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The Effect of Board Characteristics on Earnings Management in Differently-Sized European Firms:
Earnings Management and Corporate Governance

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ABSTRACT

The effectiveness and the monitoring potentials of the board are crucial parameters for management in the decision-making process. This study investigates the effect of board characteristics on the level of earnings management in EU listed firms. The findings indicate that the oversized boards function as a restricting determinant to the level of real and accrual-based manipulations. Also, the average board tenure is negatively correlated with real earnings management measures. An additional research query of this research is whether the effect of the board characteristics is diverse in different sized firms. In smaller firms, the board size impacts the accrual-based measures positively, while in the bigger firms, there is a positive association only with real earnings management measures. Furthermore, in smaller firms, an increase in board tenure seems to facilitate the manipulations using accounting policies and limit the manipulations of real activities. Finally, the results demonstrate that CEO-chairman duality is negatively related to the level of real earnings management.

KEYWORDS

Corporate Governance, Earnings Management, Target Firms

1. INTRODUCTION

The central role of the board of directors is to represent the shareholders and secure their interests monitoring the management decisions and providing guidelines for future strategies. The ownership structure determines the power and responsibilities of the board, which simultaneously influences managers' strength in the decision-making process. The quality of the board can limit or enhance the power of managers and their ability to manage the corporate problems according to their discretion or following the board's and shareholders' instructions.

The board characteristics can determine crucial corporate processes such as the financial reporting procedures, which affect the firm value and the perception of outsiders for the financial performance of the firms. The board size can reflect information about the board's monitoring ability and its attention on the management decisions and can be a significant determinant of the firm earnings performance and value (Yermack,1996; Eisenberg et al.,1998; Fuerst and Kang,2000). Lipton and Lorsch (1992) and Jensen (1993) suggest that oversized boards lack communication and effective collaboration. Consequently, board directors do not pay the required attention to the earnings management practices allowing managers to configure the level of manipulation considering

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their benefits (Dechow et al.,1996; Kao & Chen,2004; Beiner et al.,2004; Jaggi and Leung,2007). However, Xie et al.(2003), Ebrahim (2007), and Rajeevan and Ajward (2019) claimed that the board size is negatively related to earnings management because as the board size increases, more experienced and qualified members participate in the board operations, detecting and limiting the earnings management practices. The level of board independence can mitigate the earnings manipulation by assessing without prejudice the management actions (Klein,2002; Xie et al.,2003; Be'dard et al.,2004; Busirin et al.,2015). On the contrary, managers often avoid sharing corporate information with independent directors, which renders the monitoring work of independent members more complex and inefficient (Vafeas,2005; Agrawal and Chadha,2005; Larcker et al.,2007). Forbes and Milliken (1999) emphasized the board tenure as a signal of experience and expertise of board members on the detection of earnings management, which contributes to the limitation of manipulation practices. On the contrary, Vafeas (2005) supported that long-term tenure induces strong bonds between directors and managers, leading the board members to more relaxed scrutiny and monitoring procedures. The board meeting frequency can be a feature of an active and efficient board that attends and intervenes in the decision-making procedure (Vafeas,1999; Ronen and Yaari,2008; Lorsch,1992; Jensen,1993; Xie et al.,2003; Gulzar,2011). The gathering of CEO and chairman's duties on one person can provide advantages such as diminishing cost and information sharing problems (Yasser and Mamun,2015; Chang and Sun,2009) but also can lead to more intense earnings manipulation practices. According to Dechow et al. (1996), CEO-chairman duality is a feature of firms that engage in earnings management more aggressively. Also, other studies (Gul and Wah,2002; Andreson, 2003) supported the notion that the markets and analysts perceive the CEO-chairman duality as a weakness for the monitoring duties of the board. Another characteristic that possibly affects earnings management is board attendance, which according to the literature, can be a determinant of the improvement of firm performance (Brown and Caylor, 2004; Chou et al.,2013). Similarly, according to Lin et al. (2014), Quamhan et al.(2018) and Barros and Sarmento (2019) the board attendance is associated with higher levels of accounting information quality.

The purpose of this study is to investigate the impact of board characteristics on the earnings management activities of European firms during the period 2011-2019. The contribution of this research is the examination of the earnings management behavior in different-sized firms to observe the changes of the effect of the board characteristics as the firm grows. The earnings management measures are calculated with real and accrual-based estimation models to capture accounting and operating activities earnings management technics.

The results of the entire sample indicate that board size is positively associated with real earnings manipulation because of the inefficient communication and collaboration among the directors. Moreover, the members who participate in the board in a long-term period develop monitoring and administrative qualifications restricting the manipulation level. In the second stage of the empirical analysis, the earnings management profile of the sample firms seems to be diversified depending on the firm size. In smaller firms, the board size is positively related to the involvement of managers in the accounting manipulations, while in bigger firms, an oversized board is a characteristic of firms involved in manipulations of operating activities. Moreover, smaller firms with higher board tenure engage more aggressively in accrual-based manipulations in contrast with bigger firms in which an increase in board size induce a decrease in the real earnings management procedures. In addition, the CEO-chairman duality seems to be inversely correlated with real activities manipulations through the method of overproduction (abnormal production cost) in smaller firms.

The remainder of the paper is structured as follows: Sect. 2 presents an overview of the comparative literature, while Section 3 includes the methodology steps. Section 4 provides the analysis of the empirical results, and finally, Section 5 the concluding remarks.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

One of the most debated topics in the field of accounting is earnings management and the factors that facilitate or limit such corporate practices. Managers, motivated by various factors, often exercise their discretion on the financial statements to inform the externals about the actual firm performance or conceal the underline problems (Trueman and Titman,1988; Rosner,2003).