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Revisiting the Association between Corporate Governance and Earnings Management (Kurumsal Yönetim ile Kar Yönetimi Arasındaki İlişkinin Yeniden Değerlendirilmesi)

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Earnings management, corporate governance, agency theory.

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Abstract
This study aims to explain the association between corporate governance and earnings management by emphasizing the four main theories underlying corporate governance. Main focus of the paper is to take corporate governance practices as a monitoring mechanism to prevent opportunistic type of earnings management practices. While exhibiting substantial review from the world literature, the study provides an insight to the Turkish corporate governance awareness.

Anahtar Kelimeler
Kâr yönetimi, kurumsal yönetimi, vekâlet teorisi.

Jel Sınıflandırması
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Özet
Bu çalışmanın amacı, kurumsal yönetimin temelini oluşturan başlıca dört teori üzerinde yoğunlaşarak kurumsal yönetim ve kâr yönetimi arasında bulunan ilişkiyi açıklamaktır. Bu çalışmanın ana odağı, fırsatçı tipteki kâr yönetimi yönelimlerini önlemek için kurumsal yönetim uygulamalarını bir denetleme mekanizması olarak ele almaktır. Bu araştırma, aynı zamanda da gelişmekte olan Türkiye örneğinde kurumsal yönetim farkındalığına ışık tutmayı amaçlamaktır.

1. Introduction

Essential objective of financial accounting is to provide relevant and reliable information to related users for making important decisions (Williams et al., 2002). However, while making decisions, conflicts may arise between the users of accounting information and the interests of the firm. Both the users and the firm aim to maximize their benefits by manipulating accounting information to favor themselves by increasing or lowering earnings for the firm and mostly increasing only for individuals.

Managers may practice earnings management to release some useful, private and superior information to the public they know about the firm's performance. If this is the case, then earnings management is efficient and may not be harmful to stockholders and the public in general. On the other hand, financial scandals that shocked the accounting world like Enron, WorldCom, Tyco etc. have all created a public sensitivity that earnings management is used opportunistically by firm managers on behalf of their own self-contained benefits rather than for the benefits of the stockholders (Jiraporn et al., 2008).

In Turkey, earnings management turned out to be a topic of increased interest for financial regulators right after the 2001 economic crisis. The crisis put forward the significance of reliability in accounting information. Many investors in different levels had experienced big losses, and capital markets came under question. Accordingly, new regulations come into charge to assure faithful representation and establish accurate pricing in the market (CMB, 2003). To overcome earnings management, corporate governance practices have been improved and more dependency has been allocated to independent/external auditors. Primary objective of corporate governance is to act like a monitoring system, so is to solve agency conflicts by supporting management's interests with shareholders, while diminishing the management's aptitude to manage earnings (Xie et al., 2003).

The notion of earnings management is vitally important in Turkey, even though it is not broadly discussed within the scope of the literature. In this context, this study aims to enlighten the association between corporate governance and earnings

management by taking a closer look at the four main theories and to elevate the level of awareness of accounting for the users in Turkey.

2. Literature Review

In order to make an attempt to explain the association between corporate governance and earnings management, clear definitions of these two concepts are needed. Additionally, the four main theories underlying corporate governance, which are agency, signaling, stakeholder, and institutional theory require attention in order to incorporate the philosophy of corporate governance with earnings management.

2.1. Corporate Governance

"Our knowledge of what we know about the efficacy of corporate governance mechanisms is rivaled by what we do not know" (Daily et al., 2003).

Cadbury Committee (Cadbury, 1992) defines corporate governance as *"the system by which companies are directed and controlled"*. Organization for Economic Co-operation and Development (OECD) as an international organization containing 34 countries with the sole objective of encouraging economic development and world trade, defines corporate governance as:

> *"The system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance"* (OECD, 2004).

Furthermore, there is another well-known definition for corporate governance, which states corporate governance as "*a set of mechanisms through which outside investors protect themselves against expropriation by the insiders*" (La Porta et al., 2000). While corporate governance can be defined as the system that directs and controls the business activities with the management, it clarifies rules, practices, and

procedures to distribute rights and responsibilities for the managers, board and other stakeholders in the name of making the correct and reliable decisions (Gulzar and Wang, 2011). Corporate governance is beyond just a system; rather a monitoring mechanism embedded into a philosophy, which protects firms and expands the investor trust and confidence. It safeguards the stakeholders from fraud, cheating, mismanagement, dishonesty, and offenses. An underlying investors' concern about corporate governance is its potential impact on value creation (Cormier et al., 2010). Moreover, corporate governance provides transparency, accountability, efficiency, and reliability. It comprises of laws, procedures, routes, customs and instruments that influence the style a company is managed or directed (OECD, 2004).

2.2. Earnings Management

Accounting manipulation ranges over a number of methods like earnings management, income smoothing, big bath accounting, aggressive accounting, and simply fraud. Above-mentioned methods - *except for fraud* - are the results of loopholes within the scope of the accounting standards. Managers or other insiders practice earnings management to deceive stakeholders or to affect contractual outcomes by making adjustments through reported earnings. Good corporate governance structure can prevent earnings manipulation and turns earnings management into more reliable and informative tool (Gulzar and Wang, 2011).

It is fair to state that earnings management is very different than fraud. At the same time, it includes fraud, purposeful violations of local generally accepted accounting principles (GAAP), and accounting choices within GAAP that mask true economic performance and the volatility of earning (Pergola and Joseph, 2011). It concerns the selection of estimates and accounting techniques. Earnings management lies between the boundaries of legal framework and any firm that practice earnings management can be demonstrated within the borders of accepted accounting manipulation (Rashidah and Fairuzana, 2006).

Dechow and Skinner (2000) suggest that there is only a thin line between earnings management and fraud. Thus, there is a broad array of earnings management tricks

and they cannot always be easily revealed and classified. There is a scale that changes from precise conservative accounting and absolute legitimacy to fraud. However, aggressive accounting choices make it difficult to distinguish between opportunistic behavior of earnings management and the legitimate practice of accounting discretion without classifying the managerial motivations to manipulate earnings. One thing is clear that earnings management is an intentional action. It takes in any kind of manipulation that may influence financial reporting over earnings or any other related accounts under legal framework of accepted principles. This manipulation can be practiced to meet the objectives of opportunistic or efficient behavior of earnings management. The practice of managing earnings makes investors and shareholders to have distorted judgments about the company since the performance of the company does not reveal the true results. Therefore, good corporate governance structure together with effective board monitoring is essential to reduce the occurrence of earnings manipulation when motivations for such manipulations are high. Equally, Chtourou et al., (2001) have found that the board size and competence are negatively associated with earnings management.

2.3. Corporate Governance and Earning Management

The literature reviews the theoretical framework with four main theories to explain and analyze the association between earnings management and corporate governance. These theories are agency theory, signaling theory, stewardship theory and institutional theory. Directly involved with the above mentioned theories, ownership structure is a critical issue as well which is an internal control mechanism that focuses on the aspects that define the ownership of the company and refers to the manner in which titles or rights of representation redistribute the capital of the company in one or more individuals or legal entities. The monitoring power derived from the ownership structure results in the type of control exercised over the company and particularly, over the top management team (Gonzalez and Garcia-Meca, 2014).

2.4. Agency Theory

The essential point in agency theory is that the agents will generally be interested in their personal wealth and try to increase their personal gains rather than maximizing the shareholders' value, which finally will facilitate earnings management. The theory offers unique insight into information systems, outcome uncertainty, incentives, and risk in addition to the fact that it is an empirically valid perspective (Eisenhardt, 1989). The chasing of personal interests upsurges costs to the firm. These costs include monitoring and controlling costs and losses due to wrong decisions made by the managers. The outcomes of this opportunistic behavior eventually will be reflected in the firm's earnings (Jensen and Meckling, 1976). Subsequently, agents have a motivation to manage reported earnings so as to meet earnings targets and therefore, to get performance related payment or bonuses that are related to the firm's earnings. This situation generates an information asymmetry as managers practice the discretion they hold on accruals, which alternately decreases the reliability together with the relevance of reported earnings and the entire financial statements.

2.5. Signaling Theory

The main purpose for signaling theory is to give explanation for certain accounting practices. It provides an opportunity to integrate an interactive theory of symbolic communication and social benefit with materialist theories of individual strategic action and adaptation (Bliege and Smith, 2005). The theory assumes that accounting numbers need to be verified as an unaffected tool by signaling investors to better understand the firm's actual value. The researchers who used signaling theory as a hypothesis revealed that there is an information asymmetry among agents and investors. In this regard, earnings management can be seen as a useful tool, since it enables communication of private information with investors so that they can shape their long-term decisions and have valid opinions about the firm's strategies within the legal framework of law. Moreover, at the center of this theory, manipulated accounting numbers are instruments to signaling. Investors get the signal as much as firm allows them to better understand the firm's value and create stock portfolio in the best manner (Habbash, 2010).

2.6. Stakeholder Theory

Freeman (1984) defines stakeholders as *"any group or individual who can affect or is affected by the achievement of the organization objectives".* The main groups of stakeholders are the customers, employees, local communities, suppliers and distributors, and the shareholders. In addition these, Friedman (2006) includes the media, the public in general, business partners, future generations, past generations, academics, competitors, NGOs, activists, trade unions, financiers other than stockholders such as debt holders, bondholders and creditors in general, competitors, the government, regulators, and the policymakers.

Stakeholder theory describes companies as multilateral agreements between the business and its various stakeholders. The association between the business and its internal stakeholders; like managers or employees, is outlined by formal and informal laws and rules occurred in the course of time of the relationship. Although management might get finance from shareholders, they are based on employees to achieve the productive aim of the company.

According to the theory, external stakeholders, such as suppliers, community and customers, are also bordered by formal and informal laws and rules. The theory can be perceived as an extension of agency theory, which assumes board of directors to care for the interests of shareholders. The association between stakeholder theory and earnings management is that management might manage earnings so as to improve their personal gains through the expense of the stakeholders (Freeman, 2010).

2.7. Institutional Theory

According to institutional theory, companies are tied to rules together with regulations, which they must obey so as to safeguard their legitimacy and therefore, have access to resources and guarantee their survival. However, the frame that is composed of rules and regulations do not automatically assure that the business will efficiently continue its operations. The center of this theory goes with the aim that corporate governance should declare that a company is associated to an environment by stating its goals, which must create harmony with the

environmental expectations. Therefore, corporate governance should define the goals of the company as part of an existing value system inside the company (Habbash, 2010).

Good governance embraces effective monitoring. Effective monitoring can be effected by two important characteristics. First one is the size of the board. Board size is related with the performance of any firm. Smaller boards are thought as more effective and present better firm performance, since they can make strategic decisions and have strong communication with less conflict. The second is to have independent non-executive members on the board. They are thought as independent monitoring mechanism. Thus, they can reduce agency problems and improve firm performance (Saleh et al., 2005).

3. Corporate Governance in Turkey

According to Capital Markets Board of Turkey, board of directors is the highest administrative body, which makes strategic and executive-level decisions for the firm. The major aim of the board is to increase the market value of the firm to its maximum level. Moreover, the board should guarantee that shareholders get steady income and should uphold the balance between the shareholders' interest and growth of the company, in order to avoid agency problems.

Board members must not announce confidential or inside information to the public or other parties and they must not use information for their interest. Within the framework of corporate governance principles, board of directors is liable for achieving firm's goals in the most transparent behavior (CMB, 2003).

Corporate governance principles for Turkey directs board members to be efficient, independent when making decisions, free of any influence and conflicts, since these characteristics form the success and performance level of the firm. Furthermore, board should have independent non-executive members. They are expected to be objective, free from bias, and act equally when making decisions. In order to apply good corporate governance practices, the majority of the board members should be independent. However in Turkey, board of directors should have at least two independent non-executive members and one third of the members should fulfill the

criteria for independence (CMB, 2003).

The OECD has directly influenced Turkey as far as corporate governance is concerned. Capital Markets Board of Turkey has fully embraced these principles. In hope to encourage the implementation of the principles, in 2004, Capital Market Board of Turkey promulgated that the BIST companies would be liable for publishing a Corporate Governance Compliance Report along with their annual reports. The Report allowed companies to explain their compliance levels consistent with the *comply or explain* approach adopted by the Capital Markets Board of Turkey. Shortly after, in 2007, BIST has established a Corporate Governance Index (XKURY) based on the compliance levels of BIST companies to measure their profitability and income performances (Karacar and Muştu, 2014).

Turkey as a developing country with an emerging capital market and an economy should emphasize the significance of corporate governance. There are debates over the level of corporate governance among the Turkish listed firms where a portion of the academia and regulators believe that the level of corporate governance is strong enough. On the other hand, a greater portion believes that these firms are directed with weak corporate governance structures in general, meaning that there is a weak investor protection and minority rights. Moreover, nepotism acts as a major constraint for the Turkish firms with pyramidal and high family-orientated ownership structure, which holds conflicting stand against the hope to successfully implement permanent and strong corporate governance configurations. It has been the case that the majority of the family members are active in the decision making processes who are either top managers, CEOs or board members at the Turkish listed firms (Karaibrahimoğlu, 2013). It is evident that framing permanent and strong corporate governance is an immensely challenging task and in the name of ultimate success, the essence of such system should be constructed upon fairness, transparency, accountability, and responsibility (Capital Market Boards of Turkey, 2005).

Family oriented structure of ownership is very common in countries like Turkey and the United States. This may not be a problem in countries with strong structures of corporate governance, laws, protection and regulations for the rights of minority

shareholders. Such nature of a market with highly populated family oriented structure of ownership is doomed to fail in developing countries unless a new state of mind is established.

Lately in Turkey, a new generation of family oriented businesses has emerged with a more sustainability-focused view towards the future that concern and allocate more attention to corporate governance so as to survive in today's evermore competitive world (Özsöz et al., 2014). Certainly, such consciousness has been built due to several factors, one of which was the 2001 economic crisis of Turkey, which increased public interest towards corporate governance. Noteworthy reforms regarding corporate governance have been established in the period following the crisis. Capital Markets Board of Turkey (CMB) has issued the Corporate Governance Principles of Turkey for all listed firms in 2003 for the purpose of recovery and improvement of corporate governance. These principles are robustly being practiced since 2005. CMB requires all listed firms to have official web pages and imposes them to disclose their Corporate Governance Compliance Report on that site. This report presents the level of non-compliance or compliance considering the guidelines of CMB (CMB, 2003).

4. Conclusion

Earnings management and corporate governance literature indicates that the practices of corporate governance can be effectively used as a monitoring mechanism to effect the reliability and consistency of financial statements by limiting earnings management practices.

Good governance embraces effective monitoring and effective monitoring can be effected by characteristics of the board. Board size and board independency are the important practices of corporate governance. Smaller boards are thought as more effective, since they have less difficulty in monitoring, coordinating and managing issues (Fama and Jensen, 1983). Board independency can reduce agency problems and improve firm performance since it is thought as independent monitoring mechanism (Saleh et al., 2005).

Since there is an increasing awareness of corporate governance practices to prevent

earnings management manipulation after economic crises taken place in Turkey, Capital Markets Board of Turkey adjusted its rules. According to Capital Markets Board of Turkey, the number of the board members must be at least five and the number of independent non-executive board members must be at least one third of the board and in any case there has to be two independent non-executive members on the board (CMB, 2003). Without successful corporate governance where there is lack of transparency, accountability, responsibility, and fairness, manipulative initiatives are expected to intensify, quality of financial statements to mislead drastically, while earnings management along with other accounting manipulation methods to escalate.

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