



## The Effectiveness of Monitoring Mechanisms for Constraining Earnings Management: A Literature Survey for a Conceptual Framework

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### ABSTRACT

Recently, financial crisis and high profile corporate scandals in the United States, Europe and East Asia, have brought corporate governance and audit quality issues to the forefront in developing countries, emerging markets and transitional economies. In fact, the main issue involves manipulation of accounting data which lose investor confidence and trust in the financial reports. In order to enrich investor confidence and trust regarding financial reporting quality, firms need to adopt effective monitoring mechanisms. In relation to that, this paper proposes a conceptual framework to investigate the role of regulatory mechanisms concentrating on corporate governance and external audit for mitigating earnings management. Evidence from previous studies supports the proposed model. Hence, the extant study argues that firms with effective monitoring mechanisms in the form of corporate governance and external audit are less likely to allow earnings management because opportunistic earnings cause uncertainty about the economic value of a firm.

**Keywords:** Corporate Governance, Bankruptcy, External Audit, Earnings Management

**JEL Classifications:** G3, G33, G39, G32

### 1. INTRODUCTION

At the end of 1990s and in the beginning of the 21<sup>st</sup> century, investors around the world lost their confidence and trust in the financial statements because of corporate scandals or corporate bankruptcies at a large scale (e.g. Enron, Xerox, WorldCom, Flowtex, Royal Ahold and Tyco) around the globe (Fodio et al., 2013). This situation led to reduce investor confidence in the financial reports (Loomis, 1999). Therefore, it requires investigation of credibility, transparency and quality of financial reports for protecting shareholders and stakeholders interest, either through legislation or from other standards related to disclosure (Fearnley and Beattie, 2004).

According to Goncharov (2005), the core issue of the previous scandals was earnings management. In general, it involves manipulation of accounting data. This causes the quality of reported earnings to deteriorate and decrease investors'

confidence in financial reports (Gonzalez and Meca, 2014). Furthermore, it is adjustment in the financial reports by insiders either to misinform stakeholders or to reap the benefit of a contractual outcome. For instance, such harmful effects have indeed lead researchers to use agency theory as a framework (i.e., opportunistic hypothesis) in most of accounting research in earnings management (Alexander, 2010). Hence, earnings management is critical and vital factor that influences investment decisions for users of financial reports.

In general, Nordberg (2011) identified the need of some monitoring mechanisms for protecting investor interest and trust on accounting information as well as controlling of managerial opportunistic behavior (Siam et al., 2014). Corporate governance and external audit act as internal and external control mechanisms that offers more confidence and transparency in financial reporting process (Gonzalez and Meca, 2014). Similarly, good corporate governance helps in reducing agency costs by aligning the interests of

management and owners (Jensen and Meckling, 1976), and is the most important determinant in ensuring the quality of the financial reporting process by giving reasonable assurance that financial statements are free from material misstatements (Adeyemi and Fagbemi, 2010). A quality audit is likely to constrain opportunistic earnings management and reduce information asymmetry and conflicts of interest that exist between managers and shareholders (Lin and Hawang, 2010).

## 2. LITERATURE REVIEW

According to Joubert and Fakhfakh (2011), earnings management is a very important topic and has been at the core of accounting research for the last two and a half decades (Siam et al., 2014). In conjunction with previous studies, earnings management revolves around agency theory (Yusof, 2009). In fact, earnings are considered as the final economic outcome of any organization in a specific period of time, since it indicates the net performance of the company which sequentially explains about increase or decrease in wealth of shareholder (Tabassum et al., 2013). According to Healy and Wahlen (1999), earnings management involves manipulation of accounting data by insiders, which goes beyond generally accepted accounting principles (GAAP), causes the quality of reported earnings to deteriorate and reducing investors' confidence in financial reports. This opportunistic behavior, known as earnings management, entails the creative use of accounting techniques in such a way that the financial reports produced give an overly positive picture of firms' business activities and financial position (Gonzalez and Meca, 2014).

Corporate governance system as an internal control mechanism help in ensuring the quality of financial reports (Abbott et al., 2004; Klein, 2002) and has been used to reduce agency cost that may arise as a result of a conflict of interest between manager and shareholders. According to Fama and Jensen (1983) and Jensen and Meckling (1976), corporate governance codes are the gadgets for encouraging board of directors to play an active role in controlling the behavior of top management. The financial reporting quality and transparency is determined by mechanism of corporate governance (Mallin, 2013). Moreover, firm uses codes of corporate governance for making financial reporting procedure more transparent (Kamran and Shah, 2014) and for restoring battered reputations and investor confidence in, financial and non-financial companies (Mallin, 2013).

Additionally, the regulators believe that good corporate governance have the ability to improve the characteristics of boards and their committees and they work effectively for the best interest of shareholders (SOX, 2002). Furthermore, previous studies revealed that good governance mechanisms in the form of board of directors, audit committee characteristics and ownership structures can effectively constrain managers from being involved in earnings management practices (Alzoubi and Selamat, 2012; Aygun et al., 2014; Fodio et al., 2013; Gonzalez and Meca, 2014; Uwuigbe et al., 2014). Weak corporate governance mechanism result in a lower quality of reported earnings which is a strong indication of a serious decay in business ethics (Jesus and Emma, 2013).

The external audit provides another layer of investor protection for ensuring the transparency and credibility of financial reporting process (Krishnan and Visvanathan, 2009). In fact, the demand for external audit arises because of agency problems (Lin and Hawang, 2010). Additionally, Haq and Leghari (2015) investigate that the reports generated by the external auditor act as a medium of communication between the users of financial statements and auditor and are used by internal and external stakeholders for making investment decisions.

In addition, the external auditor plays essential role in verifying that financial reporting is fairly stated in accordance with the GAAP and reflects the actual economic condition and operating findings of the company (Hoitash et al., 2008). Nevertheless, various guidelines and measures, such as the competence, commitment of auditing standards, independence and exercise of due professional care has been used for ensuring the quality of external audit (Alghamdi, 2012). Moreover, the service quality of audit firm depends upon the experience of the auditor, their knowledge of the industry, and their independence. Therefore, stockholders depend on the external auditor for ensuring that the financial statement of a firm are not misleading (Siam et al., 2014).

## 3. THE CONCEPTUAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

The conceptual framework is developed to study the relationship of corporate governance and external audit with earnings management. In this proposed framework, corporate governance and external audit attributes act as independent variables and earnings management is the dependent variable. To emphasize, the present study tries to bridge the gap by giving a basis for a thorough and insightful discernment for the influence of corporate governance and external audit mechanisms on earnings management. Figure 1 illustrates the link between corporate governance, external audit with earnings management.

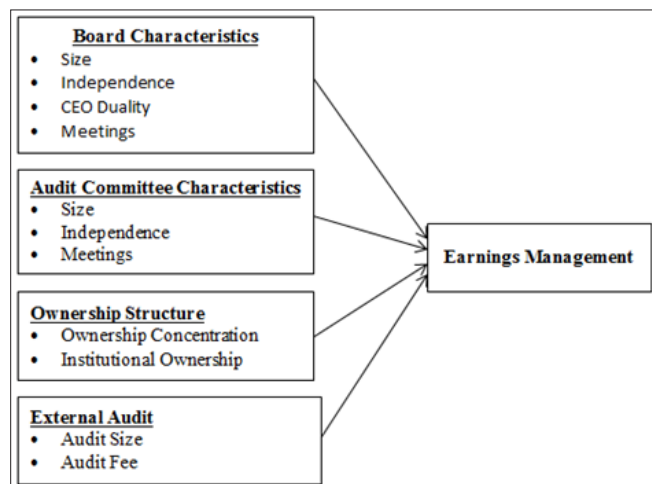
### 3.1. Board Characteristics

According to Fama and Jensen (1983), board of directors are the main decision makers in the firms. Previous studies have emphasized that board characteristics such as, board size, board independence, Chief Executive Officer (CEO) duality and meeting frequency influence the performance of the firm.

#### 3.1.1. Board size

Board size is significant for effective decisions making and has a nonlinear relationship with firm performances (Vafeas, 2005). According to Lipton and Lorsch (1992), the best board size should not exceed eight or nine directors, more than that number leads to a decrease in board effectiveness due to the process and coordination problem (Jensen, 1993). Likewise, Fodio et al. (2013) revealed that small boards are more effective because the directors can communicate better among them, as well as easy to manage. This reduces the misunderstanding and errors and issues related to financial reporting. A small board gives better financial reporting supervision because it is less bureaucratic and is linked

**Figure 1:** The conceptual framework of corporate governance, external audit and earnings management



with higher market values (Aygun et al., 2014; Iraya et al., 2015). Thus, the following hypothesis is developed:

H1: The board size is negatively related to earnings management.

### 3.1.2. Board independence

According to Alzoubi and Selamat (2012), a board comprising non-executive directors have responsibility to control and monitor management, thus, helps in reducing agency cost and improves financial reporting quality (Fama and Jensen, 1983). Moreover, independent directors do not seek self-interests and control managerial activities (Williamson, 1988). Likewise, they strengthens the firm's earnings quality in terms of earnings predictability and earnings persistency (Bita and Bazaz, 2010). Additionally, a higher proportion of independent board members encounter a lower earnings management incidence and can decrease the chance of financial information fraud (Beasley, 1996; Iraya et al., 2015; Roodposhti and Chashmi, 2011). Thus, the proposed hypothesis is:

H2: The board independence is negatively related to earnings management.

### 3.1.3. CEO duality

The CEO duality means that the CEO acts as both chairman and CEO of the board which would usually reduce the independence of the board. According to Fama and Jensen (1983) the monitoring functions of the board will be weaker when the CEO duality exists in a firm, that would also likely lead to more earnings management. From the agency theory perspective, it is necessary that these two roles are kept separate for ensuring the effective control of board over the firm's managers (Hashim and Devi, 2008). According to Chen et al., (2008), the firms that have CEOs who also chair the board are more likely to commit fraud. Davidson et al. (2004), determined that CEO duality gives the CEO greater control over the perception created by the firm's financial reports. This concentrates more power in the CEO's position and allows greater managerial discretion. Therefore, the hypothesis is;

H3: The CEO duality is negatively related to earnings management.

### 3.1.4. Board meeting

It is the responsibility of the firm directors to attend board meeting and by doing so they would have the privilege to vote key decisions (Ronen and Yaari, 2006). More frequent board meetings enhance the efficiency of board (Conger et al., 1998) and reduces the chance of fraud (Chen et al., 2008). Moreover, the operating performance of the firm will improve and more efforts are put in for monitoring the integrity of financial reports (Vafeas, 1999). Likewise, Bita and Bazaz (2010) determined that frequency of the board meetings strengthen the firm's earnings quality in terms of earnings predictability and earnings persistency. Based on all these findings, this study hypothesizes the following statement:

H4: The board frequency meeting is negatively related to earnings management.

## 3.2. Audit Committee Characteristics

Audit committee in the form of monitoring mechanism has been established by board of directors for reducing agency problem (Chen et al., 2008). In addition, it provides information regarding financial reporting purposes and control affairs of management (Fama and Jensen, 1983). According to US Sarbanes-Oxley Act of 2002 (SOX), the audit committee has been established for enhancing the integrity of financial information. Apart from the benefit that is gained from the audit committee establishment, previous studies proposed that the size, independence and frequency of audit committees meeting may impact their monitoring effectiveness (Walker, 2004).

### 3.2.1. Audit committee size

Audit committee size is considered as vital monitoring mechanism (Pincus et al., 1989). The average size of the committee is three or four members (Xie et al., 2003). For instance, too large and too small size of audit committee may affect performance of directors (Vafeas, 2005). A sufficient member in the audit committee may increases the efficiency of its monitoring function in terms of financial reporting integrity (Baxter and Cotter, 2009). Thus, the following hypothesis is developed:

H5: The audit committee size is negatively related to earnings management.

### 3.2.2. Audit committee independence

According to agency theory, the monitoring functions of audit committee increases when it has independent non-executive directors (Fama and Jensen, 1983). Accordingly, the chance of financial statement fraud is less when the audit committee is independent (Abbott et al., 2004) and are more likely to be linked with lower level of earnings management (Davidson et al., 2004; Klein, 2002; Xie et al., 2003). Moreover, independent non-executive directors may provide unbiased judgment and assessment and are able to observe management very effectively. According to Alzoubi and Selamat (2012), the larger audit committees with a greater degree of independence perform better as oversight bodies and provides better governance as compared to less independent audit committee (Xie et al., 2003). Thus, the following hypothesis is developed:

H6: The audit committee independence is negatively related to earnings management.

### 3.2.3. Audit committee meeting

According to Krishnan and Visvanathan (2009) effective and frequent audit committee meeting help to improve monitoring functions and ensuring financial reporting process. So, greater the number of audit committee meetings less the chance of fraud (Beasley, 1996). Likewise, a well-functioning audit committee comprises knowledgeable auditors and they not only reduces earnings manipulation but also enhances firm performance since it limits director interaction time (Vafeas, 1999). Thus, the following hypothesis is developed:

H7: The audit committee meeting is negatively related to earnings management.

## 3.3. Ownership Structure

The most significant ways through which a firm is able to increase its value is to develop the ownership structure of its shares. In alignment effect, the owners are also the managers of the firm and this overlapping role helps in reducing agency cost and increasing firm value. Likewise, in entrenchment effect, managers are not the owner and they have greater freedom to work for their own benefits and reducing their firm value. Prior studies suggested that ownership structure in the form of ownership concentration and institutional ownership may influence the firm earnings quality (Anderson and Reeb, 2004).

### 3.3.1. Ownership concentration

Ownership concentrations means that a large portion of firm equity is in the hand of a few individuals (Roodposhti and Chashmi, 2011). According to Wang (2006), a large proportion of ownership concentration is associated with greater chance of fraud and tendency to commit fraud. Alves (2012) reports that earnings management is significantly lower in firms with higher ownership concentration. Thus, the following hypothesis is proposed:

H8: The ownership concentration is negatively related to earnings management.

### 3.3.2. Institutional ownership

Institutional ownership represents the share of ownership held by financial and non-financial corporations. In fact, it plays an important role in the firm's corporate governance structure (Feldmann and Schwarzkopf, 2003). Likewise, these are often long-term investors and have strong incentives to collect information about the firm in which they are interested to invest (Kamran and Shah, 2014). According to Latif and Abdullah (2015) and Roodposhti and Chashmi (2011), the institutional ownership has a positive impact on the earnings informativeness. Moreover, Hashim and Devi (2012) find a positive relationship between institutional ownership and earnings management. Thus, the following hypothesis is developed:

H9: The institutional ownership is negatively related to earnings management.

## 3.4. External Audit

External audit is also another monitoring mechanism that helps in reducing agency cost and increasing firm performance (Miko and Kamardin, 2015). Moreover, they offers another layer of investor protection by decreasing the risk of misstatements (Hoitash et al., 2008). The financial statement produced by external auditors are free from material misstatements and protect the interest of all stakeholders, specifically, stockholders (Adeyemi and Fagbemi, 2010). However, Mansi et al. (2004) identify two roles of an auditor. As an information intermediary, an auditor verifies the correctness of company's financial statements before they are published. As an insurance provider, on the other hand, an auditor is legally accountable for damages to financial statement users. In line with these arguments, auditors therefore carry out primary responsibility for promoting transparency in financial reporting processes that in turn generate high quality financial statements. The external audit include the factors like audit size and audit fee.

### 3.4.1. Audit size

Previous research indicates that higher quality of audit mitigates earnings management (Chen et al., 2005; Jordan et al., 2010). A top class audit firm provides good quality audit because, the quality of audit varies among the classes of the auditors (DeAngelo, 1981). Moreover, the audit quality of big 4 auditor is greater than non-Big 4 auditors (Becker et al., 1998; DeAngelo, 1981; Watts and Zimmerman, 1986). In fact, higher quality services from big 4 auditors is due to the following reasons; they have more resources, advanced technology with trained staff for audit work and have many number of clients (Shen and Chih, 2005). For instance, Lin and Hawang (2010) concluded that industry specialist auditors and Big4 auditors have a significant negative relationship with earnings management. Similarly, the firms which are audited by a higher quality auditors are more likely to have less earnings management (Gerayli et al., 2011). Thus, the following hypothesis is proposed:

H10: The audit size is negatively related to earnings management.

### 3.4.2. Audit fee

The main responsibility of external auditors is to provide a quality audit service for their clients and charge fee accordingly (DeAngelo, 1981). In general, audit fee can be divided into normal and abnormal fee (Choi et al., 2010). Normal fees are determined by the factors which are common across the clients such as complexity, size and client risk. And abnormal fees are as a result of negotiation between the auditor and client and may be called as excess fees. The previous studies show mixed result for audit fee and earnings management. Alali (2011) found that there is a positive and significant association between earnings management and audit fees. Moreover, Ashbaugh et al. (2003) found no association between firms' total fees and earnings management. Furthermore, Frankel et al. (2002) found that audit fees are negatively associated with earnings management indicators. Thus, the following hypothesis is developed:

H11: The audit fee is negatively related to earnings management.

## 4. CONCLUSION

Earnings management area has gained considerable attention in the accounting literature after large global corporate and financial collapse. Particularly, these scandals reduce investor confidence and trust in the financial reports. Therefore, corporate governance and external audit as controlling mechanisms play an important role for improving the quality of financial reporting process. Previous studies suggested that boards of directors with smaller size, having more independent directors and high frequency of meetings are effective in their monitoring role. In the same way, audit committees with sole independence and consistent meeting patterns leads to greater efficiencies in their responsibilities. Moreover, the presence of institutional investors improves governance practices and quality of accounting information. Whereas, higher earnings quality is achieved through external audit. Specifically, this paper intends to investigate the role of monitoring mechanisms by proposing a conceptual framework in line with previous research. More significantly, this study proposed prominent factors to overcome the earnings management issues.

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