance and Accounting , University of Nairobi.

[3] Lecturer, Department of Finance and Accounting, University of Nairobi.

[4] Senior Lecturer, Department of Finance and Accounting, University of Nairobi.

1.0 Introduction

Earnings management has been blamed as the leading cause of collapse and failures of business globally. Both investors and lenders expect quality financial information in order to make accurate investment decisions. Poor quality of financial information will give negative signal to investors and lenders thereby causing organizations to miss on funding and borrowing.

From a theoretical perspective, the agency theory predicts that as result of agency problem may opportunistic behaviors by agents including earnings management. The theory further argues that through corporate governance mechanisms the problem can be constrained. Shleifer and Vishny (1997) define corporate governance as mechanisms employed by investors to constrain opportunistic behaviors. This view is supported by a number of scholars (Fama, 1980; Fama & Jensen, 1983).

1.1.1 Earnings Management

Healy and Wahlen (1999) defines earnings management as intentional alteration of financial reports by insiders mainly management with the intention of misleading stakeholders or influence contractual outcomes. Aggressive or conservative accounting principles are used to manipulate accounting information to achieve set objectives. Managers thus estimate future economic events at their discretion and these are reflected in firms' financial reports. Such events can include expected life of long-term assets, depreciation, deferred taxes, asset impairment and losses from bad debts.

Othman and Zeghal (2006) contends that the motivation for earnings management include initial public offering and subsequent equity, effective tax rates and contractual debt. This view is supported by positive accounting theory by Watts and Zimmerman (1986) that provide three possible hypotheses for motivations for earnings management: bonus plan hypothesis; political cost hypothesis and debt hypothesis.

However, agency theory predicts that in the agency- principal relationship, information asymmetry will most likely lead to opportunistic behaviors including earnings management practices. On the other hand, signaling theory argues that management using insider information will most likely manipulate information to signal good performance to investors (Yimenu & Surur, 2019).

To detect and measure earnings management, diverse techniques have been used. The accrual based methods used include: Healy Model (1985); Jones Model (1991); modified Jones Model (1995) and more recently (Kothari, Leone, & Wasley, 2005) introduced the performance matched accrual method. Most available literature agree that the Jones modified model is more accurate in detecting earnings management (Dechow, Sloan, & Sweeney, 1996).

1.2 Research Problem

The agency theory by Jensen and Meckling (1976) predicts that due to agency conflicts agents are likely to engage in opportunistic behaviors including earnings management. The signaling theory by Spence (1973) holds that due to information asymmetry management may take advantage using insider information to manipulate information to signal good performance to investors. Both theories hold that through corporate governance mechanisms earnings management can be constrained. However, earnings management still continues to be linked to serious problems in the corporate world including failures, frauds and modified audit opinions. This has brought to question the effectiveness of corporate governance mechanisms hence the need for further research on earnings management.

Various techniques have been put forth on detection and measurement of earnings management. There is literature supporting use of accrual based techniques Dechow et al. (1996) while other literature supporting performance related earnings management (Kothari et al., 2005). This means that the subject of detection and measurement of earnings management still remains unresolved, thus creating a methodological gap. In addition, from empirical evidence there is no agreement by scholars on the motivation for earnings management.

Empirical studies on earnings management and relationship with other variables was limited to a particular context thus failing to draw comparisons and perspectives from diverse contexts. This study aims to use meta- analysis technique to examine findings from diverse prior studies thus, drawing conclusions from wider perspective both local and international perspective. It is on this background that this study aims to undertake a critical literature review with the aim to identify research gaps and areas for future research.

1.3 Study Objectives

The study Sought to:

a) The review theoretical foundation on earnings management.
b) Review empirical evidence on earnings management.
c) Establish researchable gaps on earnings management.

2.0 Literature Review

The study evaluates theories that explain the earnings management problem and empirical evidence related to earnings management.

2.1 Theoretical Foundation

The Agency theory by Jensen and Meckling (1976) provides a sound theoretical foundation of explaining the earnings management. Due to agency problems managers as agents are likely to engage in opportunistic behaviors to maximize their interests at the expense of principle including earnings management practices. However, critiques of the agency theory hold that the theory takes a simplistic view by only focusing on economic perspective but failing to consider institutional and social perspectives (Yusof, 2016).

The signalizing theory by Spence (1973) also explains the motivation for earnings management. The theory argures that due to information asymetry, management may take advantage using insider information to manipulate information to signal good performance to investors (Yimenu & Surur, 2019). In addition, shareholders may also demand earnings management to impress prospective investors (Yimenu & Surur, 2019). Both agency and signaling theories argue that information asymmetry to be key motivation for earnings management practices. In addition, the theories provide the conceptual argument for constraining earnings management.

2.2 Empirical Evidence

The study evaluated empirical evidence from various studies in both international and local contexts with the aim of establishing the key findings, contributions and areas for further research.

2.2.1 Earnings Management and Corporate Governance

Based on agency theory, earnings management can be constrained by use of corporate governance mechanisms that monitor the self-seeking agent. A number of studies have tested the relationship between corporate governance and earnings management with mixed results indicating that the subject remains unresolved.

A study by liestik, Belas, Valaskova, Nica and Durana (2020) investigated earnings management in V4 countries a European quartet of countries with cultural and political alliance in Central Europe (Hungary, Czech Republic, Poland and Slovakia). A novel approach was employed in the study. The study concluded that earnings management was practiced by enterprises in these countries. The study stressed the importance of corporate governance, ethical principle and management decisions in constraining earnings management. The study was unable to conclude on the motivation for upward manipulation of earnings.

Afzal and Habib (2018) investigated the relationship between corporate governance and earnings movement using data from 74 listed firms at Karachi securities market, covering the period 2005 to 2013. Discretionary accruals were used as a measure for earnings management. The study concluded that corporate governance practices significantly constrained earnings management among Pakistan listed firms.

Alquhaif, Latif and Chandren (2017) examined the subject of women in board and relationship with earnings management in Malaysia covering the period 2010-2015. The study established that firms with higher number of independent directors were not likely to engage in real earnings management. The study also established that firms with women in the board were less likely to engage in earnings management. In this study, share buyback was used as a measure of earnings management. The study concluded that women were effective in monitoring thus reducing earnings management practices.

Chelogoi (2017) examined the relationship between corporate governance and earnings management in the Kenya context. The study obtained and tested data from 45 listed firms at the Nairobi securities exchange covering the period, 2005-2012. The study established that audit committee independence significantly reduced earnings management. The results for board independence were not significant.

Latif and Abdullah (2015) evaluated the effectiveness of corporate governance on constraining earnings management. Sampling 120 non-financial firms listed on the Pakistan stock market covering the period 2003 to 2012. The study established that audit committee independence reduced earnings management while CEO duality and institutional shareholding increased earnings management.

Kamran and Attaullah (2014) evaluated the relationship between corporate governance, ownership and earnings management. Using 272 firms listed at the Karachi Securities exchange covering the period 2003 to 2010. Discretionary accruals were used as a measure for earnings management. The study established that earnings management practices increased with increased management ownership. The study further established that institutional investors played a significant role in constraining earnings management. The study did not find a relationship between CEO duality, board size and ownership concentration. In addition, control VC variables including leverage, profitability did not influence earnings management, however the results for age as control variables were found to be significant.

2.2. 2 Earnings Management and Audit Opinion

Based on agency theory, effective monitoring can improve the quality of financial reporting. This in effect will be reflected by the audit opinion reported by the independent auditors. A number of empirical studies have examined the relationship between corporate governance and earnings management with mixed results.

Mihai and Iuliana (2019) investigated the relationship between earnings management and audit opinion in Romania context. The study analyzed data covering the period 2012 -2017. In addition, the study introduced control variables including leverage and firm size. The results indicate that audit opinion helped in constraining earnings management relating to sales manipulation. However, audit opinion did not significantly influence the manipulation relating to overproduction.

Trisakti (2019) examined the both direct and indirect relationship between CEO overconfidence, earnings management and audit opinion in Indonesian listed firms.The study collected data covering the period 2014 to 2016. The data was analysed using both multivariate and logistic regression.The study established that a positive relationship between CEO overconfidence and earnings management. However no relationship was established between earnings management and audit opinion.

Tommasetti, Santos, Macedo and Neto (2018) examined the relationship between earnings management and audit opinion in Brazil listed firms covering the period 2012-2015. Discretionary accruals were used as a proxy for earnings management using Kothari, Leone and Wasley (2005) model. The study established significant and positive relationships between earnings management and modified audit opinion in Brazil.

Lopes (2018) examined the relationship between quality of audit and earnings management in Athens. The study collected and tested data from 472 listed firms covering the period 2013 to 2015. The study concluded that earnings management reduced with increase in audit quality, based on size of the audit firm or when the big 4 audit firms were involved. Discretionary accruals were employed to measure earnings management.

Moazedi and khansalar (2016) examined the relationship between earning management and audit opinion. The study used data from 117 listed companies covering the period 2008 to 2013. To estimate earnings management, both accrual and real methods were employed using logistic regression. The study established that discretionary accruals and abnormal cash -flow from operations had significant relationships with audit opinion.

Tsipouridou and Spathis (2014) investigated the relationship between earnings management and audit opinion in Greece. Using firms listed at Athens securities market, discretionary accruals were used as proxy for earnings management. The study established no significant relationship between earnings management and audit opinion in Athens. Firm characteristics variables were found to have significant relationship with audit opinion.

2.3 Findings, Conclusions and Recommendations

Review of the empirical evidence provided mixed results suggesting that the subject on how to constrain earnings management remains unresolved. A number of studies agreeing that corporate governance mechanism constrained earnings management (Mihai& Iuliana, 2019; Chelogoi ,2017; Alquhaif, Latif & Chandren, 2017). In contrast, others are disagreeing on the effectiveness of some corporate governance mechanisms (Kamran & Attaullah, 2014). Similarly, some studies supporting the argument that audit opinion constrained earnings management, Moazedi and khansalar (2016) while others contrasting (Trisakti ,201s9; Tsipouridou & Spathis ,2014) creating an area for further research.

Most available emprical evidence evaluated were based on studies done using data from securities market leaving a research gap in the public sector. In addition, from studies evaluated, the motivation for earnings management was inconclusive. Further, to measure and detect earnings management diverse technques were used, both accrual based and real earnings approach. Although majority of scholars supported Jones modified model as the most accurate, the area remains inconclusive area for further research.

The study has contributed to theory by examing how existing theories have been used to predict relationship among research variables, formultae and test research. This study has also contributed to policy and practice by adressing earnings management motivations, detection and ways on constraining earnings management. This information will be important to policy makers and those charged with corporate governance. The study identifies clear reseach gaps that need to be adressed in future studies. Future studies should consider testing earnings management in the state owned enterprises where mininal litelature is available.

References

Afzal, M., & Habib, M. D. (2018). Corporate Governance and Earnings Management: A Model and Empirical Investigation from Karachi Stock Exchange. *Journal of Finance & Economics Research*, 51-67.

Alquhaif, A. S., Latif, R. A., & Chandren, S. (2017). Women in Board of Directors and Real Earnings Management: Accretive Share Buyback in Malaysia. *Asian Journal of Finance & Accounting*, 48-59.

Chelogoi, S. T. (2017). Effect of corporate governance on earnings management in Kenya. *International Journal of Economics, Commerce and Management, 5*(8), 641-654.

Dechow, P. M., Sloan, R. G., & Sweeney, A. P. (1996). Causes and consequences of earnings manipulation: An analysis of firms subject to enforcement actions by the sec. *Contemporary Accounting Research*, 1-36.

Fama, E. (1980). Agency Problems and Theory of the Firm. *Journal of Political Economy*, 88-107.

Fama, E., & Jensen, M. C. (1983). Separation of Ownership and Control. *Journal of Law and Economics*, 301-325.

Healey, P., & Wahlen, J. (1999). A review of the earnings mamangement literature and its implication for standar setting. *Accounting Horizons*, *13*(4), 365-383.

Iraya, C., Mwangi , M., & Muchoki , G. W. (2015). Effect of corporate governance practices on earnings management of companies listed at the Nairobi Security Exchange (NSE). *European Scientific Journal*, 169-178.

Jensen, M., & Meckling, W. (1976). Theory of the firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics, 3*(4), 305-360.

Kamran, & Attaullah, S. (2014). The Impact of Corporate Governance and Ownership Structure on Earnings Management Practices: Evidence from Listed Companies in Pakistan. *The Lahore Journal of Economics*, 27–70.

Kothari, S. P., Lcone, A. J., & Wasley,, C. E. (2005). Performance-Matched Discretionary Accruals. *Journal of Accounting and Economics*, 163-197.

Latif, A. S., & Abdullah, F. (2015). The Effectiveness of Corporate Governance in Constraining Earnings Management in Pakistan. *The Lahore Journal of Economics*, 135–155.

liestik, T., Belas, J., Valaskova, K., Nica, E., & Durana , P. (2020, October Tuesday). Earnings management in V4 countries: the evidence of earnings smoothing and inflation. *Economic Research*. doi:10.1080/1331677X.2020.1831944

Lopes, A. P. (2018). Audit Quality and Earnings Management: Evidence from Portugal. *Athens Journal of Business & Economics, 4*(2), 179-192.

Mihai, C., & Iuliana, U. G. (2019). The Influence of Audit Opinion on the Degree of Real Earnings Management. The Case of Romanian Listed Companies. *The Audit Financiar journal, 17*(156), 666-666.

Moazedi, E., & khansalar, E. (2016). Earnings Management and Audit Opinion. *International Journal of Economics and Finance*, 113-122.

Othman, H. B., & Zeghal, D. (2006). A study of earnings-management motives in the Anglo-American and Euro-Continental accounting models: The Canadian and French cases. *The International Journal of Accounting*, 406-435.

Shleifer, A., & Vishny, R. W. (1997). A survey of corporate governance. *The Journal of Finance, 52*(2), 737–783.

Tommasetti, R., Santos, N. M., Macedo, M. A., & Neto, A. S. (2018). Relationship between Modified Audit Opinion Earnings Management and Auditor Size: evidence . *Pensar Contábil, Rio de Janeiro*, 50-57.

Tsipouridou, M., & Spathis, C. (2014). Audit opinion and earnings management: Evidence from Greece. *Accounting Forum*, 38– 54.

Watts, R., & Zimmerman, J. L. (1986). *Positive Accounting Theory*. New Jersey: Prentice-Hall, Inc.

Yimenu, K. A., & Surur, S. A. (2019). Earning Management: From Agency and Signalling Theory Perspective in Ethiopia. *Journal of Economics, Management and Trade, 24*(6), 1-12.