WHY DO SOME SENIOR MANAGERS INFLATE FIRMS' REPORTED EARNINGS? ECONOMIC CAUSES AND POTENTIAL SOLUTIONS

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Abstract

We examine the economic reasons underlying the behavior of some senior managers to inflate their firms' reported earnings. While the extant literature cites accounting and corporate governance structure as potential reasons that facilitate the inflating tendency, we conjecture that opportunism at different hierarchical levels within firms do not leave much scope for some senior managers to improve firms' fundamental performance. To protect their personal utility, they resort to inflating tendency, but only if the firms' corporate governance has loopholes. A major solution offered here is to improve firms' internal management control system which could reduce within-firm opportunism. However, this solution must accompany improvements to corporate governance.

Keywords: earnings, managers, corporate governance

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1. Introduction

"On March 19, 2003, the Securities Exchange Commission (SEC) charged HealthSouth Corporation and its CEO with accounting fraud. The SEC's complaint alleged that HealthSouth had systematically overstated its earnings by at least $1.4 billion since 1999. Apart from the SEC's finding, the U.S. Justice Department used information gathered from HealthSouth executives to identify another $1.1 billion of overstated earnings" (Weld, Bergevin and Magrath, 2004).

HealthSouth is just one of the many firms that adopted Enron's infamous path in inflating their reported earnings. The outcome of this inflation is well documented. The market prices reflect a value which is more than the underlying economic value of the firm. Over time, the gap between market expectations and firm value becomes so high that the firm becomes incapable of meeting the expectations which, in turn, leads to 'over-valued equity' (Jensen, 2005). Unfortunately, the fact of inflated earnings typically becomes transparent to the market only after the over-valuation arises. At this stage, the 'bubble' bursts. Legal actions are initiated; courts conduct inquiry, order liquidation and final settlement takes place after several years. If liquidation is ordered for several firms in an economy, the economy suffers an investment decline and enters a downturn.

Earlier studies such as Weld *et al*. (2004) offer empirical evidence on such over-valuation. The reasons center around managerial opportunism: some senior managers inflate their firms' earnings to obtain their bonus which is tied to the better market price performance (Cheng and Warfield, 2005). The underlying assumption here is that increase in firm earnings leads to a rise in the market price. As the market price rises, the senior managers are motivated to maintain this inflating tendency with a view to avoid any potential market price decline and seize greater personal wealth. We believe that this managerial opportunism logic does not provide a complete economic rationale for the senior managers' inflating tendency, particularly in the light of the following argument.

Better firm earnings can be posted by one of the two routes; either (a) enhance fundamental performance or (b) inflate reported earnings. Enhancing performance refer to improving fundamental variables such as capacity, quality, lead time and delivery. However, much in line with the saying, "if you can't make it, fake it", some senior

managers systematically adopt the inflating route until the day the over-valuation bubble bursts. A more important question is that why do some senior managers adopt inflating route to better results instead of improving firm fundamentals? In this paper, we examine this research problem and offer some potential solutions.

The remainder of the paper is organized as follows. In Section 2, we identify the economic causes that offer scope for some managers to indulge in inflating their firms' reported earnings. Potential solutions to the economic causes are discussed in Section 3. Section 4 concludes the paper.

2. Economic Causes

2.1 Review of Lliterature

One stream of the extant literature (e.g., Jickling, 2003; Litan, 2002) cites the inherent lapses in the accounting regulation as the main cause for the inflating tendency. This stream argues that a multitude of accounting choices that are available often provide scope for accountants and senior managers to develop the inflating tendency. In Litan's words, "the fact is that for many kinds of transactions, there are no single 'right' answers…The lack of specifics allows accountants greater discretion in deciding how to justify various transactions". For instance, future revenues that do not accrue are falsely recognized in the current period resulting in undue increase in gross profits. Similarly, several provisions are cut a little bit from their normal write-down amounts to create a sizeable increase in net profits. Though not many solutions are identified to this cause, a few studies focus on improving fundamental auditing legislation such as the Sarbanes-Oxley Act in the US.

Another stream of the literature (e.g., Downes and Russ, 2005; Jensen, 2005) focuses largely on the corporate governance argument. They examine the structure of firms' existing corporate governance which includes the composition (external versus internal directors), directorship tenure, entrenchment in committees, formulation of ethics code and validation procedures of the board of directors and how this corporate governance structure allows the inflating tendency to flourish in firms. If a firm, for instance, has more non-permanent external directors depending on the CEO, who also chairs the board, then the CEO is more likely in a convenient position to inflate reported earnings. In sum, prior studies identify market price-related bonus in the presence of multiple accounting choices and 'easy' corporate governance enable some senior managers to inflate reported earnings.

The above two streams of the extant literature are valid in their own perspectives but we believe that they still answer only a part of our research problem. By adopting the first route of improving the firm fundamentals to post better results, not only can the senior managers enhance their own utility such as bonus but do so in perfectly legal and ethical manner devoid of any lurking fear of punishment. And so, a question remains. What prevents these managers from not seeking to improve the firm fundamentals? We believe that the answer to this question is important to complete our research problem and hence forms the core economic argument of this paper.

One answer is that enhancing fundamentals takes a long time as against a quick adjustment to the reported earnings. This is not entirely correct given the fact that the market price-related bonus (such as stock options and grants) is awarded typically on a long term basis and thus most senior managers has one or more years to improve their firms' fundamental performance. If some senior managers do not resort to improving firm performance even when they have this time, there must be a stronger underlying economic reasons causing their inflating behavior.

2.2 Economic Causes

Let us first examine the process by which some senior managers inflate reported earnings which, in turn, leads to over-valued equity. Throughout the period of inflated earnings, the firm acts as a 'black-box' to outsiders, which means that very little decision-relevant information about the firm flows to the market until the stage of over-valuation.

The 'black-box' assumption is also implicitly held in other studies (e.g., Jensen and Meckling, 1992 and Williamson, 1981) that examine transactions within firms. In most firms, no one person is likely to hold complete information about all parts of the firm. Even senior managers with large spans of control are no exception. Jensen and Meckling (1992) suggest specific knowledge, a knowledge piece that is difficult to transfer or acquire as one major reason. A worker's long experience in comprehending customer needs, which is costly to acquire, is an example of specific knowledge.

The specific knowledge that a person holds can induce opportunistic actions in certain circumstances. When does opportunism arise within firms and how do firms control the problems of opportunism are matters examined in economic theories such as agency and transaction cost economics. In general, these theories suggest if a firm invests in specific knowledge, scope for opportunism within firms is high when the accompanying incentive and control structures are not tuned to manage the potential problems of specific knowledge. A major problem which arises in specific knowledge is 'asymmetry', which means that one party holds more decision-relevant information than the other. The party can potentially use such information to augment his/her own utility at the cost of the other.

Two examples of opportunistic actions within firms are as follows. At the lower levels of a firm's

hierarchy, a worker can use specific knowledge to hide his/her inefficiency from the manager but still claim the bonus. At a higher level, a divisional manager can also depend on specific knowledge on discretionary budgets to postpone spending on a critical activity such as research advertisement in order to show better divisional incomes, which, in turn, can fetch higher bonus from the CEO. Note that opportunism within firms has a negative outcome of eroding firms' economic value. Not only a part of shareholders' wealth is seized by different employee groups; but also there is a likely decline in the firms' overall profitability because of reduced productivity of the employees who act in opportunism.

We now link this 'within-the-firm' opportunism with senior managers' tendency to inflate reported earnings. Though senior managers are able to see the negative outcome, they are not able to detect the underlying reasons because of the calculated opportunism that can occur within firms. Therefore, senior managers are not always able to improve their firms' fundamental performance. If the senior managers of all the firms that invest in specific knowledge (or any other specific resource) are affected by potential within-the-firm opportunism, then why only some managers tend to apply inflating practices? The answer lies in the nature of corporate governance in firms. Though most senior managers are rewarded by share price based bonus and they have access to multiple accounting choices, only some managers enjoy 'easy' corporate governance, which is too tempting to ignore. Hence, some senior managers resort to the second route, which is to inflate the reported earnings.

(INSERT FIGURE 1 HERE)

Figure 1 summarizes the link between the within-the-firm opportunism and the senior managers' inflating tendency.

3. Potential Solutions

We now turn to examine the potential solutions for firms to discourage inflating tendency. One way, though not the best solution, is to remove the market-price related bonus for the senior managers. Note however that this way cannot solve the within-the-firm opportunism, which is often the driving economic cause for the inflating tendency. A better solution is to start reforming firms' internal management control system (hereafter MCS). MCS must cover three inter-related elements: 1) who will do what job and how much; 2) how will the job performance be assessed; and 3) how can the performance be motivated. These three elements are cited as the legs of a 'three-legged stool' (Brickley, Smith and Zimmerman, 2001). MCS goes out of tune whenever one (or two) of its elements are not compatible with other elements. For instance, if a manager gives more decision rights to a worker but continues to assess the worker's performance based on earlier authority level, then the additional rights may be used by the person for his own welfare.

Improving a firm's MCS at the lower and higher levels of hierarchy can be handled at the senior manager's level. But a key question remains here. Where does the motivation lie for the senior managers to reform his/her firm's MCS? This is where the importance of reforming a firm's corporate governance arises[1]. Firms need to have 'tight' corporate governance structure. For instance, firms must need a balance between external and internal directors; rotate the membership in committees and a rigorous decision evaluation criteria based on both profitability and ethics for board functioning. Note that the 'tightness' in the corporate governance structure serves two objectives. First, it can oversee the CEOs' performance in terms of reforming MCS. Second, it can also ensure that the CEO and other senior managers do not steer the firm into the second route of inflating reported earnings.

4. Conclusion

In this paper, we examine the tendency of some senior managers to inflate firms' reported earnings instead of improving fundamentals such as quality, capacity and costs. Identifying a new relation between the opportunism that occurs within-the firm and the inflating tendency, we conjecture that when senior managers are less able to curb the within-the-firm opportunism which erodes firm value, they resort to inflating earnings. We offer a potential solution to discourage inflating tendency in the form of improved MCS in conjunction with a tight corporate governance structure. One limitation of our paper is the lack of empirical evidence to analyze if the theoretical predictions laid out hold well in the real-world. In this direction, a useful extension to this paper is to test the theoretic predictions through experimental research method wherein the problem and the solution variables can be manipulated to analyze the effects.

Another extension in terms of theoretical research is in the potential solution to our research problem. One could examine if all the stakeholders beginning with workers and then managers, CEOs and share holders could be considered in a multiple but linked stakeholder value chain. Each stakeholder link can be linked to the next link through a set of

[1] The term MCS is used in a broad sense in the management accounting literature (see Chenhall, 2003) which includes even the corporate governance structure. However, for the purpose of easy exposition, we distinguish the two terms in our paper as follows. While MCS relates to controls at lower and higher hierarchical levels of management, corporate governance refers exclusively to structure of board of directors.

principal-agent relationships. For instance, while shareholders and CEO can be treated as a principal and agent respectively, the CEO and the managers can also be treated as principal and agent simultaneously. Each agent could then be compensated on a uniform basis though at different rates to suit the nature and risks associated with different agents' jobs. The purpose of this solution is to see how value can be generated to shareholders (the first link in the stakeholder value chain) value whenever a worker (the last link in the stakeholder value chain) earns bonus for carrying out his/her job efficiently.

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Appendices

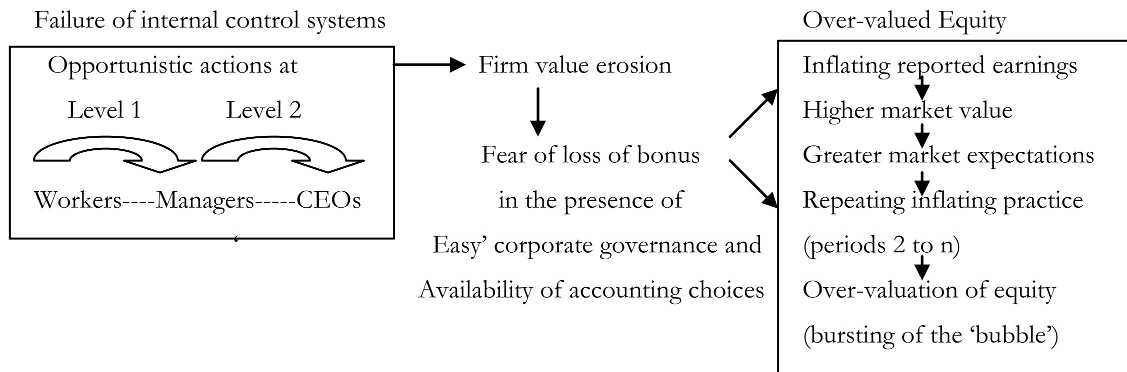

Figure 1