Earnings Management and IPO Pricing: A Conceptual Analysis

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Abstract: *This article is a review of existing practice of Earnings Management by different corporate entities in different countries of the world for conceptual understanding. The paper provides an account of four commonly used hypotheses in Earnings Management observed in different developed financial systems. It has identified the major techniques of earnings management as well as the motivation behind it and the impact of earnings management on IPO pricing is covered in the paper.*

1. Introduction

Earnings management refers to such strategies used by the management of a company, with which they can deliberately manipulate the company's earnings so that the corporate performance figures match a pre-determined target. Earnings management has received considerable attention by the financial regulators and media in recent years. The reason might be that earnings management helped some large firms such as WorldCom to cover up their poor financial state until they were collapsed. This article aims at providing a generic understanding of earnings management, and how earnings are manipulated by the firms making IPO with specific motivations.

Earnings may be referred to as the ‘bottom line’ or ‘net income’ and that is the most important item in the financial statements. Resources are allocated in capital market largely based on earnings. As earnings are the most important issue for a firm, its management wants to manage earnings in order to achieve their predicted or intended financial results. The purpose of earnings management may be of hiding true performance (Goncharov, 2005).

Insiders (such as controlling owners or managers) with greater private control benefits (examples of such private control benefits range from perquisite consumption to the transfer of firm assets to other firms owned by insiders or their families) have stronger incentives to conceal firm performance (Leuz, et at., 2003). These insiders can use their financial reporting discretion to overstate earnings and conceal unfavourable earnings realizations (i.e., losses) that would prompt outsider intervention. Insiders can also use their accounting discretion to create reserves for future periods by understating earnings in years of good performance, effectively making reported earnings less variable than the firm’s true economic performance (Leuz, et al., 2003).

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Accounting choices are the key tools of earnings management that helps the insiders to make the best possible decisions in their own interest. Many previous studies of earning management used discretionary and/or total accruals to proxy for earnings management (DeAngelo, 1981; Defond and Jiambalvo, 1991; Francis & Krishnan, 1999; Jones, 1991). Discretionary accruals is viewed as a better measure of earning management compared to total accruals as it is more easily subject to manipulation (Guay, et al., 1996). It is only discretionary accruals that can be managed. Jones (1991) comments that the discretionary component of total accruals is more appropriate as the measure of earnings management rather than the discretionary component of a single accrual. This is because managers are more likely to use several components of accruals to manage earnings. Another concern whether income decreasing or income decreasing is crucial when examining the earnings management. Management may use income decreasing accruals in order to increase bonuses, or earnings could be managed to reduce earning to reduce political costs. Hence, both are considered while examining to capture earnings management.

The remainder of the paper is organized as follows; section 2 provides a conceptual discussion on earnings management, section 3 provides different hypotheses of earnings management, section 4 shows the relationship between earnings management and quality of earnings, section 5 provides a brief discussion on earnings management and IPO pricing. Section 6 provides some recommendations to minimize earnings management in Bangladesh followed by a conclusion in section 7.

2. Earnings Management- Conceptual Issues

Depending on the tools of influencing earnings for the purpose of earning management behavior and the timing of earnings management there are different definitions of earnings management. According to Healy and Wahlen (1999) "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers". Desire to attract external financing at a low cost is an important motivation for earnings management. Managers use judgement to manipulate financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes (Healy and Wahlen, 1999). Firms manage earnings to reflect positive earnings, to help escalate earnings, and then to beat or meet market expectations (Degeorge, et at., 1999).

According to Healy and Wahlen (1999), earnings management is motivated:

(1) to benefit from favourable valuation of stock prices;

(2) to fulfil the contracts; and

(3) to meet regulatory requirements, such as government, stock exchange

The above motivations of earnings management makes it clear that the users of financial users such as equity investors, bondholders, bankers, suppliers, regulators, customers and competitors are the potential victim of earnings management (Lo, 2008). Earnings management can lead investors to make inefficient investments and suffer costs. It not only affects financial information users' decision, but also may affect decisions within firms. NcNichols and Stubben (2008) find that in the period of overstated earnings, misreporting firms over invest in property, plant, and equipment (NcNichols and Stubben, 2008)

Schipper (1989) has defined that earnings management as ‘disclosure management that is a purposeful intervention in the external financial reporting process, in order to obtain some private benefits. This definition is that it excludes managerial accounting reports or activities (such as lobbying the financial Accounting Standards Board) designed to influence or change Generally Accepted Accounting Principles (GAAP).

Healy and Wahlen, (1999) view earnings management as discretionary accounting choices within GAAP although there are other ways to achieve desired level of income (Schipper, 1989). Among different forms of earnings manipulation such as discretionary accruals, namely depreciation, discretionary revenues and revenue manipulation, manipulation of revenues is the most common form of earnings management (McNichols and Stubben, 2008). The discretionary component is assumed to represent earnings management while the non discretionary component represents the accruals that arise naturally during business operations (Cotten, 2008).

Impact of Earnings Management: Earnings management may impact investors by providing them with incorrect information. Investors use financial information to decide whether to buy, sell, or hold specific securities. Capital markets use financial information to set security prices. When the earnings information is incorrect, it is most likely markets will value securities correctly. To the extent that earnings management masks real performance and reduces the ability of shareholders to make informed decisions, earnings management can be viewed as an agency cost (Xie, et al., 2003).

Techniques of Earnings Management

Earnings management may be done in several ways. The techniques of earnings management can be classified under three broad headings.

The table below shows three major types of techniques of influencing earnings number

Types of Earnings Management	Method	Example
Within – GAAP earnings management (GATT alternatives)	Exploiting the available flexibility within GAAP (Such as Changes and Choices in Accounting Principles and Accrual Estimation)	LIFO Vs FIFO, Choices of calculating depreciation, changes in useful life of assets, recording/taking back provisions
Out-of GAAP	Non-compliances with GAAP	• Early recognition of revenue (for example, before goods are shipped); • Assuming a higher or lower rate of depreciation to reduce or increase reported earnings. • Taking expenses that are not reasonably expected to generate future cash flows and label them as

		investment expenditures WorldCom's practice of capitalizing operating expenses represent a striking example of the misapplication of accrual accounting (Bergstresser and Philippon,2006).
Real Transactions	Managing earnings by managing real transactions	Timing of asset disposals, R & D and maintenance expenses.

(Source: adapted from Bauwhede and Willekens (2003)

The first category consists of techniques based on exploiting the flexibility allowed by (GAAP). For example, the choice between various inventory valuation and depreciation techniques, decisions whether to record certain provisions and at what amount. The firms are tempted to abuse this flexibility to manage earnings.

The second category of earnings management techniques are done by not complying with GAAP. Early recognition of revenue before shipment is a usual type of technique to influence the earnings. Furthermore, accelerating the reporting of future revenues or delaying the reporting of current costs helps to hide poor current performance.

Finally, the third category occurs by managing real transactions such as timing of assets disposals, managing maintenance and R&D expenses (Bauwhede and Willekens, 2003).

Insiders such as managers and controlling owners manage reported earnings in order to mask true firm performance and to conceal their private control benefits (such as perquisite consumption) from outsiders (they conceal private benefits because, if these benefits are detected, outsiders may take disciplinary action against them). For example, insiders can use their financial reporting discretion to overstate earnings and conceal unfavourable earnings realizations (i.e., losses) that would prompt outsider interference. They can also use their accounting discretion to create reserves for future periods by understating earnings in years of good performance, effectively making reported earnings less variable ('smooth') than the firm's true economic performance. In essence, insiders mask their private control benefits and hence reduce the likelihood of outside intervention by managing the level and variability of reported earnings (Leuz, et al., 2003). The conflict of interest between insiders and outsiders motivate insiders to engage in these earnings manipulations.

This has been identified in a study of earnings of large firms over a fourteen quarters period of time where a steady growth was on observed. According to Scholer (2005), few firms report small losses and earnings decreases whereas, many of the firms report small positive earnings or increases, and this obviously indicates the sign of earnings management.

3. Earnings Management Hypothesis

Earnings management hypothesis can be described under four hypotheses. These are related to income smoothing, management compensation, ownership control or management buyout, and political costs issues.

The income-smoothing hypothesis: This hypothesis states that managers select accounting policies to minimize the variance of reported earnings. More specifically, managers may decrease reported earnings when operating performance is unusually high and increase reported earnings when operating performance is unusually low to 'smooth' earnings (Yoon & Miller, 2002).

The management compensation hypothesis: Under this hypothesis, managers attempts to increase reported earnings when their financial compensation depends on earnings. When operating performance exceeds the upper limit of bonus, managers may have incentives to reduce reported earnings. On the other hand, when operating performance is so low that managers cannot "manipulate" earnings to exceed the lower limit of bonus compensation, then the managers may adopt "big bath[1]" strategies (Yoon & Miller, 2002). Under this strategy, if managers cannot manipulate earnings to reach the required minimum earnings targets in a given year, they will attempt to shift current earnings to the future since their compensation will not be affected regardless if they miss the targets by a little or a big amount. By decreasing current earnings (adopting mechanisms such as by prepaying expenses, taking write-offs and/or delaying the realization of revenues) in favour of enhancing future earnings, the managers increase the probability of getting a large bonus the following year. Leuz, et al., (2003) find that when operating performance is extremely poor, some firms tend to take big bath strategies.

The ownership control or management buyout hypothesis- This hypothesis states that depending on the situation, managers will either increase or decrease reported earnings to protect the ownership control of firms. For example, if managers plan to increase their ownership percentage through a management buyout, then there usually remain clear incentives for managers to understate earnings in an attempt to acquire a firm at a lower price (Yoon & Miller, 2002; Xie, Davidson and DaDalt, 2003). However, if managers are fearful of acquisition of the firm, by a third party, they will have incentives to increase reported earnings.

Political cost hypothesis: Firms believing in this hypothesis may have incentives to manage earnings in such a way that their relative political interests are well protected. For example, rate-regulated firms will have incentives to manipulate earnings to a lower direction when the firms want to have a rate increase approved by a regulatory agency. In addition, firms may have incentives to decrease reported earnings when they lobby their governments to take certain actions to curb import of competitive foreign products.

4. Relationship Between Earnings Management and Earnings Quality

Earning quality is an abstract perception since quality cannot be directly examined. For example researchers could not come to conclude about what exactly 'high quality' of earnings mean. Depending on the perspective from which the quality is judged, earnings quality is simply to how well future earnings could be forecasted using current earnings. Under an informational perspective (the informational perspective means the important feature of accounting numbers is their information content. Information content is the information contained in the components of earnings (Schipper, 1989), quality of earnings is one of many signals that may be used to make decisions and judgments such as the valuation of securities (Schipper, 1989). From the valuation perspective, earnings are of good quality if it is a good indicator of future earnings (Penman and Zhang, 2002). AS per this perspective, the higher the earnings quality, the better the future earnings forecast. Similarly, current earnings are of low quality when future earnings forecast have low correlation with current earnings (Mackee, 2005). While there are other interpretations of earnings quality, high quality earnings are conservative, while low quality earnings are upwardly managed earnings (Kin Lo, 2008).

Penman pointed out the following five factors affect earnings quality (Mackee, 2005):

i. GAAP quality

ii. Audit quality

iii. GAAP application quality

iv. Business transaction quality

v. Disclosures quality

Quality of earnings depends on selection of the best available accounting methods, detection of misstatements by the auditor, consistency and appropriateness of the accounting methods used by the company, reflection of real economic value in the financial results and full and fairness of disclosures.

Most of the research on the quality of earnings focuses on the effects of changes in accounting estimates. Independent auditors and the Securities and Exchange Commission (SEC) can enforce accounting standards by creating framework that will provide a relatively low-cost and credible means for corporate managers to report financial results to external capital providers and other stakeholders. Therefore, financial reporting helps the best-performing firms in the economy to distinguish themselves from poor performers and also helps to allocate resources efficiently in the capital market. It also assists stakeholders to make decisions. Current earnings, which reflect management reporting judgment, have been widely found to be value-relevant and are typically better predictors of future cash flow performance than are current cash flows (Healy and Wahlen, 1999).

Earnings management has a lot in common with earnings quality such as highly managed earnings have low quality. However, the lack of earnings management is not sufficient to guarantee high quality earnings (or high quality accounting numbers more generally), because other factors contribute to the quality of earnings. For example, accountants delicately following a poor set of standards will generate low quality financial reports. However, researchers have found that there is much closer connection between earnings management and earnings quality. There exists strong relationship between earning quality and earning management when earnings quality directly signals earnings management. Semi-strong relationship exists when the earnings quality metric partly indicates earnings management. The weakest type of the relationship is observed when earnings quality metrics infers earnings management (Ghoncharov, 2005)

Although earnings quality and earnings management are sometimes used interchangeably, there are only a few measures of earnings quality which are strongly related to earnings management. As described above that earnings management occurs by using the accounting choices, real cash flow decisions and the fraud accounting to deprive some stakeholders and to influence the contractual outcomes, it may be concluded that the quality concepts such as earnings smoothing, loss avoidance, accrual quality (magnitude of accruals, discretionary accruals) constitute earnings management. Accrual quality (accrual estimation errors) has semi-strong relationship with earnings management and all other measures cannot be used as proxies for earnings management (Ghoncharov, 2005).

5. Earnings Management, Firm Value and IPO Performance

Firms especially those who are issuing Initial Public Offerings (IPOs) have some motivations to manipulate earnings. These firms manage Pre-IPO earnings upward i.e. primary issue firms have positive discretionary accruals. IPO firms are better able to resort to earnings management because there exists information asymmetry between investors and IPO issuers prior to their public offerings (Xiong, et al., 2010). The motive for earnings management by IPO issuing firms is to inflate the IPO price with a view to benefiting insiders (sponsored directors/shareholders) at the expense of IPO subscribers.

Primary issue firms and secondary firms have differing levels of earnings management. In Cotton's (2008) view, "while firms issuing only primary shares manage earnings upwards, those issuing a combination of primary and secondary shares do not manage earnings upwards, and firms issuing only secondary shares manage earnings downwards" (2008). The shares issued by the company are known as primary shares, while the shares sold by the insiders are called secondary shares (Cotten, 2008). Secondary issues firms do not manage earnings upwards with a view to reducing the likelihood of lawsuits.

IPOs usually experience fairly large returns (under pricing) on the first day of trading. Of the possible reasons for under pricing, asymmetry of information between the IPO issuing firms and outside investors is a significant reason. Information asymmetry provides the managers with the scope and incentives to embrace opportunistic behavior, including earnings management. If IPO issuers manipulate accounting variables substantially to show a rosy picture of IPO issuing firms, the accounting statements and variables will be less likely to represent their 'true profitability' , and the valuation will naturally be less accurate. In such a situation, underwriters may (and often does) adjust for the effect of earnings management to appropriately pricing the issues (Nagata & Hachiya, 2007). Prior research has found that there is a negative association between pre-IPO earnings management and subsequent stock returns over a 3-year period (Xiong, et al., 2010).

Hunt, Moyer and Shevlin (1997) find that for a given earnings level, smoother earnings are associated with a higher market value of equity. This view holds after controlling for the underlying volatility of operating cash flows, indicating that earnings volatility is incrementally informative to cash flow volatility. Burgstahler and Dicheve (1997) report that firms with a consistent pattern of earnings increases command higher price-to-earnings multiples, after controlling for earnings levels.

Tying management incentives to the stock price may have had the perverse effect of encouraging managers to exploit their discretion in reporting earnings, with an eye to manipulating the stock prices of their companies. Bergstresser and Phillippon (2006) find evidence that more “incentivized” CEOs—those whose overall compensation is more linked to company share prices—lead companies with higher levels of earnings management.

Earnings Management and firm size

Burgstahler and Dichev (1997), estimate that 8-12% of the firms with small pre-managed earnings decrease control earnings to achieve earnings increases whereas 30-44% of the firms with small pre-managed losses manage earnings (by exercising discretion) to create positive earnings. They observe that these practices are more widespread among medium- and large-sized firms.

With regard to the relationship between firm size and earnings management, it has been found large firms are more likely to manage earnings than the small firms. These firms have better bargaining power to influence auditors. Moreover, it has been found that large firms usually do not report earnings correctly (Kim, et al., 2003). There are, however, differing arguments that argued that large-sized firms may be less likely to manage earnings relative to smaller counterparts because they are followed by more financial analysts (Kim, 2003). Moreover, the reputation cost of managing earnings is very significant to big firms and this might restrict them to do so.

6. Earnings Management in Bangladesh- Some Observations:

In Bangladesh there is low compliance with disclosure regulations (Akteruddin, 2005). Integrity of audit firms is also questionable. Auditors are not required to state whether or not disclosure rules are properly complied with. In such a scenario, it is plausible to assume that management of firms may manage earnings upward to induce mispricing of shares and benefit from it. Higher earnings produce higher stock prices and higher stock prices produce greater proceeds from the IPO issues with less dilution of earnings and control. However, to our knowledge, only a few empirical studies are seen on the extent earnings management in Bangladesh. Razzaque et.al. studied evidences of earnings management in textile sector listed companies and found evidence of discretionary accrual management. The evidence indicates that in all other sectors, earnings management must be significantly prevalent. Besides their study, we have few examples of accounting treatment by few financial firms/banks which we consider management of earnings. These are:

i. It appears from audited financial statements of a private Bank for the year ended December 31, 2006 that no provision for staff gratuity has been made in the books of the bank. Gratuity benefits are accounted for in the books of the bank at the time of such payment, i.e. on cash basis. This accounting treatment may be called an example of earnings management because the Bank did not ascertain the actual liability for employees’ gratuity benefit and did not kept provisions for the same when it was due. The cost of employee benefits should have been recognized in the period in which the benefit is earned by the employee, rather than when it is paid or payable (BAS 19). So bank should ascertain the amount of Gratuity Benefits as per BAS 19 each year and full provision should be provided for the accrued liability. This earnings management falls under out of GAAP method meaning it is a violation of GAAP.

ii. It appears from the audited financial statements of a financial institution for the year ended on December 31, 2006 that the institution has provided for Tk.36,274,775.00 for the liabilities for its employees' gratuity scheme instead of Tk.239,092,524 as is required under Bangladesh Accounting Standards (BAS)19 : Employee Benefits. In this case, the institution has made short provision of Tk.356,817,749 (Tk.393092524-36274775) for the liabilities of its employees' gratuity. It appears that the institution overstated its profit to the tune of Tk. 356,817,749 by providing short provision for its employees' gratuity and consequently understated its liabilities to that extent which affected the true and fair view of the state of affairs as on December 31, 2006. It has also affected the earnings for the period ended on December 31, 2006.

7. Policy Implications

i. Earnings management is less likely to occur in companies whose boards include both non-executive independent directors and directors with corporate experience. The composition of audit committee with corporate finance, accounting and or investment banking backgrounds help reduce the incentives for managers to earnings management due to their fear of being caught. The SEC of Bangladesh should make earnings management a top priority in its monitoring agenda. It can direct accounting professionals to provide adequate and relevant information in their certified financial statements to meet existing disclosure requirements to check earnings management. SEC can form an earnings management task force to control earnings management to safeguard investors' interests.

ii. The SEC must set the level of discretion that managers should be allowed to exercise in financial reporting. This is because earnings management have significant impact on stock markets and investors.

iii. In Bangladesh, IPOs are priced on the basis of projected Earnings per share or EPS (under book building method). Therefore, they manipulate EPS beforehand. So pricing should not be based on projected earnings; instead it should be based on historical EPS (3/5 years). In India, pricing is not based on projected EPS.

iv. At present, (margin) brokers and merchant bankers provide to the investors on the basis of price earnings ratio of marginable securities. This gives the companies to get incentives to manage and show higher earnings in order to avail more margin for investors which may ultimately result in manipulation of the market price. Therefore, margin should not be linked with the P/E ratio of marginable securities.

8. Conclusion

On balance, one of the most important reasons of earnings management is to present the financial performance of the company in the best possible manner. There might me some reasons for earnings management such as market expectations especially before IPO, contractual motives, regulatory motives and so on. If we relate human psychology to this matter of earnings management, we will find that, as human being we always like to see things in positive manner than in negative ones. Though the truth is always true, sometimes people cannot accept that due to their inner self. If management shows the true but realistic earnings, which might not be at par with the expectation of stockholders, it might bring negative outcomes for all; hence, management tries to protect all those uncertainty by showing some rosy picture of the business through earnings management.

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Under big bath strategy, the manager under-reports current earnings by the maximum, preferring to take a big bath in the current period to report higher future earnings. In spite of short-term pain at the bottom line, heavy one-time charges under this strategy can clear the decks for sharply improved performance in the future (Jo, Hoje, Kim and Yongtae,2007).