EARNINGS MANAGEMENT

AND

CORPORATE GOVERNANCE

IN

NEW ZEALAND

A thesis presented in partial fulfilment of the

requirements for the degree of

Master of Business Studies

in

Accountancy

at Massey University, Palmerston North.

VIVIENNE MARY SAMPSON

2003

ABSTRACT

Despite the enormous body of literature on earnings management, little research has been done in New Zealand. Corporate governance is recognised worldwide as a means to improve corporate performance and increase shareholder value. Boards of directors are held responsible for monitoring the preparation of financial reports and should constrain any earnings management. Earnings management is more likely to occur in companies with weak governance structures such as companies that are targets of takeovers where directors' self-interests may not be aligned with shareholder interests.

This study examines the extent of earnings management in a sample of publicly listed New Zealand companies partitioned by takeover activity and tests the relationship between earnings management and the effectiveness of corporate governance. Abnormal working capital and discretionary accruals models are used to detect earnings management. Board effectiveness is measured by various corporate governance structures that include the percentage of independent non-executive directors, board size, existence of an audit committee and ownership features.

The results of this study indicate that takeover target firms, relative to control firms, have an increased level of earnings management by abnormal accruals, more earnings losses, lower leverage ratios, a larger board size, a larger number of grey (affiliated) directors, fewer independent directors, and a greater proportion of institutional ownership. Target firms are audited mainly by Ernst & Young or Deloitte Touche Tohmatsu whereas KPMG and PricewaterhouseCoopers mainly audit control firms.

The estimated accruals measures provide consistent evidence to indicate there is earnings management by income-increasing accruals. Discretionary accruals are managed upwards to avoid earnings losses and earnings decreases but regressions of the accruals measures produce ambiguous results relating to the effectiveness of corporate governance structures. Some evidence finds associations between measures of discretionary accruals and the existence of an audit committee and between the proportions of independent and grey directors in control firms where there are also significant firm-attributes such as size, leverage, cash flows from operations and earnings loss. There is evidence of an association between the level of working capital accruals and board ownership in target firms.

It can be concluded from the research that New Zealand companies exhibit earnings management and sound corporate governance practices. Target firms relative to control firms have weaker governance structures that may have contributed to the takeover activity.

ACKNOWLEDGEMENTS

This study has taken much longer than I envisaged at the start. However I have persevered and now I wish to give special thanks to my supervisor, Professor Jack Dowds, for his continued encouragement and guidance.

I also acknowledge the support received from my employer, The Open Polytechnic of New Zealand, particularly Jane Needham, Head, School of Accounting, Finance and Law, for financial assistance and research time. Thanks are due to Corinne Ross for technical assistance in presenting the work.

My family deserves my sincere thanks and appreciation for their moral support. I am grateful for statistical and SPSS advice from Neil and encouragement from John. I owe extraordinary thanks to my husband Bruce for his proofreading and helpful suggestions.

TABLE OF CONTENTS

ABSTRACT i

ACKNOWLEDGEMENTS ii

TABLE OF CONTENTS iii

Chapter One Introduction 1

1.0 Introduction 1

1.1 Research objectives 4

Chapter Two Literature review 7

2.0 Introduction 7

2.1 Earnings Management Research 7

2.1.1 Incentives for Earnings Management 7

2.1.2 Means of Detecting Earnings Management 8

2.1.3 Motivation for the Current Research 11

2.2 Corporate Governance Research 12

2.3 Research on Takeovers and Mergers 20

2.4 Summary 22

Chapter Three Hypothesis Development 23

3.0 Introduction 23

3.1 Relevant accounting theories 23

3.1.1 Agency theory 23

3.1.2 Normative accounting theory 26

3.1.3 Positive accounting theory 27

3.1.4 Disciplinary theory of takeovers 27
3.2 Hypotheses Development 28
3.2.1 Earnings Management Hypothesis 28
3.2.2 Corporate governance hypotheses 31
Chapter Four Research method 35
4.0 Introduction 35
4.1 Research Design 36
4.1.1 Detection of Earnings Management 36
4.1.2 Corporate Governance Factors 41
4.1.3 Takeover Activity 47
4.2 Sample Selection 51
4.3 Data collection 52
4.4 Data analyses 53
4.5 Limitations 53
Chapter Five Results And Analysis 54
5.0 Introduction 54
5.1 Sample Descriptive Statistics 54
5.2 Earnings Management 63
5.2.1 Descriptive Statistics for Accruals Measures of Earnings Management 63
5.2.2 Earnings Management Hypothesis 69
5.2.3 Additional Tests 74
5.3 Corporate Governance and Earnings Management 78
5.3.1 Descriptive Statistics for the Independent Variables 78
5.3.2 Commentary on Descriptive Statistics of Some Independent Variables 81

5.3.3 Correlation Analysis ... 84

5.3.4 Regression Results for Tests of the Corporate Governance hypotheses ... 87

5.3.5 Hypotheses Conclusions ... 97

5.4 Takeover Activity ... 99

Chapter SIX Discussion and Conclusion ... 103

6.0 Introduction ... 103

6.1 Discussion ... 103

6.2 Limitations and Further Research ... 108

6.3 Concluding Remarks ... 110

List of Appendices ... 111

APPENDIX ONE ABBREVIATIONS ... 112

APPENDIX TWO LIST OF FIRMS EXAMINED ... 113

APPENDIX THREE WORKSHEET AND SPSS DATA FILE ... 117

APPENDIX FOUR GRAPHS ... 125

APPENDIX FIVE STATEMENTS OF CORPORATE GOVERNANCE ... 129

References ... 130

List of Plates ... 136

Plate 1 Arthur Levitt, Chairman of SEC in 1999 ... 136

Plate 2 A Happy Board of Directors ... 136