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A Systematic Approach to the Motivations for Earnings Management: A Literature Review

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Abstract

Earnings management literature attempts to understand why managers manipulate earnings. Our paper presents a review of growing body of literature on motivations for the earnings manipulation. In consequence, our objective is to provide an ample classification of the reasons. A selection of leading papers was reviewed systematically from 1985 to early 2019 resulting in 383 articles. The results of the paper are important for both theoretical and empirical researches on the earnings management. For one side, we offer a theoretical discussion on the incentives and factors; on the other side, the paper aims to highlight recent progresses in the field. Screening, classifying and systematic review of earnings management literature do not only generate a structured overview of the work performed in this area during more than thirty years, but it also provides insights for further research. Our findings confirm that earnings management topic remains a fertile ground for academic research. Second, although there are many possible motives for managing earnings, the spotlight has been mainly on those incentives that are related to the stock market. Third, in terms of the factors and characteristics of the environment, the impact of institutional factors (investor protection, ownership concentration, legal enforcement) is especially accentuated by the authors. Finally, our research confirms that there are still many other opportunities to research. Therefore, in the last section we identify potential line of investigations.

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Earnings management
Manipulation
Literature review.

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1. Introduction

A wave of corporate scandals, such as tragic collapses of giant companies: Enron, WorldCom and Tyco International in the United States, has highlighted the critical need to improve the accounting information presented by the managers. These together with other scandals such as Parmalat in Italy, and most recent examples of Pescanova or Gowex, have intensified the investigation and drawn further attention to the earnings management, and the issue of reasons for such behaviour.

Therefore, earnings management is defined as *a purposeful intervention in financial reporting, designed to reach earnings targets by varying accounting practices. However, the action takes place without necessarily violating accounting regulations. It takes advantage of the possibilities of choice in accounting policy. The action can mislead stakeholders, and it can cause them to make decisions on the basis of the financial reports that they would not have made otherwise* (Callao,

Jarne, & Wroblewski, 2014b). Other definitions can be found in Schipper (1989); Healy and Wahlen (1999); Dechow and Skinner (2000); Park and Ro (2004); Roychowdhury (2006) among others.

Earnings management literature, besides the definition of the concept, centres the attention on the sample selection, measurement earnings manipulation, but principally, it attempts to understand why managers manipulate earnings. There is a broad interest in the findings explanation of the reasons for earnings management.

Therefore, our paper has three objectives: first, we review the growing body of literature on the motives which lead managers to earnings management. A spectrum of studies why managers manipulate earnings is indeed wide and diversified. In consequence, a selection of leading papers was reviewed systematically from 1985 to early 2019. Second, based on the review of major accounting journals, we develop our complex classification of the reasons for earnings management. Third, we provide discussion on the further possible lines of investigations. The research is motivated by the following facts. First, the literature has revealed an ongoing and persistent investigation on different incentives. Last research papers still have an increased interest towards investigation of the reasons for earnings management, see for example, Debnath (2017) investigated firm's growth, performance and earnings management; Sundvik (2017) focused on tax rate changes and earnings management; Lawal, Nwanji, Opeyemi, and Adama (2018) investigated corporate governance and earnings management; Idris, Siam, and Nassar (2018) examined the board independence and earnings management, among others. Second, studies, which focused on incentives for earnings management, mainly provide empirical views. We can find reduced number of papers that offer a systematic approach of the classification of the motivations for earnings management, see studies of Jiambalvo (1996); García, Garcia, and Mora (2005); Spohr (2005); Verbruggen, Christiaens, and Milis (2008); Valle (2016). Nevertheless, these studies focus mostly on the incentives for earnings manipulation. The aspects of the characteristics of the environment of the companies, macroeconomic variables, have been almost totally omitted.

Therefore, the main contribution of the paper is to increase the understanding of why earnings management occurs by presenting the systematic classification of the incentives and factors for earnings management. Knowledge why earnings management takes place is essential for users of financial statement information. Consequently, academics, regulators, and practitioners may all benefit from the discussion of different views about earnings management motivations, as understanding the reasons of the managers can permit to increase the reliability of the investors' decisions. In consequence, it can permit to focus on how to limit such activity. Second, in the last section, we present future research trends and possible further lines of investigations. This section will be a special interest for authors who are looking for the possible future research questions. The paper proceeds as follows. In the next section we describe briefly the agency theory and its connection to the earnings management. Second, we present the database and methodology applied. In the third section, general overview is outlined in terms of the causes for earnings management. The next two sections review and discuss two perspectives on reasons for earnings management: managerial incentives and factors of the environment. The last section presents the conclusion and we provide discussion of the future research.

2. Firms Do Manage Earnings

Literature on the earnings management demonstrates that incentives for earnings management are always present in managers' daily activities. It is believed that managers always have incentives to control information (see for example, (Dechow & Sloan, 1991; Holthausen, Larcker, & Sloan, 1995; Shackelford & Shevlin, 2001)). Laux (2003) even suggested the inevitability of the earnings management. However, in some circumstances the level of certain incentives can decrease or increase depending additionally on the micro and macro factors of the environment of the companies. These circumstances are affected by the agency problems referring to the relationship between managers and shareholders (called agency theory).

Lambert (2001) showed that agency theory is commonly used to explain certain accounting issues such as conflicts of interest, incentive problems, and mechanisms for controlling incentive problems. Agency theory raises a fundamental problem in the organization of self-interested behavior. A corporation's managers may have personal goals that compete with the owner's goal of maximization of shareholder wealth. Since shareholders authorize managers to govern the assets of the firms, a potential conflict of interest exists between these two groups: managers and shareholders (see for example, (Fama & Jensen, 1983; Lambert, 2001; Quick, Sattler, & Wiemann, 2013; Sunder, 1997)).

In this conflict of interests the managers can deal with decisions that do not maximise shareholders' interests. Hence, they (managers) can manage reported earnings to obscure their actions. In consequence, earnings management can lead investors to make non-optimal investment decisions considering manipulated reported earnings (see, (Dye, 1988; Lambert, 2001; Sunder, 1997)).

3. Data and Methodology

We identified a total of 383 articles in a period from 1985 to early 2019. We collected the articles based on the academic publishing houses specializing in academic monographs and scholarly journals: Science Direct,

Wiley, Dialnet, Elsevier, and University Press, as well as, publishing web page: Google Scholar. We discarded 32 articles because of the access limitation[1].

Within the selected papers 86% of the articles are published in journals, and most of them are published in the major, worldwide leading journals. Data is based on the Journal Citation Reports (JCR), see for example, Journal of Accounting and Economics (3.75 impact factor in 2018), The Accounting Review (2.49 impact factor in 2018), Journal of Financial Economics (5.73 impact factor in 2018), Journal of Accounting Research (4.89 impact factor in 2018), Journal of Accounting and Public Policy (2.35 impact factor in 2018), etc.

Content analysis has been employed to review articles. Each paper was thoroughly screened in terms of research question and findings. In Table 1 we present the database of the selected journals.

Table-1. Database of journals and other reviewed literature.

Journals	Number of articles	
Journal of Accounting and Economics	48	
The Accounting Review	22	
The International Journal of Accounting	15	
Journal of Financial Economics	11	
Journal of Accounting Research	10	
Journal of Accounting and Public Policy	9	
Journal of Finance	8	
Journal of Corporate Finance	7	
Accounting Horizons	6	
Contemporary Accounting Research	6	
European Accounting Review	6	
International Journal of Economics and Finance	5	
Journal of International Accounting	5	
Accounting Review: 4; Advances in International Accounting: 4; Journal of Banking and Finance: 4; Journal of Business: 4.		
Accounting and Business Research: 3; Advances in Accounting: 3; International Business Research: 3; Journal of Accounting: 3; Procedia Economics and Finance: 3; Review of Accounting Studies: 3.		
Other journals	136	
Total	331	86,4%
Other publishers: Blackwell Publishing: 1; Prentice Hall: 2; Springer: 1	4	1,0 %
Conference, Congress, Symposium, PhD Thesis	21	5,5 %
Working papers	27	7,1 %
TOTAL ARTICLES	383	100%

4. Causes of the Existence of Earnings Management

For one side, the literature showed a wide range of incentives, which appear from unambiguous situations and decisions that managers can undertake. These decisions derive from specific economic, financial, political or social interest. The interest can be important for the company or managers in a precise period of time. Managers can, for example, use decreasing earnings (one of the earnings management techniques) to benefit from tax reductions, price control reductions, etc.

Besides the incentives, managers can be faced with circumstances of the environment where the company is operating. Influence of regulatory bodies or characteristics of the background of the company can influence the decisions of the managers to engage in earnings management. More favorable conditions can facilitate/ preserve the manipulation. On the other hand, more strict characteristics of the business environment can preserve or in some situations facilitate the manipulation. These sets of circumstances we call factors. In effect, we can represent reasons for the existence of earnings management as a function of two variables: incentives and factors.

Earnings Management = f (incentives, factors)

In Figure 1 based on the revision of the literature we provide our systematic classification of incentives and factors for earnings management. In the next sections we will follow this classification.

[1]High price of the subscription.

5. Incentives for Earnings Management

Literature of earnings management has widely focused on incentives for earnings management. Different authors proposed different theories and classifications on why companies manage earnings. Based on the literature, we divided all the different groups in five main groups of incentives: incentives related to market expectation and valuation, contractual incentives, political incentives, incentives related to company's specific situation, and other incentives. Last group includes incentives that are not included in the previous groups, for example, labor union contracts, proxy contest, etc.

5.1. Incentives Related to Market Expectation and Valuation

Market incentives arise when managers of the firms perceive a connection between reported earnings and the company's market value. Authors showed that managers use their accounting discretion in response to the market information. This information can stimulate managers to manage earnings. We can distinguish three categories: market valuation of the continuing nature, market valuation related to specific events, and analysts' forecast incentives.

5.1.1. Incentives of the Market Valuation of Continuing Nature

Traditionally, market pressure has been interpreted as efficient monitoring mechanisms by shareholders (Jensen & Meckling, 1976; Jensen, 1986). However, other view has been less optimistic about the likely effects of such pressures (Porter, 1985). Managers have accused markets of being short-term oriented. The markets have been distracted them from the long-term commitment to a strategy. In 2006 McKinsey and Company carried out a worldwide survey, in which more that 42% percent of respondents (managers and board members of publicly traded firms) strongly agreed that the issue earnings guidance led firms to focus more on short-term earnings' perspectives. This contrast between theory and practice highlights the importance of the impact of market pressure on strategic behaviour of the firms.

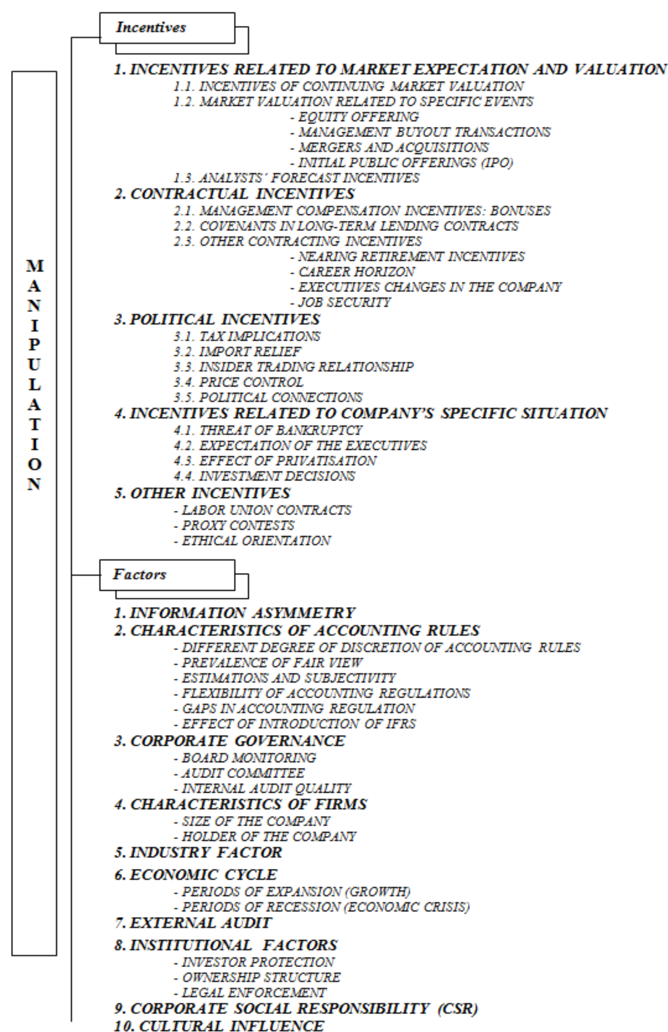

Figure-1. Reasons for earnings management.

Callao, Jarne, and Wroblewski (2017a) demonstrated that the scope of earnings management varies depending on the decisions of the managers and their adjustments to the requirements of the markets. They showed that weaker companies with less value engage in earnings decreasing, and in effect, they reduce the value of their companies to be able to opt for market niche. This is a clear example of the influence of market pressure on managers' decisions.

5.1.2. Market Valuation Related to Specific Events

Market pressure incentives also can be connected to the punctual and specific events of the companies. Managers can use their accounting discretion to increase/ decrease earnings in special periods of the companies, such as: surrounding initial public offerings, equity offerings, buy-outs, mergers, etc. This effort is undertaken to alter perceptions of the investors. Not surprisingly, for example, high accruals can be observed in the periods before stock offerings to increase the image and value of the company.

One such situation is where the companies issue new stocks and offer them on the markets, equity offering (Masulis & Shivakumar, 1999). Earnings manipulators are more inclined to report positive earnings or earnings increases in the year preceding an equity offering to create an illusion of firm growth. This action attracts potential investors and raises the funds (Easton & Zmijewski, 1989). The same evidence is observed in Aharony, Lin, and Loeb (1993); Teoh, Welch, and Wong (1998) who stated that there is a strong evidence of the positive relationship between earnings management and abnormal stock returns, and a negative relationship between reported earnings and abnormal post-offering stock returns. It occurs because managers are willing to issue equity manage earnings upward in order to increase the offering proceeds. On the other hand, the potential investors, or mainly speaking, the market, can understand these high reported earnings as a transitory increase. Hence, it is created an important pressure between managers and investors, see Table 2.

Table-2. Payoffs from "earnings management game" between offering firms and market participants.

At offering announcement	Before offering announcement	
	Firms do not overstate earnings	**Firms overstate earnings**
Investors do not believe prior earnings to be overstated	(0,0)	(H,-H)
Investors believe prior earnings to be overstated	(-H,H)	(-C,-C)

Note: *H stands for a positive payoff (earnings) and C stands for the costs of earnings management.
Source: Shivakumar (2000).

We can observe that firms before announcing their offerings may follow two strategies: they can either overstate the value of stocks or not overstate. The market participants (investors) also have two strategies. They either believe or do not believe that earnings before offering announcements were overstated. If the firms do not overstate the values and the investors do not believe prior earnings to be overstated, both firms and investors do not receive additional earnings (payoffs from earnings management). It means, earnings management is not observed (0,0). On the contrary, if the firms before offering announcement overstate earnings and investors do not believe prior earnings to be overstated, in this situation, managers of the firms may perceive inflated earnings, and investors on the opposite side, loose the same magnitude of the earnings overblown by the firms (H,-H).

If the firms overstate earnings, but the investors believe prior earnings to be overstated, both firms and investors lose the value of the costs of earnings management (-C,-C). It means that value between the real value of the equities and the estimated value, for one side managers as well as for investors' decreases. Finally, if the firms do not overstate earnings and the investors do believe prior earnings do be overstated, it means that firms lose the estimation at the offering announcement and the investors, on the contrary, gain this difference (-H,H).

Other situation is *management buyout transactions*. In this situation the interests of owners and managers are opposite. Managers can increase their probability of receiving capital gains by creating favourable buy and sell opportunities of the company's stock for themselves (Spohr, 2005).

Another situation when market efficiency can constitute a support for the existence of earnings management is *a mergers and acquisition context*. Erickson and Wang (1999) showed that managers manipulate earnings upward to raise the market price that favourably can affect the exchange ratio. Similarly, Rau and Vermaelen (1998) and Botsari and Meeks (2008) provided evidence that acquiring firms overstate their earnings reports prior to stock swap acquisition announcement by using aggressively discretionary accruals.

Finally, a special case of offerings is a process of the issuing of offerings for the first time. *The initial public offerings (IPO)* process is particularly susceptible to earnings management. It is because it offers entrepreneurs both: motivation and opportunities to manage earnings (see for example, (Liu, 2019; Rao, 1993; Teoh et al., 1998)). It emerges because, as reports (Rao, 1993) there is almost no news media coverage of firms in the years before the IPO. This scarcity of information about the issuer forces investors to rely heavily on the prospectus, which itself can contain incomplete financial information (Rao, 1993). In the Figure 2 we may observe the time line of the IPO date. Mainly, the interval of manipulation may be observed in the period following to the

IPO date, in the fiscal year+1, where the 3 to 6 months reporting lag is normally established. At the same time, the stock returns are expected in one to three years.

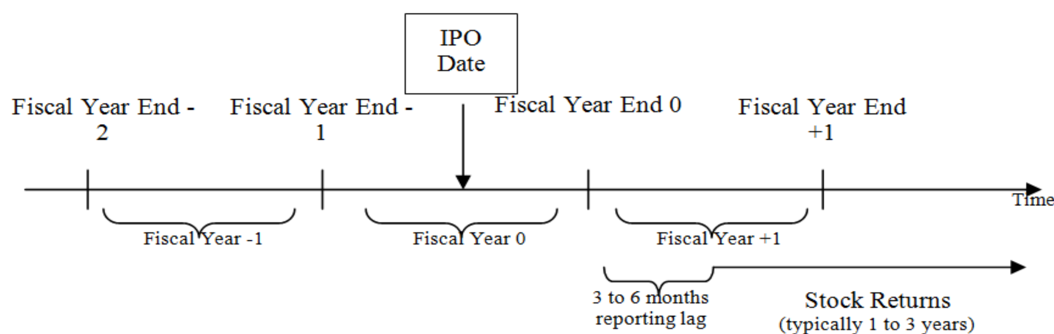

Figure-2. Time line of the initial price offering date.

Source: Teoh et al. (1998).

5.1.3. Analysts' Forecast Incentives

Payne and Robb (2000) examined incentives of the management to meet and exceed earnings forecasts. Their findings demonstrated that managers increase income to achieve forecasted earnings levels, and their desire to increase income is negatively correlated with analysts' forecast dispersion. Abarbanell and Lehavy (2003) examined the relationship between systematic analyst forecast errors in terms of management behaviour. Specifically, they observed that extreme income decreasing earnings led to extremely optimistic analyst forecasts. At the same time, the incidence of small positive forecast errors was associated with managers applying discretion to slightly beat analyst forecasts.

Brown and Caylor (2004) demonstrated that managers have highest incentives to meet forecasts when the price effect of meeting or beating earnings expectations is higher compared to earnings decreases or losses. Lee (2007) showed possible earnings management paths: the firms can beat, meet or miss earnings expectations, see Figure 3. As explained Lee (2007) when firms beat earnings expectations, it is expected that firms manage earnings downwards. Second, when firms meet earnings expectations, it is expected that firms manage earnings upwards, which is also documented by Skinner and Sloan (2002); Bartov, Givoly, and Hayn (2002). They explained that market penalizes firms asymmetrically for failing out the analysis to meet or beat expectations. Therefore, firms have strong incentives at least to meet earnings expectations.

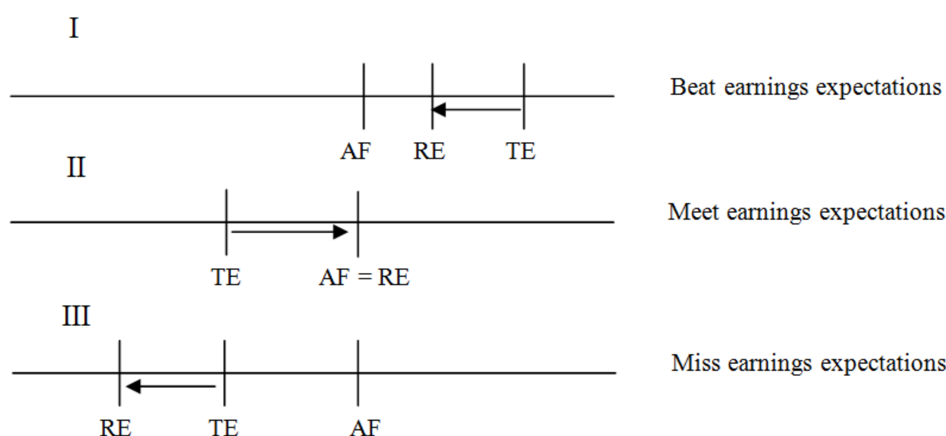

Figure-3. Predicted earnings management paths of firms and analyst forecast.

AF = Analyst forecast.
TE = True earnings.
RE = Reported earnings.
Source: Lee (2007).

Finally, firms that miss earnings expectations (third situation, Figure 3) do not engage in earnings upwards, because they cannot meet earnings expectation even with earnings management. Hence, they have a higher chance of meeting or beating analysts' expectations in future periods.

5.2. Contractual Incentives

The second group of incentives is contractual incentives. Watts and Zimmerman (1978) developed a Positive Accounting Theory. This theory shows that accounting choices of the firms should be made to minimize the contracting costs, so as to attain efficient corporate governance. Nevertheless, Positive Accounting Theory assumes that managers and investors are rational and they will use the flexibility of the

accounting policies and they will choose accounting procedure to influence contractual outcomes for their interests. We differentiate three categories: bonuses, covenants in long-term contract, and other contracting incentives.

5.2.1. Management Compensation Incentives: Bonuses

One of the most widely cited papers related to the effect of executive compensation plans on accrual decisions is the Healy (1985) study. Healy (1985) hypothesized that managers have an economic incentive to manipulate earnings in order to increase their cash compensation. Healy (1985) examined typical bonus contracts, providing a complete analysis of their accounting incentive effects. The study shows that managers have an economic incentive to manipulate earnings in order to increase their cash compensation.

Other studies also underline the relationship between earnings management and manager bonuses. Holthausen et al. (1995) for example, demonstrated that managers manipulate earnings to obtain bonuses. Xu (1997) showed that executive bonus is less likely to be paid if the annual dividends per share are less than a level expected. He concluded that executive bonuses depend mainly on accounting income, if they are paid.

Guidry, Leone, and Rock (1999) tested the bonus-maximization hypothesis. They demonstrated that managers make discretionary accrual decisions to maximize their short-term bonuses. Finally, we can conclude with one of the most famous examples, the case of WorldCom. Managers had bonuses that were based on revenue growth. Their salaries, bonuses and options were tied to the stock price of the company. Top-level managers were receiving about $10m of retention bonuses from the company that were repayable on termination (Ball & Shivakumar, 2006).

5.2.2. Covenants in Long-Term Lending Contracts

Within the different agreements in the company, debt covenants contracts[2] are the most common (see studies, (DeAngelo, DeAngelo, & Skinner, 1992; DeFond & Jiambalvo, 1994; Dichev & Skinner, 2002; Sweeney, 1994)). Sweeney (1994) and DeFond and Jiambalvo (1994) found that managers of firms close to debt covenant violation respond with income-increasing accounting changes. They demonstrated significantly positive unexpected accruals in the year prior to violation. They suggested that managers manipulate earnings to prevent default on debt contracts.

However, other studies do not find evidence supporting the debt covenants hypothesis. DeAngelo et al. (1992) argued that managers of financially distressed firms are not likely to inflate earnings in order to avoid debt covenant violations. Instead, their findings indicated that managers of financially troubled firms use negative abnormal accruals, which reduce the reported earnings even further. They suggested that managers of these firms have incentives to highlight the firm's financial difficulties to be able to obtain better terms in their contract renegotiations.

5.2.3. Other Contracting Incentives

Within other contracting incentives we can distinguish several incentives. Nearing retirement incentives can lead to earnings management by exposing the long-run results of the firm (Dechow & Sloan, 1991). Murphy and Zimmerman (1993) showed that executives respond to earnings-based incentives and behave opportunistically in this context.

Davidson, Xie, Xu, and Ning (2007) investigated whether the age and *career horizon* of the executives of the firms affect earnings management. Their findings demonstrated that firms with older chief executive officers, who are nearing the retirement age, are associated with extensive earnings increasing.

Another contracting incentive is connected to *executive changes in the company*. The literature (see for example, (Pourciau, 1993; Vancil, 1987; Wells, 2002)) found that the motivations and opportunities for income manipulation vary with the circumstances of the chief executive officer change. The authors separated the routine and non-routine executive change. In the case of routine executive changes, there is a little conflict of interest between the old and the new executives, which might lead to less opportunistic earnings management (Vancil, 1987). As explained Vancil (1987) during a routine, planned executive turnover, the former and successor chief executive officer both have the same goal: to make the incoming chief executive officer successful.

On the other hand, the degree of earnings management will be higher in times of non-routine changes. Non-routine changes are often unplanned due to inadequate time and/or insufficient opportunity to select a successor chief executive officer (Vancil, 1987).

Job security, to a great extent, is an important discipline mechanism that deters managers from engaging in wrongdoing. Given the large loss to the lifetime wealth associated with dismissal, this ex-ante alarm gives managers an incentive to exert greater effort and undertake actions to improve the real performance of the firms in order to alleviate their concerns about job security (Cai, Fang, & Li, 2017). In their study, the results confirmed the hypothesis that the higher risk of dismissal leads to the higher opportunistic effects on earnings management.

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[2] It is an agreement between a company and its creditors.

5.3. Political Incentives

The political cost hypothesis predicts that if managers face the possibility of politically-imposed wealth transfers (e.g., taxes, price control, tariffs, import relief, etc.) they will choose accounting procedures that reduce the expected value of the transfer, through reducing its size. Among political incentives we distinguish five categories: tax implications, import relief, insider trading relationship, price control, and political connections.

5.3.1. Political Incentives: Tax Implications

The influence of taxes on companies has largely been considered within a framework. The context of a tax-incentive allows firms to pay taxes at a reduced rate for a limited period of time, or tax avoidance if certain requirements are secured. If managers attempt to maximize firm value by minimizing tax costs, the spread of tax rates in the periods surrounding the rate change can provide a substantial incentive for them to accelerate revenue and defer expenses. This is one possible hypothesis. Consistent with this hypothesis, empirical results indicated that firms report significantly higher discretionary accruals for the years before tax-rate increases (Desai & Dharmapala, 2006). Managers managed earnings upward to take advantage of lower tax rates that are available in certain years (Jasrial, Puspitasari, & Muktiyanto, 2018).

Apart the activity to minimize the tax implications for the company, we can find tax avoidance activity. The activities of Enron are a famous example. Joint Committee on Taxation (hereafter JCT) of the U.S. Congress Joint Committee on Taxation (2003) provided a unique perspective of the use of tax shelters for earning manipulation. In summary of various transactions, the JCT concluded that Enron's management set high financial accounting goals and realized quick tax-motivated transactions that generated sizable financial accounting benefits.

5.3.2. Political Incentives: Import Relief

Import relief is defined as: "several measures taken by the government to temporarily restrict import of a product or goods to protect domestic products from competition" (Van Der Boom & Ung, 2010). This protection can be in a form of subsidies, loans with low interest rates, or tax exemption. Jones (1991) is the first study which treated earnings management caused by import relief. She examined accruals by U.S. firms during import relief investigations. The paper concluded that managers of companies who benefit from import relief could act in their own self-interest.

Phillips, Pincus, and Rego (2003) for example, argued that managers use their discretion to generate temporary book-tax differences. In the same line of investigation, Holland and Jackson (2004) demonstrated that firms manage their earnings carried out by deferred tax incentives.

5.3.3. Political Incentives: Insider Trading Relationship

The accounting scandals brought into light the failure of insider trading mechanisms. These trading relationships can benefit from private information (see for example, (Givoly & Palmon, 1985; Richardson, Tuna, & Wu, 2002; Xie, 2001)). The process of the information of insider trading is presented in Figure 4.

We can observe that the process of the insider trading relationship begins far before the publication of the reports. The insiders obtain the information from the managers about the firm-specific parameter and results (step I on the Figure 4). Then the activities of the managers take place, outcome is obtained, means manipulation is prosecuted as was established, expected and determined with the insiders (step II and III). Then firms release the reports, the managers are paid, and the insiders trade (using the information obtained before) (step IV). A new period starts and the truth about earnings results emerge to the market.

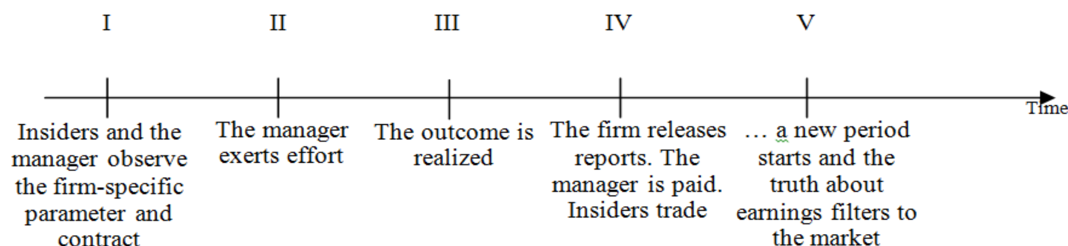

Figure-4. A timeline of insider trading.

Source: Ronen, Tzur, and Yaari (2006).

5.3.4. Political Incentives: Price Control

There are two types of firms: firms in competitive industries (not price-regulated) and firms in non-competitive (price-regulated) industries. Within the price-regulated industries managers have incentives to use earnings manipulation. The regulated industries are subjected to regulatory constraints that managers can try to relax using earnings management mechanisms.

Watts and Zimmerman (1986) study is the first who treated this political incentive for earnings management. They demonstrated that managers of firms in regulated sectors suffer acute pressure from antitrust authorities regarding price controls and market shares. Additionally, the managers in these price-regulated industries tend to report pessimistic earnings forecasts, since they do not want to appear overly profitable firms (Watts & Zimmerman, 1986).

Schipper (1989) suggested that obtaining favourable treatment from regulators is one of the conditions that give rise to earnings management. Healy and Wahlen (1999) argued similarly that there are incentives for firms in regulated industries to manage earnings in order to stay within regulatory constraints. Consistent with this argument, Petroni (1992) reported that firms in the regulated property-casualty insurance industry understate claim loss reserves in order to pre-empt attracting regulatory attention.

Finally, Gill-de-Albornoz and Illueca (2005) affirmed that when the government establishes a price increase for industries under price regulation, firms implement a conservative accounting policy in order to artificially reduce reported earnings and diminish their political visibility.

5.3.5. Political Connections

According to a study of Braam, Nandy, Weitzel, and Lodh (2015) earnings management enables politically connected firms to preserve the reputations of the firm, and at the same time, it helps to achieve the desired performance outcomes. Moreover, politically affiliated firms are likely to undertake earnings management to increase earnings to improve performance in order to develop better chance of being promoted (Chaney, Faccio, & Parsley, 2011).

Additionally, managers of firms with political affiliations are less likely to be penalized for engaging in earnings management even if they are detected (You & Du, 2012). Furthermore, political connection enables firms to secure favourable regulatory treatment (Agrawal & Knoeber, 2001) and access to valuable resources (Ding, Li, & Wu, 2018) among others.

5.4. Incentives Related to Company's Specific Situation

5.4.1. Threat of Bankruptcy

Empirical evidences suggested that bankrupt companies manipulate earnings more than healthy firms (Egbunike & Igbinovia, 2018; Rosner, 2003). Ahmadpour and Shahsavari (2016) for example, examined the link between earnings management and the quality of earnings using bankrupt and non-bankrupt listed firms. They found that the bankrupt firms are inclined to opportunistic earnings management than the non-bankrupt. Egbunike and Igbinovia (2018) demonstrated that bankruptcy threat can lead to earnings management in order to escape bankruptcy and regulatory sanction

5.4.2. Expectation of the Executives

Literature indicates that earnings management can be motivated by high expectation of the executives to achieve good results or avoid reporting looses. Managers can have an excessively strong belief that they can "mask" or "makeup" the result to show the company as profitable and beneficial, or to hide underperformed results (see for example, (Callao, Jarne, & Wroblewski, 2017b; Callao, Jarne, & Wróblewski, 2018; Goel & Thakor, 2003; Shette, 2018)).

5.4.3. Effect of Privatization

Authors examined the incidence of earnings management around the time of the privatisation. Khan (2003) and Martin and Parker (1997) demonstrated that managers can benefit in the period of post privatisation period. It is because, the initial shock of privatisation is over, and they can benefit in terms of better wages or of the increase employment opportunities. Iqbal, Khan, and Ahmed (2015) found that managers of the firms slated for privatisation were engaged in earnings management to inflate the financial worth of the firms to maximise the privatisation proceeds.

5.4.4. Investment Decisions

Martinez (2001) argued that earnings management can cause serious inefficiencies in resource allocation between firms. Linhares, Costa, and Beiruth (2018) revealed that earnings management is positively associated to the investments. This can interfere in the probability of a company being classified as under or over invested. Therefore, the higher level of earnings management, there is a greater probability of the company to diverge from the ideal level of investment.

5.5. Other Incentives

Labor union contracts can be one of the incentives in terms of earnings management. As explained Banning and Chiles (2007) there are differences between union firms and non-union firms. The unions alter the underlying employment relationship between employer and employee. Managers facing strong labor unions tend to shelter firm resources to gain bargaining advantage over labor unions (see for example,

(Bronars & Deere, 1991; Matsa, 2010)). Pagano and Volpin (2005) reported that managers who do not have enough corporate controls tend to have favorable trade terms with workers.

Proxy contests is defined as an event that can occur when stockholders develop opposition to some aspect of the corporate governance (DeAngelo, 1988). Managers have incentives to overstate earnings during a proxy contest (DeAngelo, 1988). Moreover, in a hostile takeover situation, management will employ all available defences in a proxy contest, such as: repurchasing stock, acquiring a competitor of the bidder and filing private antitrust litigation, or turning around to acquire the suitor itself (Bagwell, 1991; Faleye, 2005) earnings management to show a different image of the company.

Ethical orientation is other possible incentive for earnings management behaviour. Managers oriented toward relativism are more likely to engage in earnings management than those who are oriented toward idealism, meaning attitude towards the consequence of an action and how the individual's attitude affects the welfare of others (Elias, 2002). Managers with low professional commitments are more inclined towards managing earnings than those with high professional commitments. Similarly, managers who received information on the legal consequences of the decisions are less likely to manage earnings (Liu, 2012; Septiari & Maruli, 2017).

6. Factors Influencing Earnings Management

Circumstances or factors are conditions and characteristics of the environment of the firms that affect decisions of the managers. These situations can stimulate or restrict managers to engage in earnings management.

6.1. Information Asymmetry

There is too much information available in the financial market. Within perfect, complete and efficient markets, there is no substantive role for financial disclosures since financial statements are completely relevant and completely reliable. Users of financial statements would not have conflict with managers over accounting judgments and thus no scope for accounting manipulation (Holthausen & Leftwich, 1983; Rodrigues & Teixeira, 2007; Watts & Zimmerman, 1979).

However, market imperfections exist. Dye (1988) and Trueman and Titman (1988) demonstrated that the existence of information asymmetry between management and shareholders is a "necessary" condition for earnings management. Shareholders cannot perfectly observe a performance of the firms and prospects in an environment in which they have less information than the manager. Precisely, due to the inherent advantage of asymmetric information, wealth can be transferred from shareholders to managers (Sun & Rath, 2009). Schipper (1989) and Richardson (1998) provided empirical evidence that the extent of information asymmetry is positively correlated to the degree of earnings management.

6.2. Characteristics of Accounting Rules

First element, the availability of different degree of discretion allows managers to make accounting choices appropriate to their businesses. Hence, the reported earnings can convey information on economic earnings (Dye & Verrecchia, 1995; Laínez & Callao, 1999). Abbas and Ayub (2019) demonstrated that management, on the basis of this discretion, can manipulate the financial information. A reduction in discretion is predicted to lessen a manager's ability to communicate with shareholders (Healy & Wahlen, 1999).

Tan and Jamal (2006) showed that managers are more likely to engage in earnings management when there is significant discretion in accounting principles. Consequently, Tan and Jamal (2006) demonstrated that when accounting discretion is reduced, managers are more likely to use operational variables for earnings management purposes. Demski (1998) and Nelson (2003) also confirmed that when accounting standards allow for discretion, opportunistic managers can similarly report a decreased level of earnings, and this makes it difficult for investors to discern a firm's value from earnings patterns.

Another element of the characteristics of accounting rules is ***a prevalence of the fair view*** as a reference in elaboration of the accounting information. It is expected that attainment of the fair view is a main objective to be pursued by the financial statements of the companies. Laínez and Callao (1999) showed that the performance of accounting practices is expected to fulfill the requirements of fair view. Nevertheless, in practice, the real purpose of the managers could have been handled and hidden. Guay and Verrecchia (2006) explained that conservative accounting systems rely on easy-to-verify information, while true and fair view accounting systems rely on difficult-to-verify information. In consequence, the latter are much more exposed to earnings manipulation than the former.

Another key component of accounting characteristics is the necessity of the application of the ***estimations and subjectivity.*** These estimations involve the subjectivity of managers and create uncertainty regarding the presented numbers. Managers exercise professional judgment in areas involving accounting estimates, uncertainties, and inherent subjectivity. Literature demonstrated that accounting standards have an implication on earnings management behaviour. It is because the principle-based system creates the managers room to exercise professional judgment in areas involving accounting estimates, uncertainties, and inherent subjectivity (see for example, (Ewert & Wagenhofer, 2005; Laínez & Callao, 2009; Yu, 2008)).

Other element is ***the flexible nature of some accounting regulations.*** When there is a higher degree of optional selection of the rules, there is the greater possibility for the company to make an accounting choice. We can find an ongoing debate related to accounting rules and earnings management. Nelson (2003) explained that, for one side, tightening accounting standards reduces earnings management through judgments. Rigid and detailed accounting rules provide limited accounting options and restricting the scope for subjective judgments constrains the ability of managers to behave opportunistically (see also (Healy & Wahlen, 1999; Watts & Zimmerman, 1990)). However, at the same time, the rigid accounting norms can leave accounting gaps. Not everything may be regulated.

On the other hand, Nelson (2003) explained that the aggressiveness of reporting decisions increases with an increase flexibility of accounting standards. More flexible rules provide greater scope for choice and involve a higher degree of implicit subjectivity in the application of criteria by the managers. In consequence, there is a wide field to exercise the discretion (see also Jeanjean and Stolowy (2008)).

The existence of ***accounting regulation's gaps*** is another phenomenon that enables companies to establish their own criteria; therefore, it can lead to earnings management. The complexity of economic and financial operations is continually rising. Accounting standards cannot keep the pace in establishing accounting regulations. In certain situations there is a lack of applicable regulation; in consequence, it can enable companies to use earnings management.

Finally, studies widely investigate the ***effect of mandatory introduction of IFRS*** on earnings management. Mostly, scholars hypothesize that IAS/IFRS increase earnings quality in part because the standards are principles-based, and they find evidence that use of is associated with less earnings management (see (Aussenegg, Inwinkl, & Schneider, 2008; Barth, Landsman, & Lang, 2008; Mas, Diantimala, & Saputra, 2018)).

While others like Callao and Jarne (2010) found evidence of an increase of earnings management when adopting IAS/IFRS instead of original domestic standards. It is due to the higher flexibility and subjectivity in application of valuation criteria compared to the local standards (e.g. fair value). Pereira and Alves (2017) also demonstrated that after the adoption of IAS/IFRS there are still indications of earnings management. Finally, Mongrut and Winkelried (2019) provided compelling evidence against the belief that the mere adoption of the IFRS is sufficient to guarantee transparency in emerging markets.

6.3. Corporate Governance

Literature investigated whether relevant governance control devices, such as: the board of directors, the audit committee or internal audit quality, are effective in reducing the earnings management. This emphasis is due in part to the prevalence of highly publicized and egregious financial reporting frauds such as: Enron, WorldCom, Aldelphia, and Parmalat, an unprecedented number of earnings management activities by corporate management.

Among the set of corporate governance mechanisms, ***the board of directors*** is often considered the primary internal control mechanism to monitor top management, and protect shareholder interest. Large literature examined the relationship between board monitoring and earnings management. The results are rather mixed. For one side, the large board of directors is connected to the higher degree of earnings management because they are less efficient, less functional, and there is less coordination and communication between members (Chen, 2010; Ibrahim & Jehu, 2018; Jensen, 1993; Klein, 2002; Xie, Davidson III, & DaDalt, 2003).

On the other side, other studies showed the opposite results. Larger boards provide more expertise and increase the monitoring capacity (Chelogoi, 2017; Dalton, Daily, Johnson, & Ellstrand, 1999; Pearce & Zahra, 1992).

Other important element of corporate governance is the ***audit committee***. The audit committee first appeared in the 1970s in the US, gaining prominence as a weapon against the financial scandals of the era (most notably the scandal involving the Equity Funding Corporation of America). Following these scandals the NYSE made Audit Committees a listing requirement in 1978. The literature demonstrated that well-functioning and well-structured audit committee can prevent earnings management (Hamid & Ahsan, 2018; Klein, 2002; Xie. et al., 2003).

Internal audit quality is the third element of the corporate governance mosaic. The studies show mixed results. The existence of internal audit quality will not secure the absence of earnings management, but the existence of a high quality internal audit will decrease the probability of earnings management (Rankin, Schwartz, & Young, 2003; Stewart & Subramaniam, 2010).

6.4. Characteristics of the Firms

Within the different characteristics of the firms the **size of the company** is one of the main characteristics that have direct connection to the existence of earnings management. For one side, the larger the firm size, the less earnings management can be feasible. Literature showed several arguments: larger companies can have more sophisticated and effective internal system control (Beasley, Carcello, Hermanson, & Lapides, 2000; Burgstahler & Dichev, 1997) large firms take into consideration their reputation costs when engaging in

earnings management (Beasley et al., 2000) larger companies undertake huge risk in the business operation so they are less involve in earnings management (Debnath, 2017) etc.

On the other hand, other studies showed contrary result. Barton and Simko (2002) for example, demonstrated that large-sized firms face more pressures to meet or beat the analysts' expectations; therefore, they easily can engage in earnings management. Second, large-sized firms have greater bargaining power with auditors (Nelson, Elliott, & Tarpley, 2002). Large-sized firms have more space to handle a wide range of accounting treatments (Kim, Liu, & Rhee, 2003). Large-sized firms have stronger management power (Dechow & Skinner, 2000; Rangan, 1998) among other reasons.

Another characteristic is *the holder of the company*: state-owned companies (the property rights belong partly or entirely to the government/ is public), and private hands companies (private owners). Literature founds differences in managing earnings. It is because, both have completely different motivations and they work in different circumstances. State-owned companies, for example, gain more financial and political support from the government than non-state-owned companies (Faccio, 2006; Qian, 1994). In the state-owned companies generating profit is not the only goal of state-owned enterprises. State-owned enterprises also undertake various social responsibilities, such as maintaining social stability and providing employment, etc. (Li & Zhou, 2005; Li, Xue, & Hui, 2018).

On the other side, the privately owned firms are in a weaker position compared to the state-owned companies. It is because their specific political and historical factors. They are under pressure to report a better-than-real financial performance to reassure the market (Ding, Zhang, & Zhang, 2007) for example.

6.5. Industry Factor

The firm industry is seen as an important variable in determining accounting choices, because the proprietary costs vary according to industry. A firm operating within one industry can engage more in earnings management than one operating in another (Callao & Jarne, 2011; Jiao, Mertens, & Roosenboom, 2007; Kallunki & Martikainen, 1999; Lee, 2007; Watts & Zimmerman, 1986). Kallunki and Martikainen (1999) explained that it is because investors compare the economic conditions of firms within the industry. If the extent of earnings management differs considerably from the industry-wide average, investors and other stakeholders may regard it as a signal of the future success of the firm. In other words, the amount of earnings management of a firm cannot be expected to deviate too much from the industry-wide average in the long run (Kallunki & Martikainen, 1999).

Jiao et al. (2007) demonstrated that firms in the same industry face similar market conditions and (growth) prospects; therefore, earnings management may be expected to be similar. Trueman (1990) explained that the managers try to adjust their earnings to match industry results. Moreover, Beneish (2001) showed that certain industries can provide more incentives to manipulate than others. It is associated not only with the fact that certain industry belongings can lead to higher incentives for increasing or decreasing earnings management, but it is also explained that in specific sectors different level of competition affect companies.

Finally, the industry earnings performance can be also used as a benchmark for evaluating performance of the firms (Antle & Smith, 1986; Freeman & Tse, 1992).

6.6. Economic Cycle

The economic cycle understood as a natural fluctuation of the economy between periods of expansion (growth) and recession may easily influence on the decisions off the executives[3]. The abundant studies of earnings management demonstrated the influence of the economic cycle on the existence of earnings management. We can observe two main tendencies.

The first group of studies indicated that when the economy, as a whole, is performing well, managers will be under pressure to report increased earnings to meet the expectations. Alternatively, when the economy is not performing as well, the penalty for not reporting positive results might not be as severe as in "good times" (Cohen & Zarowin, 2012). Similarly, Rajgopal, Shivakumar, and Simpson (2007) showed that firms have a greater tendency to manage earnings upward during good times. On the contrary, managers manage less earnings in the crisis years (Filip & Raffournier, 2012).

Cimini (2015) demonstrated that after the burst of the financial crisis it is observed the reduction in earnings management. It is because the increase of conservatism during the financial crisis should raise earnings quality and impair earnings management. Additionally, the close monitoring activity of the auditor during the crisis contributes to an increase in the quality of financial reporting, which reduces earnings management.

A second group of studies showed contrary results. Conrad, Cornell, and Landsman (2002) described that during periods of crisis managers manipulate more earnings to cover their financial gaps and fulfill the objectives of the companies. Managers try to smooth the effect of fluctuation of the markets because, as explained by Baulkaran and Asem (2012) the market reacts more adversely to negative earnings news. Finally,

[3] For definition of economic cycle, see for example, studies of: Ohn, Taylor, and Pagan (2004); Lee and Mason (2010); Dustmann, Glitz, and Vogel (2009) among others.

Callao and Jarne (2011) showed that earnings-increasing discretionary accruals have increased during the crisis periods. This is not due to crisis as such, but the crisis has strengthened some incentives to manage earnings, such us the indebtedness.

6.7. External Audit

External auditors, besides accountants and internal auditors are important mechanism to prevent reporting manipulation (Balkaran, 2008; Lopes, 2018; Quick & Wolz, 1999; Quick & Aschauer, 2014). They play an important role in moderating earnings management by minimizing opportunities to manage earnings in the fourth quarter (Brown & Pinello, 2007).

Earnings management studies examined also whether auditors are sensitive to management's incentives (see for example, (Anderson, Kadous, & Koonce, 2004; Hirst, 1994)). Hirst (1994) for example, found that auditor judgments are sensitive to managers' buyout-induced incentives to make income decreasing accruals. However, when incentives are instead associated with bonuses, auditors are not affected.

Additionally, the post-Enron era has witnessed a growing concern related to the issue of external auditor quality. The role of external auditor is becoming a key factor because the auditor is considered as a factor to prevent and limit managers' ability to manipulate, but that alone is not enough and not necessarily always true.

6.8. Institutional Factors

Academic literature provided papers on the impact of institutional factors on the level of discretionary accruals. Within the institutional factors, three of them are the most important: investor protection, ownership concentration, and legal enforcement.

First, according to broad literature the earnings management decreases in countries with stronger ***investor protection*** (Dyck & Zingales, 2004; Leuz, Nanda, & Wysocki, 2003; Nenova, 2003; Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998; Shen & Chih, 2005; Zhang & Uchida, 2014). Leuz et al. (2003) for example, demonstrated that earnings management is expected to decrease because strong protection limits ability of the insiders to acquire private control benefits, which reduces their incentives to mask firm performance. Nenova (2003) and Dyck and Zingales (2004) argued that legal systems protect investors by conferring on them rights to discipline insiders (e.g., to replace managers). Shen and Chih (2005) showed that earnings management declines in countries with stronger investor protection. Zhang and Uchida (2014) demonstrated that strong investor protection provides additional legal infrastructure.

Second, ***the ownership structure*** of a firm is considered an important institutional factor which has a monitoring role in constraining the earnings management. Extent literature suggests two different views. Ownership concentration is positively related to earnings management. Higher ownership concentration improves the quality of managerial decisions. This is because the presence of a small number of holders leads to closer monitoring of management and implies less opportunity for earnings manipulation (Amir, Shaari, & Mohd, 2019; Dechow, Sloan, & Sweeney, 1996; Jiambalvo, 1996).

However, other studies documented evidence that ownership concentration actually can induce to earnings management (lower ownership concentration representing in higher number of shareholders). The argument here is that, the large shareholders have the capacity to pressure the managers to improve earnings so that their market value can improve. Due to this excessive pressure, the managers will engage in earnings management (Aharony, Lee, & Wong, 2000; Wang, Xu, & Zhu, 2001).

Finally, there is a positive impact of ***legal enforcement*** on the reduction of the earnings management. Cai, Rahman, and Courtenay (2008) stated that earnings quality is positively influenced by legal enforcement. They demonstrated that the stronger the legal enforcement, the greater will be the influence on the reduction of earnings management. Leuz et al. (2003) showed that strong legal enforcement limits the ability of insiders to acquire private information that leads to a decrease in management incentives to hide firm performance. Ewert and Wagenhofer (2005) found that legal enforcement decreases earnings manipulation and increases reporting quality.

6.9. Corporate Social Responsibility (CSR)

Is there a relationship between the Corporate Social Responsibility and earnings management? Hong and Andersen (2011) suggested that there is. They demonstrated that American companies with a higher level of social responsibility showed a better level of accounting quality and less earnings management. Prior, Surroca, and Tribó (2008) found evidence that the combination of earnings management and Corporate Social Responsibility has a negative effect on the financial performance of entities.

However, Gargouri, Shabou, and Francoeur (2010) did not find the evidence. Grecco, Geron, and Grecco (2017) also found that there is not a relationship between Corporate Social Responsibility and earnings management. Nevertheless, they suggested that firms with greater social engagement do not manipulate earnings.

6.10. Cultural Influence

The focus on the analysis of how traditional countries' variables can influence managerial decisions in terms of earnings management is other interesting factor. He, Kimmel, and Cox (2017) for example, indicated that there is a significant positive relationship between culture (uncertainty avoidance, individualism, and power distance) and earnings management. Desender, Castro, and Escamilla (2008) demonstrated a significant influence of cultural measures, such as individualistic societies, can be less susceptible to manipulations. They found that countries with high level of individualism tend to have lower levels of earnings management. In addition, they found that egalitarianism, defined as a society's cultural orientation with respect to intolerance for abuses of market, is negatively correlated to earnings management.

Finally, Doupnik (2008) showed that the cultural dimensions of uncertainty avoidance and individualism are significantly connected to earnings management. Besides, culture has a stronger relation with earnings smoothing than with earnings discretion, and cultural dimensions explain a greater percentage of the variation in aggregate earnings management.

7. Conclusion and Implications for Future Studies

Earnings management literature attempts to understand why managers manipulate earnings. One implication of this review is that earnings management remains a fertile ground for academic research. Every day new studies shed lights on new incentives.

Second, although there are many possible motives for managing earnings, the spotlight has been mainly on those incentives that are related to the stock market. The interaction between accounting numbers and stock markets reaction can indeed push management towards earnings management.

Third, in terms of the factors and characteristics of the environment, the impact of institutional factors (investor protection, ownership concentration, legal enforcement) is especially accentuated by the authors.

Fourth, there are still many other opportunities to research. Therefore, future lines of investigations are more likely to provide new insights to broaden the questions that have been addressed, motivations for manipulation, rather than methodological aspects, or conceptual aspects. Consequently, based on the detailed analysis and ample classification of incentives and factors provided, we present possible future lines of investigations.

Future research could investigate further the effect of the Corporate Social Responsibility on the behaviour of the earnings management.

Second, it is surprising that the link between big enterprises and earnings management has received only modest attention.

Additionally, future contributions could be focused on multinational enterprises and some issues not addressed yet, such as bankruptcy or other environmental factors.

Another research line could focus on the meeting earnings benchmarks. It seems to be one of the new directions for earnings management.

Moreover, we suggest that it would be attractive for future research to address earnings management around the culture factor. We found only some research papers related to this topic.

Other potential future line of the research can compare the different range of incentives within the emerging countries and verify them with developed countries. The question that arises: do developing countries have the same incentives as developed countries?

Furthermore, the focus on listed firms has left room to investigate non-listed more closely. It seems important to develop a research to examine the incentives of earnings management in unlisted companies and make a comparative analysis of listed and unlisted companies in terms of the different managerial incentives.

In addition, we have not found research regarding earnings management to obtain subsidies or grants from the government, which might be the case for non-profit firms. We believe that there are research opportunities in that area, to shed some light on non-for-profit firms trying to manage earnings.

Finally, most research demonstrates that earnings management led to negative economic consequences. Are any possible positive consequences of earnings management?

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