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EARNINGS MANAGEMENT AND CORPORATE GOVERNANCE: LEGAL AND REGULATORY IMPLICATIONS

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1. Introduction

This paper intends to place earnings management in the broad context of corporate governance literature and to provide some insights into its legal and regulatory implications. Corporate scandals related to manipulation and fraud of accounting reports are now abundant with billions of dollars in monetary value. Beyond the obvious impact on debtholders, shareholders and others these acts of accounting malfeasance have a broader and potentially more serious implication as they corrupt the trust on the well functioning of financial markets. Financial markets trade claims on future cash flows which depend on a large variety of risks and contingencies. Investors in equity and debt securities are in fact buying a promise on future paybacks and consequently rely heavily on contractual agreements based on public financial information to direct their decisions. If investors start to doubt on the reliability of financial reports they will place a higher discount factor on future cash flows and consequently depreciate current prices or will, at the limit, not even trade. Thus the distrust on financial reports may potentially have a larger and negative impact on the functioning of financial markets.

To understand the earnings management phenomenon a multidisciplinary approach is needed. It is the case because managers do not use accounting techniques to distort financial reports for the sake of doing it. Managers of public companies operate in a complex network of incentives which are related to the financial position of their companies, the corporate governance environment, legal and regulatory enforcement, likelihood of civil prosecu-

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tion among other factors. Thus, despite the fact that earnings management is performed using accounting techniques it is not solely an accounting phenomenon. It is involved in a more complex series of relations and institutional arrangements. This interdisciplinary nature makes the study of earnings management a challenge even for seasoned researchers. It demands an obvious knowledge of financial accounting and auditing coupled with a good understanding of corporate governance and financial economics and a more than cursory knowledge of securities regulation and law enforcement.

Given this scenario this work intends to achieve two related purposes: (*i*) to provide a general but technically rigorous overview of earnings management and its relation to corporate governance and financial markets in order to allow readers to (*ii*) understand the legal and regulatory implications of the topic. This discussion is not intended at least primarily to accountants and financial economists but rather to lawyers and enforcement agents who demand a better understanding of earnings management to pursue their activities.

The rest of the paper is organized as follows: section 2 discusses corporate governance and firm behavior and lays the main motives for earnings manipulation; section 3 places financial accounting in the context of corporate governance arrangements; section 4 introduces the literature on earnings management while section 5 discusses the main techniques used to perform it; section 6 discusses the implications of earnings management in the legal and regulatory arena; section 7 concludes the paper.

2. Corporate Governance and Firm Behavior

The importance of corporate governance is enormous and can be verified by the considerable growth in the empirical literature on the topic. Researchers from accounting, economics, finance, management and law have investigated the relation between corporate governance and several firm characteristics. Since the seminal work of Berle and Means (1932), the importance of the governance mechanisms used by firms to discipline the separation of ownership from control has been recognized. In recent years this topic has also received significant attention from practitioners[2] and regulators (the Sarbanes-Oxley Act in the US and the Cadbury Report (1992) in the UK being only two examples of major initiatives taken worldwide) following recent governance and accounting scandals (Stiglitz, 2003; Barca and Brecht, 2002; Hellwig, 2000; Holmstrom and Kaplan, 2003). This suggests that the current control mechanisms in place in most organizations are not delivering the expected results (Coffee, 1999; Bebchuk, 2004; Barclay and Holderness, 1989; Jensen, 1989). This point was made earlier by Blair (1995). In the academic literature, especially after the nineties, the availability of international databases allowed researchers to investigate empirically the relation between corporate governance – especially investor protection – and firm behavior and the level of capital market development (La Porta *et al*., 1997; 1998; 2000; 2002). Shleifer and Vishny (1997), Becht *et al*. (2002), Michaud and Magaran (2006) and Denis (2005) provide important reviews of this extensive literature, and Hermalin (2005) discusses trends in the study of corporate governance. Faccio and Lang (2002) discuss the ownership structure of European corporations and Rajan and Zingales (2003) provide an interesting view on the relation among corporate governance, investor protection and financial development. Tirole

2. The classical book by Burrough and Helyar (1990) displays the proxy contests of the eighties and it's not directly related to the current debate on corporate governance.

(2001) discusses the research agenda on corporate governance and points to important topics for future research. There are also important textbooks in the field like Bolton and Dewatripoint (2005) that provide a comprehensive analytical coverage of the topic focusing on contracts while Tirole (2005) provides an exhaustive discussion of corporate finance using an agency theory framework.

Research in this area can be divided into two broad categories. The first, in the tradition of La Porta *et al*. (1997; 2000; 2002), try to relate the level of investor protection and other institutional variables on the level of capital market development and its impact on firms' behavior. The second, best represented by Gompers *et al.* (2003), tries to discover the relation between firm-level corporate governance arrangements and firm behavior. Works in the tradition of La Porta *et al*. (2000) have made a seminal contribution to finance and economics by empirically showing the relation between capital market development and the level of investor protection provided by each country's legal and institutional environment. These authors have shown that in countries were investors are not adequately protected, capital markets are anemic and firms have to rely on insider deals to finance their operations. An insider finance model will prevail in these countries, with firms relying on special relationships with banks and the government to access capital. These authors also relate the level of capital market development to the legal tradition. Common law countries are more likely to develop strong public credit and equity markets with dispersed ownership structures. In contrast, code law countries are more likely to present insider finance models with almost no public equity and credit markets. This line of enquiry has established that institutional variables like investor protection and legal tradition have a pervasive effect on the actions taken by firms to finance their activities.

Given the importance of institutional variables, other researchers (Karolyi, 2005; Doidge *et al*., 2006, 2007; Doidge, 2004) have tried to explain the trade-off faced by firms immersed in environments were investors are not adequately protected. Firms in these countries will find it very difficult to raise capital to finance growth opportunities. These firms face a trade-off because they can commit to superior levels of investor protection in order to attract foreign capital. However, controlling shareholders lose private benefits of control, which are supposedly very high in environments where investors are not well protected. Controlling shareholders face the loss of private benefits of control in order to have access to foreign capital to finance existing growth opportunities. Based on this argument, Karolyi (2005) argues that firms that issue ADRs in the United States – a form of legal binding according to Coffee (1999) – are the ones with larger growth opportunities at home and with relatively lower levels of investor expropriation. For the controlling shareholders of these firms, it is more advantageous and less costly to find money to finance profitable projects. These authors contribute to a vibrant literature on the effects of private benefits of control and cross-listing on firm behavior (Doidge *et al*. 2006, 2005, 2004, 2007; Doidge, 2004) along with Dyck and Zingales, 2004 and Palepu *et al*., 2002). Doidge *et al*. (2007) argue that country-level corporate governance variables are the most significant ones in shaping the performance of firms and managerial behavior. They argue and provide empirical evidence that country-level variables have a larger impact on firms' valuations than firm-level variables

The second tradition in this literature tries to understand the impact of firm-level variables on the behavior of firms, including firm performance, valuation, cost of capital and returns (Agrawal and Knoeber, 1996). Gompers *et al*. (2003) – the classic paper in the field – created a G-Score and

related it to firm valuation. However, recent evidence (Cremers and Nair, 2005; Core *et al.*, 2006) demonstrates that the results of Gompers *et al.* (2003) are statistically weak. Larcker *et al.* (2007) reviews this literature and concludes that "*the empirical research examining the association between typical measures of corporate governance and various accounting and economic outcomes has not produced a consistent set of results*". These authors discuss the validity of the typical corporate governance metrics used in the literature as the reason for the lack of association between firm-level governance and economic and accounting outputs. Another possible justification for these results is that all firms contained in the samples used in these papers are from the US, where investors receive a superior level of investor protection. Thus, supposedly firm-level arrangements will not be significant in the US because the institutional environment already protects investors well.

Some recent research gives support to this alternative idea. Black *et al.* (2006a, b) provide empirical evidence that firm-level corporate governance attributes do play an important role for a sample of Korean firms. Haniffa and Hudaib (2006) find similar results for a sample of companies from Taiwan. Lara *et al.* (2007) also find similar evidence in Spain. However, most important for this thesis are the results presented by Chong and López-de-Silanes (2007), who report a strong association between firm-level governance and firms' performance across Latin America. They argue that firm-specific variables are likely to be relatively more relevant in countries where investors receive less protection from the legal and institutional environments.

Given the novelty of this research (most of the papers have been published in the last five years), it is premature to reach conclusions about the relative importance of firm-level *versus* country-level corporate governance attributes in shaping the economic outcomes of modern corporations.

3. Corporate Governance and Financial Accounting

The literature on the relation between corporate governance and financial accounting also has grown significantly in recent years (Imhoff, 2003). Accounting scandals like Enron and Worldcom have brought significant attention to accounting manipulation and its causes (Mulford and Comiskey, 2002; Stiglitz, 2003). Bushman and Smith (2001) review this literature up to the nineties, focusing on the use of accounting numbers in executive compensation. They recognize, however, as Sloan (2001) pointed out, that the use of accounting numbers in compensation arrangements is marginal. A more recent vein in this literature investigates the relationship between corporate governance and the properties of accounting reports. Nobes (1998) classifies accounting systems based on the financing model and cultural inheritance but with no empirical evidence on such a relation (Wallace and Gernon, 1991, also provide a qualitative discussion of accounting systems). He argues that countries with common law legal traditions and strong equity markets present accounting reports designed to inform external users, so these reports are more informative. Alternatively, countries with code law legal traditions and weak equity markets present financial statements more focused on meeting regulatory needs. This general classification, however, is not based on empirical evidence. Bushman and Smith (2003) provide an illustrative discussion of the interactions between corporate governance and financial accounting. More recent research (Cheng, 2004; Graham *et al.*, 2005) provide evidence that managers can destroy firm value in order to sustain earnings performance and to keep their remuneration. This evidence increases the importance of studies which relate accounting reports and their corporate governance use.

In a seminal work, Ball *et al.* (2000b) related conditional conservatism (Basu,

1997) with countries' legal tradition and found that firms located in common law countries with developed equity and credit markets present more conservative earnings than firms located in code law countries. They argued that the demand for conservative (used as a proxy for quality) accounting is higher in common law countries and managers have incentives to provide informative accounting reports. Ball *et al.* (2000b) provided clear and indisputable evidence that the actual properties of published accounting reports depend on managers' incentives to provide informative numbers and not on regulations and standards alone. Ali and Hwang (2000) went in the same direction, analyzing firms from 16 countries and finding evidence that earnings are more informative in countries where (*i*) financing is provided through public equity markets as opposed to insider transactions, (*ii*) accounting standards are dictated by private sector bodies, (*iii*) the state participation in the economy is low, (*iv*) tax rules do not have a huge influence on accounting reports, and (*v*) more is spent on external auditing. Ali and Hwang's (2000) result generally confirm those presented by Ball *et al.* (2000b) regarding the determinants of the informativeness of earnings. Barton and Wayne (2004) provide an interesting discussion of the quality of accounting reports in an unregulated US environment.

Ball *et al.* (2003) investigated the conditional conservatism of earnings for a sample of firms from four East Asian countries. Their research design allows direct examination of the effect of codes and regulations over the actual incentives managers have to provide informative reports because all these countries share the Anglo-Saxon common law tradition but do not have developed equity and credit markets. Their result shows that firms in these countries present the same level of conditional conservatism previously found in code law countries. Their result provides additional evidence that informativeness depends on incentives and not on accounting standards. Expanding this line of research, Ball and Shivakumar (2005) examined conservatism in two samples of British public and private firms that are exposed to the same set of regulations and auditing standards but face different incentives. Their result shows that British public firms present a higher level of conservatism than their private counterparts despite being exposed to the same set of rules and regulations. There is also reported evidence (Ball and Shivakumar, 2006) that financial reporting at the time of IPOs is consistent with the tendency for listed firms reporting to be more conservative than previously as private firms, consistent with the results in Ball and Shivakumar (2005). They show that the evidence presented by Teoh *et al.* (1998 a, b) in support of the alternative hypothesis, that IPO firms opportunistically inflate earnings to influence the IPO price, is unreliable.

Bushman and Piotroski (2006) extend Ball *et al.* (2000b; 2003) and Pope and Walker (1999) by taking into account a variety of other country level institutions beyond legal tradition to explain conservatism. Bushman and Piotroski (2006) show that investor protections embodied in corporate law and the efficiency and impartiality of the judicial system play a significant role in creating incentives for timely loss recognition. Firms in countries with strong investor protection and superior judicial systems present more conservative accounting numbers. They also analyze the channels through which institutions influence conservatism, such as executive compensation, securities litigation and debt covenants. They also innovate by including political economy determinants like the state participation in the economy. Bushman and Piotroski (2006) also follow Holthausen (2003) by taking a quantitative approach to classify countries.

These recent papers contribute to prior research on cross-country determi-

nants of financial reporting like Alford *et al*. (1993), Ali and Hwang (2000), Francis *et al*. (2003), Guenther and Young (2000) and Land and Lang (2002), Bandyopadhyay *et al*. (1994), Chan and Seow (1996), Davis-Friday and Rivera (2000), Hope (2003), Huijguen and Lubberink (2003), Joos and Lang (1994) and Lang *et al*. (2004). Meek and Thomas (2004) provide a comprehensive review of market-based international accounting research. Other authors have taken a similar approach, investigating the impact of legal institutions, incentives and enforcement on earnings management, such as Leuz *et al*. (2003), and Burgstahler *et al*. (2006). There is also a similar vein in the literature concerned about the impact of institutions and incentives on disclosure, like Raonic *et al*. (2004), Jaggi and Low (2000) and Bushman *et al*. (2004). Collins and DeAngelo (1990) provide an important contribution to this literature by investigating the relation between market's response to earnings announcements and proxy contests (DeAngelo, 1988).

This body of evidence confirms the hypothesis that the actual properties of published accounting reports depend on the economic incentives managers have to publish such informative numbers. It seems that an informative accounting report is an equilibrium outcome that depends on the demand for high-quality information. However, these papers treat accounting incentives at the macro and institutional level. They assume all firms immersed in a given country have the same incentives to provide informative reports and consequently produce results that reflect the average firm. Holthausen (2003) pointed out this limitation and calls for research dealing with firm-level incentives to provide informative reports. As the financial economics literature on corporate governance has shown (Karolyi, 2005), some firms immersed in very poor institutional environments have the incentives to opt out and try access external sources of funds. These firms, presumably, will have the incentive to provide informative accounting reports to facilitate monitoring by boards, audit committees and external auditors. Arguably, the importance of firm-level incentives will be relatively higher in countries with poor investor protection (Chong and López-de-Silanes, 2007).

There is also a significant body of research which addresses the impact of firm-specific corporate governance attributes – predominantly board characteristics – on the quality of earnings and earnings management for samples of firms from developed countries (especially the US and UK). Klein (2002) and Vafeas (2005) investigate the impact of board composition and audit committee attributes on earnings management and the quality of earnings respectively. Yu (2005) relates earnings management, analyst coverage and board composition and concludes that firms with stronger internal governance manage earnings less. Ali *et al*. (2007) find that family firms face lower agency conflicts and consequently report higher quality earnings and make better financial disclosures. DeFond *et al*. (2007) finds that annual earnings announcements are more informative in countries with higher quality accounting earnings or better enforced insider trading laws. Kanangaretnam *et al*. (2007) also find that firms with higher levels of corporate governance have lower information asymmetry around quarterly earnings announcements. Sivaramakrishnan and Yu (2007) report that earnings quality is higher for firms with less serious residual agency problems. They relate more informative accounting to the adequacy, not the strength, of corporate governance. Ahmed and Duellman (2007) find that firms with stronger boards present more conservative accounting earnings using three measures of conservatism. Lobo and Zhou (2001) also find a significant relation between disclosure quality and earnings management. Laux and Laux (2006) and Peasnell *et al*. (2005) report

that boards influence earnings management. LaFond *et al.* (2007) examine the relation between earnings smoothing and governance and find that firms with greater levels of discretionary smoothing experience lower liquidity, lower trading volume and higher bid-ask spreads. They also find that discretionary smoothing is related to less strict governance measures. Beasley (1996) investigates the relation between board of directors composition and financial statement fraud. Park and Shin (2004) examine the relation between board composition and financial statement fraud in Canada. More recently Sivaramakrishnan and Yu (2008) relate governance with earnings quality. Beekes *et al.* (2004) show the relation between board composition and timeliness. Agrawal and Chadha (2005) discuss the relation between corporate governance and accounting scandals. Bartov *et al.* (2001) discusses the relation between audit qualifications and discretionary accruals as a proxy for earnings quality in the same direction of the Becker *et al.* (1998) paper. Chtourou *et al.* (2007) also discuss the relation between earnings management and corporate governance.

A large number of works investigate the relation between cross-listing and financial reporting. Lang *et al.* (2006) find that cross-listed firms exhibit lower earnings management activity than their purely domestically listed counterparts. However, these firms manage earnings more than their American peers. This result suggests that cross-listing alone does not make financial statements of non-US firms comparable to American firms' reports. Khanna *et al.* (2003), Ashbaugh and Davis-Friday (2001) examine the disclosure practices of foreign firms listed on American stock exchanges and find increased financial disclosure. Ashbaugh and Olsson (2002) examine the valuation properties of accounting numbers prepared under IAS and US-GAAP. Lang *et al.* (2003a, b) investigate the impact of cross-listing on the information environment on which firms are immersed and on the quality of their earnings.

In a recent paper, however, Larcker *et al.* (2007) criticize the literature that attempts to relate corporate governance to accounting outputs. They mention the absence of a clear and consistent set of associations between firm-level governance and accounting. This problem can be caused, as mentioned before, by the fact that most studies in this area are performed with firms from the US and UK, where the institutional level of investor protection is already high. Presumably, the importance of firm-level incentives and corporate governance arrangements will be higher for firms immersed in poor institutional environments (Holthausen, 2003 and Chong and López-de-Silanes, 2007).

Recently, a relatively small body of research has investigated the relationship between corporate governance and financial reporting in emerging markets, where supposedly firm-level governance is relatively more relevant than macro arrangements. Fan and Wong (2002) partially address this question by examining the relation between informativeness and the ownership structure of firms in seven East Asian countries. They find a negative relation between ownership concentration and timeliness, which is consistent with two alternative explanations. First, concentrated ownership creates agency problems between controlling shareholders and outside investors, causing controlling shareholders to report earnings for self-interested purposes. Second, concentrated ownership may prevent leakage of proprietary information. In the same sense, Chen *et al.* (2007) investigate the relationship between firm-specific corporate governance attributes (especially board characteristics like independence and financial expertise) and discretionary accruals in Taiwan. Their results show that the independence of members, financial expertise of independent directors and vo-

luntary formation of independent directorships are associated with lower earnings management. Other studies have investigated similar questions in other emerging markets, such as Claessens *et al*. (2000), Kim and Yi (2006) and Lee and Liao (2004), Firth *et al*. (2007). The evidence is even sparser in Latin America and Mexico, the work of Machuga and Teitel (2007) being a notable exception. This body of research is generally consistent with the notion that firm-level arrangements do have an important influence on the properties of published accounting reports.

4. Earnings Management

Earnings management is intrinsically related to earnings quality. Earnings management is defined by Schipper (1989) as a deliberate intervention in the financial accounting process in order to provide (usually for managers[3]) some private gain. Burgsthaler and Dichev (1997) show how earnings are managed to avoid earnings decreases and losses as an example of one motivation affecting manager's behavior. Leuz *et al*. (2003) argue that earnings management arises to mislead some stakeholders or to influence contractual outcomes, such as covenants, or tax returns.

Dechow and Schrand (2004) relate earnings quality to three desirable features of earnings: (*i*) to reflect current performance, (*ii*) to be useful for predicting future performance and (*iii*) to accurately annuitize intrinsic firm value. Considering this paradigm, earnings management clearly decreases earnings quality (Dechow and Schrand, 2004). Earnings management can be implemented by manipulating real transactions or accruals. Some authors have focused on real transactions manipulations (Hand, 1989; Bartov, 1993; Dechow and Sloan, 1991) but the main focus of the earnings management literature has been on accrual manipulations. However, accrual manipulations are difficult to measure from outside the firm. In this context several metrics for earnings management based on aggregate accruals have been proposed by the literature. Healy (1985) and DeAngelo (1986) apply total accruals and first-differences in total accruals as proxies for management discretion over earnings. Jones (1991) designed a model that relaxes the assumption of constant nondiscretionary accruals and estimates the discretionary accruals as the residuals of a time series regression between total accruals and changes in revenues and PP&E. Dechow *et al*. (1995) modify the Jones Model by including the change in accounts receivable in the accruals model and found better empirical results than previous models. The main criticism of these models is that they do not control for growth as accruals may not move one for one with sales and PP&E (Dechow and Schrand, 2004).

This literature points into the direction that earnings management is an undesired feature of accounting numbers and that its occurrence should be detected. Earnings management impacts negatively the usefulness of accounting numbers as inputs into corporate governance arrangements. If earnings are manipulated, outsiders will have to use other tools to monitor managers. Credible reported earnings are essential to monitor performance and consequentially to be used in contractual arrangements between managers and firm's stakeholders. However, managers may have incentives to manipulate earnings in order to hide poor performance, to pay fewer taxes, to expropriate minority shareholders and so on. A recent vein of the literature has being concerned with detecting the incentives behind earnings management practices. Leuz *et al*. (2003) show

3. This view assumes that the major conflict of interest is between shareholders and managers. Sometimes, as it's the case in Brazil, the major conflict can be between controlling shareholders and minority shareholders. This clearly changes the incentives managers have to manipulate earnings.

that earnings management is higher where investors are protected less. This result is consistent with other studies which investigate related properties of accounting numbers like conservatism and timeliness (Ball *et al.*, 2000b). This research has suggested that the actual degree of informativeness in accounting reports depends on the incentives managers face to produce it and not on the standards and regulations *per se* (Ball *et al.*, 2003). Researchers have shown (Leuz and Wusteman, 2004) that firms located in countries where the insider financing model (credit oriented financial systems) predominates do not have the incentives to produce informative accounting numbers while firms located in countries where the outsider financial model dominates (developed public debt and equity markets) produce relevant accounting reports to inform a dispersed base of shareholders.

However, some firms located in countries where the insider model predominates may have the incentives to try to opt out of their country's poor financial system to access external financial markets to fund their existing projects (Holthausen, 2003). Motives for cross-listing vary with geography and firm's sector and technology (Pagano *et al.*, 2002), but it usually involves access to more liquid capital markets and new business opportunities. These firms may have to abide to strict corporate governance rules and disclosure requirements in order to have access to international capital. Cross-listing in the American Stock Exchanges has been the major option for foreign firms trying to raise capital abroad. These firms have to comply with the American rules for listing which includes reconciling their financial statements to US GAAP – this requirement opened an important research vein trying to investigate the impact of cross-listing on the properties of accounting numbers (Bradshaw and Miller, 2004; Lang *et al.*, 2006 are good examples). Thus, an interesting phenomenon happened: firms from countries with credit oriented financial systems and poor investor protection with, supposedly, strong incentives to manipulate earnings and poor local oversight, have to prepare financial statements under rules designed for firms located in a outsider financial model country with more strict rules for preparation and disclosure of accounting reports. This situation leads to a natural question: what happens to earnings management when firms from credit oriented, poor investor protection countries with significant incentives to manipulate earnings and poor oversight from local authorities do list in a country with huge public markets for equity and debt, superior protection to investors and significant requirements on disclosure and financial statement preparation? Which set of factors dominate? The local, less rigorous, supervisory environment or the external superior governance model? Does cross-listing change the properties of accounting numbers prepared under the local GAAP?

To answer these questions Lang *et al.* (2006) show that foreign firms listed in the US present higher levels of earnings management than comparable American firms. They compare earnings management metrics built on statements prepared under US GAAP for American and foreign firms. Their results corroborate the argument presented by Siegel (2005) which states that cross-listing in the US does not provide the expected "legal bonding" but only a "reputational bonding" because the American authorities – specially the SEC – do not have the will or the resources to enforce their requirements on foreign firms. Lang *et al.* (2006) results, however, are not based on reports prepared under local GAAP. Their result is based on accounting numbers adjusted to US GAAP and cannot shed light over the impact of cross-listing on the earnings management practices of foreign firms using their local GAAP. To answer this question it is necessary to examine the earnings management metrics measured under local GAAP of foreign fir-

ms listed in the US Exchanges from countries where managers face strong incentives to manage earnings. Brazilian firms represent an interesting setting to investigate this question.

Previous research has shown that countries' institutional differences (especially legal origin – common *vs.* code law) systematically influence firms' reporting behavior, in addition to accounting standards (Ball *et al.*, 2000b; Ali and Hwang, 2000; Leuz *et al.*, 2003; Ball *et al.*, 2003; Leuz 2003a; Ball and Shivakumar, 2005; Bradshaw and Miller, 2004; and Burgstahler *et al.*, 2006). However, these papers treat firms homogeneously within countries and do not consider within-country differences in firms' attributes. My work is based on the notion that firm-level incentives do play a significant role in shaping the properties of accounting reports. Holthausen's (2003) comments on Ball *et al.* (2003) illustrate this point in detail. Managers of firms that try to opt out of their country's financial reporting regime and raise external finance need to reduce agency costs. If they believe their firms have better future economic prospects than, say, the average of the market, they may find it profitable to disclose information about their superior performance and to pledge themselves to better governance systems in order to reduce agency costs and facilitate contracting with external parties. These firms have strong incentives to provide informative accounting reports that will help outsiders assess their economic performance, which is unobservable. Thus I expect to see a close link between firm-level governance arrangements and informative accounting reports, which, I suppose, act as complements.

An important sub-theme of the literature on corporate governance and accounting quality is the possibility that firms in countries with relatively weak corporate governance regimes can achieve improved accounting quality either by cross-listing or by adopting the accounting standards of a stricter regime. Lang *et al.* (2003a and 2003b) show that cross-listing improves a firm's information environment and reduces its cost of capital. They show, however, that this improvement is not enough to bring the quality of the accounting reports of cross-listed firms to the same level of their US counterparts, suggesting that other factors beyond accounting standards play a role in shaping the properties of accounting reports. Other authors (for instance, Siegel, 2005) argue that cross-listing has little *de facto* impact on firms' actions because American regulators have little power to enforce their rules abroad. These results suggest that it may be interesting to investigate the impact of cross-listing and firm-specific attributes on the properties of accounting reports.

5. Earnings Management Techniques and Procedures

Initially it is necessary to differentiate earnings management and fraud. Earnings management is a deliberate action to interfere in the neutral process of producing financial accounting numbers with the intent of obtaining some private gain within the boundaries of generally accepted accounting principles (GAAP). Thus, earnings management differs from fraud which is a clear and undisputable violation of accounting rules or even theft. Usually is not so easy to split earnings management from fraud in actual cases when both can occur concurrently. This separation is only possible with a profound knowledge of the limits and grey areas in accounting standards.

Earnings management can be divided in three main categories reflecting it motivations: (*i*) earnings smoothing, (*ii*) earnings target and (*iii*) big bath accounting. Earnings smoothing is the use of accounting discretion to reduce volatility in earnings. The idea is present an earnings figure which is stable and preferably growing at an steady rate. Recent research (Loomis, 1999) has shown that investors pay a pre-

mium on firms which present stable earnings. There are several possible explanations for this phenomenon. The first is that investors can be mislead and believe that firms with smoothed earnings are less risky than their counterparts because managers have superior information and this kind of practice is hard to be detected especially when accounting estimates (*e.g.*, provisions for bad debts) are used. Managers also like smoothed earnings because they do not have to outperform in the future. Assume for instance a company which presents in the current period an abnormal performance over its past behavior. Analyst and external users will likely expect this current performance to be repeated in the future which can cause an enormous pressure on managers. Managers will favor the use of provisions in order to save this good performance into the future – just as an example. Equity analysts also dislike earnings volatility because it makes earnings per share harder to predict. As it is normally said the earnings management game is not only on the person who misguides but also on the ones who are misguided.

Earnings targeting is generally related to an attempt to avoid a breach of a contract or a general expectation related to the accounting figure – it can also be related to the book value of equity instead of earnings. Managers can manage earnings to avoid covenant violations like debt to equity ratios or financial expenses over EBITDA. Covenant violations are extremely expense to be renegotiated which creates a genuine motive to manage earnings. Analyst's expectation is also another source of a target. No company likes to fail expected earnings per share thresholds. Big bath accounting is the excessive pessimism on accounting estimates around certain company events. Generally a new CEO likes to account for all possible provisions and recognize all liabilities (no matter how unlikely they are). All bad news are given at a single point in time keeping the good news for the future – yes, some sort of Machiavelian accounting. Big bath is the deliberate distortion of accounting reports for the worst which can also be associated with company events when the controlling shareholder has the incentive to reduce stock prices in order to damage minority shareholders and maybe buy them out of the company in the future. It is interesting to note that not all earnings management activity is intended to improve the financial position.

Earnings management can be performed using pure accounting techniques (*e.g.*, changing a depreciation rate or a provision), real transactions (e.g. delaying the selling of property plant and equipment to postpone earnings) or a mix of the two approaches. The techniques actually used depend on the incentives and restrictions managers face. In countries with strong public equity and debt markets where companies rely heavily on external sources of funds to finance their operations experience has shown that techniques to improve revenues are the main source of manipulation followed by the recording of fictitious assets and understatement of liabilities. These techniques are used because companies face pressures to present earnings in accordance to expectations also because revenues are not taxed directly as it is the case in Brazil. In other countries like Brazil where accounting reports have been usually liked to tax reports (prior to IFRS adoption) and revenues are taxed the cases of revenue misrepresentation are relatively less frequent.

Creative managers have used a myriad of techniques to improve revenues. A very common technique is called "channel tuning" in the accounting jargon. It basically involves the dispatch of products to intermediaries who can return the products which have not been sold. According to revenue recognition rules these transactions could not be recorded as revenues. Companies however create subsidiaries and other special purpose companies with the sole intent of sending inventory for future resale but record the sales immediately after

the dispatch. Sometimes the inventory end up never been sold and the recognized revenue figure is completely fictitious. Another technique commonly used is the accounting of advancement from customers as revenues instead of liabilities. The recent financial crises uncover the practice of many financial institutions of selling receivables with full commitment of buying them back in the future as revenues (Repo 105 type of transactions). These transactions could not have been accounted in this fashion because the seller has not transferred the main risks and benefits of the receivables.

The transaction quoted above as a Repo 105 is one of a kind which illustrates a frequent problem associated with earnings management. Transactions like these can be legally but not economically considered as a sale. It is the essence over form principle in GAAP. Some transactions have the appearance of being fair but are not from a economically point of view. As financial statements have to reflect the true and fair view of the company's position these transactions have to be uncover. This however demands very specialized legal and accounting expertise which is not available always at the right time on the part of auditors and regulators. The complexity of financial instruments – especially derivatives – has been instrumental to earnings management activities performed in recent years.

Another topic of increasing importance is the misrepresentation of liabilities. Some companies try to avoid to present liabilities in their balance sheets especially when they are related to provisions for legal disputes. Misrepresentation of liabilities is serious because it has an enormous potential to mislead equity and debtholders. Investors may buy securities issued by firms with worst financial positions than their accounts present.

Experience has shown that earnings management activity has assumed different forms over the years depending on economic conditions, legal and institutional environments. Generally earnings manipulation assumes new forms and takes advantage of the general public lack of knowledge about financial accounting and complex financial structures. It is therefore imperative that regulators, investors, auditors, board and audit committee members as well as other interested parties be up to date with financial and accounting innovations in order to reduce the insider's informational advantage.

6. Legal and Regulatory Implications

The corruption of corporate reports' integrity has several legal and regulatory implications. It is natural to start with the lack of confidence in financial statements which add a great degree of uncertainty over contracts written on accounting numbers. Covenants, dividend payments, executive remuneration, public tariffs, taxes and all other kind of outputs which depend on accounting variables will have their reliability questioned. This problem may cause the use of other variables in corporate contracts which will be relatively more expensive than the use of public accounting data. Thus, earnings management can be an important transaction cost of companies. On the other side low integrity financial reports may increase the likelihood of litigation. Several scenarios may exist but the threat of class actions and actions originated from minority investors over corporate officers misbehavior is just one example. Auditors also may be challenged in court related to their behavior (or lack of) in detecting and exposing accounting problems.

Fraudulent reports are not exposed around the time the misrepresentations are actually performed. Generally there is a time lag between malfeasances and their detection by auditors or regulators. During this time several corporate actions based on accounting reports are performed (*e.g.*, dividend payments). What happen when the problems are exposed to the general public? There is considerable debate (at least in

Brazil) about the meaning of fraudulent reports which are approved by the Board and receive clear auditing opinions.

The distinction between earnings management and fraud is not easily detected in the real world. This problem also raises several questions about the administrative, civil and criminal responsibilities of the officers, directors, and auditors involved. This grey area naturally leads to incentives to misbehavior. Corporate officers under pressure to deliver good performance may choose to manipulate earnings under the impression that they will not be easily detected and when detected will not be successfully prosecuted. This kind of behavior may indicate that officers believe that this kind of misbehavior pays off.

Earnings management is also a nightmare for regulators. They have to invest scarce resources in order to train people and develop systems to prevent, detect and punish earnings manipulators. These resources would be better employed in other activities more associated with the development of equity and debt markets. It is hard to find hard evidence and proofs of earnings management to be used in litigations which cause regulators to spend valuable resources to make their cases.

7. Conclusions

This paper attempts to present a brief discussion of the corporate governance environment in which modern corporations are immersed and its relation to earnings management. It also provides some insights into the legal and regulatory implications of earnings management. The exposition intends to shed some light on the subject with an especial emphasis in a legal audience which is not familiar with earnings management and its idiosyncrasies.

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