

# ***Corporate Governance And real earnings management: International comparison***

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## **Abstract**

This paper examines systematic differences in real earnings management across 24 countries, Our examination countries covering 2006 to 2010. we hypothesize that real earnings management is more constrained by strict discipline in countries with stronger corporate Governance. But Our findings suggest that the relationship between corporate governance and real earnings management is very weak.

Key words: Corporate Governance, real earnings management

## **1. Introduction**

Using the hand-collected data and the data from which we have based on a previous study (Enomoto et al., 2015) we will examine the relationship between real earnings management and corporate governance in 24 countries. Corporate Governance data from the Governance Metrics International (GMI).

Managers have an incentive to adjust earnings for their own benefit while violating shareholder interests. Previous studies show that managers have many incentives to manipulate earnings (Sun & Liu, 2011). At the same time, corporate governance plays a role as a tool solution for solving information asymmetries and effective distribution of economic resources to solve the agency problem among different stakeholders (Shen & Li, 2014; Kang & Ko, 2014; 2016).

Managers can implement the real earnings management in order to achieve earnings to the target level and hide the performance and "true" behavior of the company. In addition, the real earnings management may have a negative impact on the future value of the company and would be undesirable for investors. For example, Cohen and Zarowin (2010) find that companies that issuing seasonal equity offerings (SEO) are engaged in real earnings management and that the decline in SEO performance because of the real earnings management is more severe than the management of accumulated earnings. Kim and Sun (2013) note that real earnings management is positively correlated with the implicit cost of equity even after controlling the effects of real earnings management. Thus, managers in countries with strong corporate governance may avoid managing real earnings.

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## 2. Earnings management and Corporate Governance

Every company has a goal to earnings in an effort to maintain business continuity. earnings is defined as the excess of the revenue with the cost within a certain period cannot be separated from management performance. Earnings as one measure of the success of management in operating the company. Therefore, the management company is always willing to show a earnings in the financial statements(Susanto & Pradipta,2016:17). One alternative that is performed by the company's management is to take earnings management. "Earnings management is the choice by a manager of accounting policies, or real actions, affecting earnings so as to achieve some specific reported earnings objective"<sup>3</sup>(Scott,2015:445). Thus, earnings management includes both accounting policy choices and real actions (Called real activities manipulation).

According to (Roychowdhury,2006:337) real activities manipulation define as "departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations".

There is a set of real management practices to influence earnings, some of which affect sales and production costs that are reflected in their cash flow, which affects asset values. These practices can be summarized as follows: (Cohen et al.,2008:756)

- Accelerate the timing of the sale by increasing the discount or more lenient credit terms: such discounts and loose credit terms will temporarily increase sales volume, but these facilities are likely to disappear once the company returns to old prices. Additional sales will boost the earnings for the current period on the assumption that the earnings margin is essentially positive. However, both price discounts and more lenient credit terms will result in lower cash flows in the current period.

- Reporting the low cost of goods sold through increased production: managers can increase production too much to increase earnings. When managers produce more units, they can distribute fixed industrial costs over a larger number of units, thereby reducing fixed costs per unit. As long as the reduction in unit fixed costs is not offset by any increase in the marginal cost per unit, the total unit cost will be reduced. This reduces the cost of goods sold (COGS) and the company can report a higher operating margin. However, the company will continue to bear the costs of production and other acquisitions that will result in higher annual production costs relative to sales, and lower cash flows from operating operations to sales levels.

- Reduction in estimated (discretionary) expenses, including advertising, research and development, SG & A expenses. The reduction of such expenses will enhance the earnings of the current period. It can also result in higher cash flows in the current period (with the risk of future cash flow decreases) if the Company generally pays for these expenses in cash.

These practices are preferred by managers, as Graham & et al. In his study in 2005 when he surveyed a sample of 400 financial managers to determine the factors affecting the declared earnings. The study found that 78% of financial managers give up long-term economic value in order to show a more stable and stable earnings. Indicates that they are willing to manipulate real activities

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<sup>3</sup> Scott, W., 2015, Financial Accounting Theory, 7edition, Pearson Canada Inc.

to achieve these goals. He notes that executives are reluctant to use accounting flexibility under generally accepted principles through the management of receivables to manage earnings, although the management of entitlement is less harmful when compared with loss of abandonment of projects of economic value. This tendency may be to replace real economic measures rather than accounting options as a result of their association with accounting fraud at Enron (Graham et al. 2005: 66). Managers may prefer to manage receivables on real management because receivables management can take place after the end of the fiscal year when the need to manage earnings is the most assertive, while real earnings management decisions must be made before the end of the fiscal year. However, the company may have limited flexibility to manage Due to the fact that the administration of entitlements is constrained by commercial transactions and manipulation of entitlements in previous years (Gunny, 2010: 756).

Earnings management is viewed as detrimental to firms' value due to impact the on financial reporting quality. This is mainly because information asymmetry between insiders and outsiders will be higher and hence it has the potential to decrease shareholders' wealth as the information will be less informative to shareholders (Mohamad et al., 2014). Thus, the corporate governance mechanisms could mitigate the information asymmetry and reduce the divergence between shareholders and managers. In this regards, a large body of academic literature have examined the impact of corporate governance variables on earnings management (see for examples, Park and shin, 2004; Xie et al., 2003; Dechow et al, 1996; Sarkar et al., 2006 Cornett et al, 2008). Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting. (Cadbury,1992,para:2.5)<sup>4</sup> Governance is also defined as a tool that deals with the ways in which suppliers of finance to corporations guarantee a return on their investments.

### **3. Impact of governance mechanisms on real management**

Corporate governance mechanisms are a means of reducing earnings management practices, but the role of these mechanisms in reducing the motivation and practices of earnings manipulation varies according to the strength and rigor of the laws and mechanisms of governance applied in each country. Moreover, earnings management motives can be influenced by the cultural factors of core values For each community.

#### **3.1 Board of Directors and Earnings Management**

The Board of Directors and its committees are a good way to monitor the behavior of executives and management and to protect capital from misuse by

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<sup>4</sup> Cadbury, A., (1992) Report of the Committee on the financial aspects of corporate Governance, London: Gee & Co.

the administration. The greater the number of independent members of the Board of Directors and its committees, the greater the independence of the Board. Supervising and supervising the administrative and financial performance of the company and ensuring the credibility of the financial reports prepared by the management (Tamimi and Al-Saidi, 2015: 138).

The Board of Directors is one of the important tools for corporate governance, as it not only protects shareholders' interests through effective control, but helps maximize the company's financial performance and long-term shareholder wealth (Zahra & Pearce, 1989: 330). Moreover, the control of non-executive directors is more effective in management oversight. Peasnell et al. (2000) provided evidence of Board independence and manipulation of earnings and found that companies with independent boards were less likely to report optional entitlements that impact income-increasing. The study concluded that the board contributes to the integrity of lists Finance. In contrast, Park & Shin (2003) found no correlation between the external directors' contribution to the Board and improved governance practices due to the concentration of ownership and the absence of a good job market for external managers.

### **3.2 Distributed ownership and earnings management**

There are many factors that lead to the practice of managing earnings, but the need for their practice arises once the performance of the company is assessed by external parties, especially when there is an agency relationship between the owners and the management. Once the ownership is separated from the management, For positive results for those who have current or potential interests, the sole proprietor of the project when he manages and operates his work is not likely to be held fraudulently accountable for it (Muthews & Perera, 1991: 228). The agency's theory states that less focused ownership may motivate managers to manipulate financial figures for their own interests in order to obtain rewards based on more earnings and less pressure than other shareholders. Concentrated ownership can increase the effectiveness of the monitoring of the board (Gulzar & Wang, 2011:138). In contrast, dispersed ownership is an effective mechanism in countries with advanced capital markets. Dividing shareholders prefer exit strategy (Desender, 2009: 7)

Consequently, centralized ownership reduces conflict of interest, reduces information asymmetry and thus reduces the manipulation of earnings, but this view may not always be correct because when reporting is partly directed to a third party, it means that the real performance of the company is likely to be manipulated Although the property is concentrated.

### **3.3 management compensation and earnings management**

Companies design a compensation package for their managers to align the financial interests of the manager with the interests of shareholders and include most compensation packages for the basic salary and remuneration for performance, such as shares and stock options, and found some studies that there is a significant positive relationship between compensation policy and the quality of corporate governance (Kang et al. , 2006) (Core et al., 1999). On the other hand, very high levels of ownership can reduce the company's value as a result of the CEO's reluctance to invest and discourage risk, while stock

options can reduce the value of the company by increasing the incentive for the CEO to accept excessive risks (Kim and Lu, 2011).

Therefore, a good and appropriate compensation program helps to align the interests of management with the objectives of shareholders and thus reduce the conflict between them. As mentioned above, administrative compensation is linked to a certain level of earnings and stock prices when the development of a good compensation mechanism will help to reduce the manipulation of earnings and affect the prices of shares. We therefore expect a negative correlation between the good compensation mechanism and the earnings management.

Based on the previous view we can put the following hypothesis:

*There is a significant relationship between corporate governance and the management of real earnings*

#### 4. Data and methodology

From a previous study (Enomoto et al., 2015) data on earnings management for countries of the study sample were obtained. This study exploits the fact that (Enomoto et al. (2015) provide the country-level values for two measures of earnings management. Table 1 presents those two measures of earnings management. They describe the method used to develop their two earnings management measures (REM1 and REM2) as follows:

"According to Roychowdhury (2006), sales manipulation through price discounts and lenient credit terms and overproduction lead to abnormally high "production costs" relative to sales. Thus, sales manipulation and overproduction induce an imbalance in production costs and sales, resulting in a lower correlation between the change in production costs and the change in sales. We therefore use the contemporaneous correlation between the change in production costs and the change in sales (indicated by REM1) as measures of sales manipulation and overproduction. The reduction of discretionary expenditures to manage earnings should lead to abnormally low discretionary expenses. Therefore, such behavior leads to departure from the normal levels of optional expenditures. Based on the interpretation of previous studies of optional expenditures as a linear function of sales, the linear correlation between the change in optional expenses and change in sales (REM2) will be used as an indicator of the reduction of optional expenditures. If optional expenses are reduced for earnings management, REM2 must also show a low value" (Enomoto et al. 2015: 186-187).

Table 1

Summary Statistics of Real earnings management and Corporate Governance

Country	Real earnings management			Governance Index
	REM1	REM2	Rank	
Japan	0.928	0.753	1	3.3
Holland	0.859	0.651	2.5	6.45

Switzerland	0.827	0.714	3	5.86
Ireland	0.824	0.645	5.25	7.21
BELGIUM	0.846	0.6	5.5	4.35
Denmark	0.817	0.646	6	4.79
Finland	0.818	0.609	7	6.38
Germany	0.824	0.57	7.75	5.8
Indonesia	0.797	0.585	9.5	3.14
Spain	0.782	0.64	9.5	3.97
Italy	0.796	0.556	11.5	5.25
United State	0.791	0.535	12.5	7.16
France	0.781	0.56	12.5	4.7
Portugal	0.804	0.402	14.5	4.14
United kingdom	0.765	0.524	15	7.6
India	0.747	0.49	16	4.54
Hong Kong	0.776	0.422	16.5	4.06
Jordan	0.715	0.467	18	3.94
Pakistan	0.726	0.444	18	3.94
Malaysia	0.744	0.345	20	4.21
Philippines	0.644	0.412	20.5	3.94
Sri Lanka	0.701	0.371	21	3.94
Australia	0.622	0.336	23	6.65
Iraq	0.574	0.277	24	3.94

**Real earnings management** ( source: Enomoto et al.2015: 191)

**Governance Index** (source: [www.gmiratings.com](http://www.gmiratings.com))

In the measurement of the corporate governance variable, the International Corporate Governance Rating issued by GMI (Governance Metrics International) was adopted. A global governance assessment firm established in 1999 and merged with Morgan Stenally in 2014. The firm publishes a corporate governance report annually in 39 developed countries as well as countries with emerging markets in 60 countries.

The GMI index ranges from 1-10 to 1 on the scale. A country with a low rating in the strength of corporate governance measures, and a country with a ranking of 10 is the best among the group of countries ([www.corpgov.net](http://www.corpgov.net)).

## 5. Result

The simple linear regression model was used to examine the impact of corporate governance on earnings management according to the following model:

$$REM = a + \beta GOV$$

Table (10) shows that there is an inverse relationship between the management of real earnings and corporate governance, but it is a weak and insignificant relationship. And when testing the decline of governance on the management of earnings. The results of ANOVA analysis of regression testing show that the value of F is 1.165 and the probability value of 0.292 is greater than 0.05 and thus reject the hypothesis that the regression is insignificant and therefore there is no relationship between the dependent variable (earnings management) and the independent variable ). The value of R2 indicates that the independent variable contributes to (0.050) of the change in the dependent variable (earnings management). The results shown in Table (10) indicate that increasing the GOV variable in one unit will lead to a decrease in real earnings management by (-1.154). This indicates that countries have strong governance procedures that have a real earnings management practice. The effect of governance on managing fraudulent earnings is greater than the impact on real earnings management. The contrast is that governance measures are largely directed at reducing fraudulent practices.

Table 2

The impact of governance in managing real earnings

Variable	a	T	Sig.
constant	18.233	3.321	0.003
GOV	-1.154	-1.079	0.292
<b>General characteristics of the model</b>			
P-Value	F	R2	Correl.
0.292	1.165	0.050	-0.224

Therefore, based on the statistical results and after a set of considerations that explain the significance of the regression equation, we conclude by rejecting the hypothesis, which provides the answer that *"there is no significant relationship between the governance and the real earnings management of the sample countries"*

## Conclusion

The objective of the study is to examine the relationship between real earnings management and corporate governance at the country level for a sample of 24 countries. Our examination countries covering 2006 to 2010. we hypothesize that real earnings management is more constrained by strict discipline in countries with stronger corporate Governance. But Our findings suggest that the relationship between corporate governance and real earnings management is very weak. Perhaps the reason is that governance mechanisms are unable to detect real earnings management and therefore some countries have a strong corporate governance base like Australia but have strong earnings management.

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