

STAKEHOLDER INFLUENCE ON EARNINGS MANAGEMENT: ETHICAL CONSIDERATIONS AND POTENTIAL AVENUES

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Abstract

Financial reports are a major bonding agent in (prospective) firm-stakeholder relationships. Therefore, earnings management might induce stakeholders to accept terms of trade which they would have not, knowing the true situation. The issue becomes even more complicated and potentially conflict-laden if some stakeholders would possess the ability to influence firms' earnings management behavior and exploit this at the expense of others. Four generalizable avenues of potential stakeholder influence are presented.

Keywords: Stakeholder Theory, Earnings Management, Ethical Implications

1. INTRODUCTION

Financial reporting serves two main purposes in modern business life. On the one hand, it determines tax liabilities as well as residual income which are distributable⁵ amongst owners. On the other hand, it ought to inform further stakeholders about the value of their explicit and implicit claims in the firm. Stakeholders are manifold and include, but are not limited to, auditors, creditors, customers, employees, labor unions, suppliers and other contractors.

Contemporary accounting principles view stakeholders as mere consumers of financial statements. As a consequence, research on earnings management (i.e., 'window dressing' or 'earnings manipulation') primarily focuses on the techniques and the degree to which firms deceive stakeholders through their earnings management activities.

The goal of this study is to determine whether this is necessarily the case. Might stakeholders even be able to influence the formation and reporting of earnings? If they actually influence the accounting process in this respect, their role becomes ambiguous. They would simultaneously constitute users as well as factors influencing financial accounting information. To render things even more complex, these stakeholders might exploit their position at the expense of others. Four theoretical explanations for the deviation from the classic dichotomy between users and preparers of financial statements are discussed.

First, the behavioristic approach states that stakeholder behavior towards the firm is reciprocally determined by individual expectations and valences. In this sense, financial statements are a means of interaction upon which stakeholders and firms develop terms of trade for their transactions.

Second, in a similar vein, organizational sociology exhibits means of influence for employees through collective voice. Third, derived from the catering approach, I argue that various stakeholder groups have different (and potentially time-varying) demand for earnings management. Fourth, the cultural approach formulates the theory that the (non-) acceptance of earnings management in a society depends strongly on social and legal institutions which, in turn, are determined by culture.

The paper is structured as follows. First, I will present fundamentals of earnings management and show that it is a profoundly ethical issue. Moreover, stakeholder theory and its connection to accounting are discussed. Financial reporting and, more specifically, corporate earnings serve as a bonding agent in contemporary economic transactions. Stakeholders adjust their terms of trade based on information which, to a non-negligible part, stems from financial reports. The traditional dichotomy in financial reporting is presented next. It results from a long line of traditional approaches to financial accounting theory dating back to the late 19th century. In the following, I try to consolidate both views and present possible avenues how stakeholders might overcome this classic dichotomy.

2. FUNDAMENTALS OF EARNINGS MANAGEMENT

In a seminal paper, Healy & Wahlen (1999) define earnings management as an act of managerial "judgment in financial reporting and in structuring transactions to alter financial reports to (...) mislead some stakeholders about the underlying economic performance of the company" (p. 368). Hence, this encompasses the whole range of earnings management activities from real cash flow choices to accounting earnings management. The continuum of earnings management activities presented in Figure (1) ranges from conservative (i.e., income-decreasing) to aggressive (i.e., income-increasing) accounting and

⁵ This paper is partly based on my dissertation at Bielefeld University. I thank Jürgen Ernstberger and Hermann Jahnke for valuable comments and suggestions. All errors remain my own.

even onto outright fraud (e.g., Goncharov (2005), p. 24). Conservative accounting earnings management consists of the overstatement of reserves, increases in provisions for bad debt, overstatement of write-offs, the use of the declining-balance (i.e., accelerated) depreciation method instead of straight-line depreciation, etc. These choices reduce earnings relative to the neutral state. Aggressive accounting, on the other hand, is based on reducing reserves, write-offs, provisions for bad debt and so forth. It inflates earnings relative to neutral, unmanaged earnings.

There are a couple of problematic issues in the distinction of aggressive earnings management and fraud. Intentional and deliberate misstatements do not encompass mere errors. For instance, Dechow & Dichev (2002) find that accruals are not only an earnings management tool, but also prone to estimation errors. From outside the organization, it is not trivial to appropriately assess managerial intent. Moreover, the misstatement or omission has to be material. Yet, defining 'materiality' in itself requires judgment and thus offers management considerable leeway (Johnson (1999)). Standard setters do not provide clear qualitative and/or quantitative guidance and criteria for appraising materiality. Hence, it depends largely on the auditor's professional judgment. Quantitatively small misstatements or omissions might still be material if they, for instance, turn small losses into profits, and increase the propensity to meet analyst consensus forecasts or loan covenants.

3. ARE MANAGED EARNINGS AN ETHICAL ISSUE?

The underlying premise of the whole strand of earnings management literature is that firms discretionarily deviate from 'true' economic earnings via financial reporting or real business transactions. Thus, earnings management research (implicitly) requires an assumption of 'true' earnings, a concept which in itself is non-trivial and highly debated. Macintosh (2009) posits that "income (...) cannot be defined, only described" and goes on saying that "income is only a socially constructed linguistic object" (p. 158) rather than a universal, "permanent and extra-linguistic" (p. 165) concept. As a result, it can never be universally true as it depends on a socially constructed, and ever changing, set of accounting regulation. Consequently, he suggests that researchers, auditors and standard-setters refrain from the use of the term 'true and fair view' and instead prefer the phrase that "statements have been prepared to conform to current promulgated GAAP and concepts" (p. 168). Lev (2003) establishes a more practical definition of truth as a "statement (...) that corresponds to (...) facts" (p. 30). Yet, his resulting conclusion of how the report of accounting earnings corresponds to the truth is equally bleak. Earnings, reported shortly after the corresponding fiscal year, contain numerous estimates and assumptions, rendering them inevitably imprecise. As such, they necessarily are "a far cry from facts" (p. 31). Hence, one may argue that a certain degree of earnings management is unavoidable (e.g., Heintges (1997), pp. 174f.).

Figure 1. Distinction between earnings management and fraud⁶

	Accounting choices	Cash flow choices
	Within-GAAP	
'Conservative' accounting	Overly aggressive recognition of provisions or reserves	Delaying sales
	Overvaluation of acquired in-process R&D in purchase acquisitions	Accelerating R&D or advertising expenditures
	Overstatement of restructuring charges and asset write-offs	
'Neutral' accounting	Earnings that result from a neutral operation of the process	
'Aggressive' accounting	Understatement of the provision for bad debts	Postponing R&D or advertising expenditures
	Drawing down provisions or reserves in an overly aggressive manner	Accelerating sales
	Out-of-GAAP	
'Fraudulent' accounting	Recording sales before they are 'realizable'	
	Recording fictitious sales	
	Backdating sales invoices	
	Overstating inventory by recording fictitious inventory	

⁶ Modified and implemented from Dechow & Skinner (2000), p. 239.

As postulated before, earnings management is 'within-GAAP'. Ample evidence shows that firms which are eventually found guilty of accounting fraud and forced to restate their earnings, previously engaged, and seemingly overextended themselves, in legal earnings management prior to the actual misstatement periods (e.g., Bell & Carcello (2000); Crutchley et al. (2007); Ettredge et al. (2010)). Thus, there seems to be a slippery slope from earnings management to fraud. Small, gradual instances of earnings management potentially erode ethical behavior of managers and their organizations and, in the long-term, result in aggregate fraud cases (Gino & Bazerman (2009); Johnson et al. (2012)). In this respect, Harris et al. (2010) provide evidence that small loss avoidance (i.e., benchmark beating), which is typically associated with rather small amounts of earnings discretion (Burgstahler & Chuk (2011)), is positively associated with accounting fraud. Evidence from an experimental setting show that managers tend to rationalize their behavior "when organizational consequences are favorable", "as if the ends justify the means" (Johnson et al. (2012), p. 922).

Nevertheless, there also are positive views on earnings management. These follow the notion that true economic earnings are rather volatile and convey only little information about future earnings and cash flows. Managerial accounting discretion, thus, merely conveys private information through making long-term sustainable earnings more visible (e.g., Sankar & Subramanyam (2001)). Additionally, even if earnings would be managed in the short-term, accrual reversals ensure that earnings are unbiased in the long-term, which "allows [a stakeholder] to detect persistently poor performance" (Arya et al. (1998), p. 9).

Therefore, to reconcile which view of earnings management is consistent, one has to consider whether stakeholders are able to see through the firm's earnings management activities. For it to be purely beneficial, by conveying private information about sustainable long-term prospects, they would have to fully see through earnings management. Otherwise, this would inevitably result in disequilibrium (Ronen & Yaari (2008), p. 117f.). On the other hand, if the market is able to fully comprehend earnings management, by definition, it can never be pernicious. As this assumption is rather hypothetical and far-fetched, it is at least highly unlikely that the notion of it being purely beneficial can hold (for comprehensive reviews on empirical evidence, c.f., Dechow et al. (2010); Healy & Wahlen (1999)). The situation might be described best in the spirit of Akerlof (1970). In a simplified model, there are three kinds of firms (Ronen & Yaari (2008), p. 118). Good news firms with truthful and bad news firms with truth- or untruthful earnings reports. Stakeholders know that the intrinsic value of an average good (bad) news firm is 220 (160), respectively. But they are uncertain about the underlying quality and truthfulness of each separate firm. Moreover, it is known that 60% (40%) of the firms have good (bad) news and that 20% of bad news firms portray themselves as good news firms by issuing untruthful reports. In effect, stakeholders discount the value of truthful good news-reports and in turn overestimate the value of untruthful bad

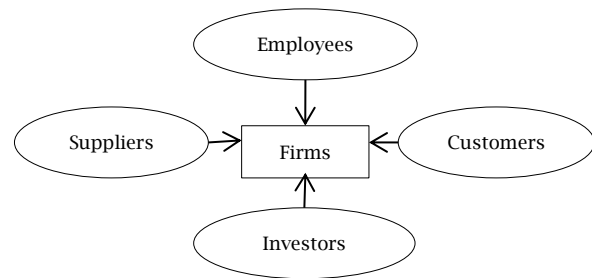
news firms.⁷ In summary, this brings me to the conclusion that earnings management has to be considered, at least somewhat, pernicious.

4. FUNDAMENTALS OF STAKEHOLDER THEORY

In the following, I will present how the stakeholder approach relates to financial reporting of the firm. Freeman & Reed (1983) define stakeholders as "those groups who have a stake in the actions of the corporation" (p. 89). Thus, stakeholders consist of a wide range of individuals and organizations with which the firm has explicit or implicit contractual relationships involving firm-specific assets. As a result of investment and asset specificity, firm-stakeholder relationships are characterized by a mutual dependency. According to Donaldson & Preston (1995) it is not based on a mere one-sided interest of a stakeholder in the firm but a corresponding functional interest of the firm in establishing and maintaining the stakeholder relationship. Although stakeholder theory is closely related with resource dependence theory (Pfeffer & Salancik (1978)), insofar as it also originates from the idea of (implicitly) contracting on firm-specific assets, it evolved into a normative theory of the organization. It addresses the issue of "who [besides owners and their agents] is allowed to take part in decision-making concerning organizational objectives and strategies" (Phillips et al. (2003), p. 487).

Following the traditional 'Input-output model', a company is regarded as a "black box" (Jensen & Meckling (1976)) which stands in contrast to transparent market transactions. Already Coase (1937) establishes the notion that, in this case, a market price mechanism allocating input factors is replaced by an "entrepreneur-coordinator, who directs production" (p. 388). Figure (2) presents this "Production View of the Firm" (Freeman (2010), p. 5). With - financing by debt and equity investors, it transforms input factors such as labor, capital goods and upstream products into finished goods and services.

Figure 2. Input-output model of the firm⁸



In his seminal paper "The Nature of the Firm", Coase (1937) explains the parallel occurrence of multiple firms and markets in our modern economy. More specifically, he brings forward the questions

⁷ According to Bayes' theorem, the value *V* of a good news firm, depending on the rate of expected earnings management by bad news firms amounts to $V = 220 \cdot 60 \cdot ((1/((.60 \cdot 1) + (.40 \cdot 20))) + 160 \cdot 40 \cdot ((.20/((.60 \cdot 1) + (.40 \cdot 20))) - 220 \cdot 80 + 160 \cdot 12 = 212.80$ which is below its intrinsic value of 220.

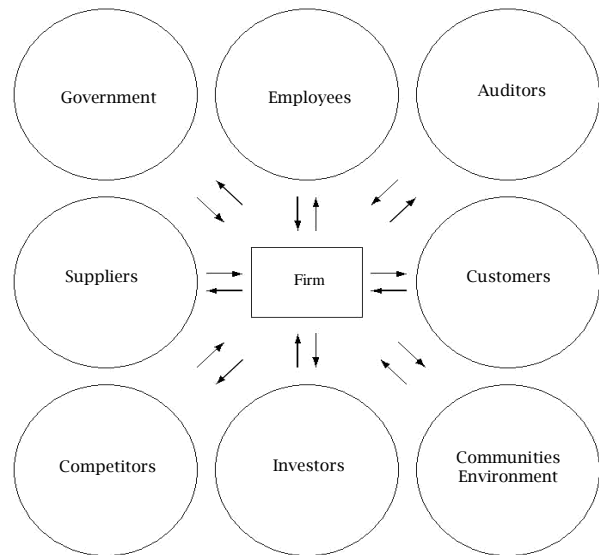
⁸ Modified and implemented from Donaldson & Preston (1995), p. 68.

"why, if by organising one can eliminate certain costs and in fact reduce the cost of production, are there any market transactions at all?" and "Why is not all production carried on by one big firm?" (p.394). Former market transactions will be internalized as long as internal transaction cost is lower than the cost of market transactions. Williamson (2002) formalizes this notion. For less specific and complex transactions, the manager chooses a market transaction which does not require maintaining a large, costly firm bureaucracy. As specificity increases, the cost of conducting market transactions increases comparatively more than internal transaction costs. Yet, as internal transactions require management time and coordination, the cost of an additional internal transaction increases, as well. This results in "diminishing returns to management" (Coase (1937), p. 395) or "diseconomies of large scale" (Williamson (2002), p. 176). Depending on the growth rate of the firm's bureaucracy, and the increase in the rate of mistakes made by management, the firm will eventually reach its size limit (Coase (1937)). Hence, stakeholder relationships might be a suitable middle ground between pure internal and pure market transactions. For instance, suppliers invest in, administer and maintain certain firm-specific assets, using their own management's time and bureaucracy. They can specialize and, therefore, reduce the rate of mistakes. This leads to comparatively cheaper input supply. Asset specificity limits the supplier's ability to sell its products on the market, and limits market sources for the firm, as well. Thus, both the supplier and the firm, enter into a mutual dependency. In summary, stakeholder relationships are a hybrid of market and internal transactions from a transaction cost perspective.

The processes of establishing and expanding a firm by (quasi-)incorporating former market transactions thus create a 'nexus of contracts' (Jensen & Meckling (1976)). This nexus is a vast combination of mutual explicit and implicit contracts, as well as legal statutes (Easterbrook & Fischel (1991)) between owners, managers and various other stakeholders which bargain "with the firm over a set of rights that will protect the firm-specific assets that it makes available for production" (Boatright (2002), p. 183). Albeit implicit contracts are not enforceable in court, they tend to be self-enforcing as the contracting parties face the risk of reputation and relationship capital losses following a breach of contract (Bull (1987)). Moreover, as already mentioned, firm-specific assets and investment create a bilateral economic dependency between the firm and its stakeholders. They cannot be transferred to another "use or user (...) [without] a loss of productive value" (Williamson (2002), p. 176). Taking this a step further, one may even argue that the firm itself is constituted out of "a constellation of cooperative and competitive interests possessing intrinsic value" (Donaldson & Preston (1995), p. 66).⁹ Figure (3) summarizes the

nexus of mutual relations between the firm and its stakeholders in contrast to the traditional input-output model.

Figure 3. The stakeholder model of the firm¹⁰



Besides the existence of mutual contractual relations and dependencies, there is a second necessary condition for a stakeholder relationship. Not every contract necessarily constitutes a stakeholder relationship. Discrete, single transactions, which are unlikely to be repeated, do not qualify (Bowen et al. (1995)). As such, Macneil (1978) distinguishes discrete from relational, repeated transactions as being "entirely separate not only from all other present relations but from all past and future relations as well" (p. 856). Table (1) indicates the repeated, forward-looking nature of stakeholder relationships which is reflected in both implicit and explicit claims. For instance, employees possess claims which are forward-looking, and thus based on repeated transactions, such as job security and promotion prospects. Moreover, employees and capital providers are players which directly contribute to the production process. Auditors and tax authorities (as one branch of government) are just indirectly connected to production. Institutionally, they play an essential role through the enforcement of accounting practices which constitutes essentially a service to other stakeholders, such as suppliers and customers. As discussed earlier, the latter might adjust their terms of trade with the firm (partly) on the basis of financial reports which "act as a major social bonding agent in today's fragile global social, economic and financial capitalism" (Macintosh (2009), p. 142).

some influencers (e.g. the media) have no stakes" (p. 86). This is not to say that "influencers" are meaningless in this context. They, in the truest sense of the word, are influential on the firm through potentially influencing stakeholders (e.g. Joe et al. (2009)). Phillips (2003) applies a similar stakeholder framework and labels influential parties as 'derivative' stakeholders which potentially exert benefit or detriment on the firm.

¹⁰ Modified and implemented from Donaldson & Preston (1995), p. 69 and Freeman (2010), p. 55.

⁹ Donaldson & Preston (1995) distinguish between stakeholders, with whom the firm has a mutually dependent relationship, and influential parties: "It is essential to draw a clear distinction between influencers and stakeholders: some actors in the enterprise (e.g. large investors) may be both, but some recognizable stakeholders (e.g. the job applicants) have no influence, and

Stakeholder theory not only has roots in economics and contracting theory but also in organizational sciences which tend to consider the firm as a coalition of individuals (March & Simon (1958); Staehle (1969)). This coalition is based on decisions by each individual member. The decision to participate, and remain, in a coalition is determined by a balance between inducements and contributions. This 'theory of organizational equilibrium' goes back to Barnard (1938) and Simon (1945). Barnard (1938) further distinguishes between an external and internal balance. The internal balance develops between employees, investors, suppliers and customers, whereas the external balance covers an alignment in objectives of the coalition (i.e., the firm) and its social environment. Hence, stakeholders decide to take part in a joint venture as long as they determine that their contribution to the firm is matched by an appropriate inducement. Stakeholder-agency theory stipulates that their concrete behavior is determined by possible power differentials between stakeholders and the firm (Hill & Jones (1992)). For instance, if the firm depends less on the stakeholder than vice versa, the stakeholder is less likely to leave the coalition even if terms of trade eventually deteriorate. Expanding on this notion, Frooman (1999) categorizes stakeholder relationships as either low interdependence (i.e., neither the firm nor the stakeholder are particularly dependent on each other), firm power (i.e., the power differential is in

favor of the firm), stakeholder power or high interdependence. As such, stakeholder theory does not normatively imply equal treatment and influence of all stakeholders (Phillips et al. (2003)).

In summary, a stakeholder relationship in the context of organizational management and financial reporting is based on four crucial attributes. It requires (1) an explicit or implicit contract, involving (2) repeated transactions, regarding (3) firm-specific assets, investments or skill sets, resulting in a (4) mutual dependency.

It has to be made clear that the various stakeholder interests and claims constituting the firm are rarely aligned, except for the quite basic "stake in the continued existence of the firm" (Hill & Jones (1992), p. 145). From an organizational perspective, management's central purpose therefore is to balance these various interests (Donaldson & Preston (1995); Hill & Jones (1992)). If management, for whatever reason, fails to fully account for those conflicts, then stakeholders themselves will adjust their terms of trade to anticipate other stakeholders conflicting goals. On a related note, another pitfall of the stakeholder approach is opportunistic managerial actions, which are rationalized by pressure by some stakeholder groups. Therefore, stakeholders have to be aware not only of their peers' goals and actions but also of potentially opportunistic managerial behavior (Phillips et al. (2003)).

Table 1. Stakeholders' explicit and implicit claims¹¹

<i>Stakeholders</i>	<i>Explicit Claims</i>	<i>Implicit Claims</i>
Employees	Wages, benefits (e.g., workspace, vacation, pension, parking), work hours, severance agreements	Working conditions (e.g., safety, pleasant workspace), job security, future prospects (e.g., wage increases, benefits, promotions)
Auditors	Audit Fees	Reputation, continuing demand for audit services, avoidance of litigation, prospects of cross-selling opportunities for non-audit services
Customers	Price, payment terms (e.g., due date, discount, credit limit, interest rate), quantity of goods or services purchased, performance contracts (e.g., service agreements, warranties)	Specified quality of performance, continuing supply of goods or services, continuing availability of spare parts and maintenance service
Debt investors	Interest rate, payment terms (e.g., maturity, credit limit, collateral), quantity of funds supplied	Timely payment, continuing demands for funds, investment security
Equity investors	Residual claim on profits, involvement in strategy setting, fringe benefits	Future prospects (e.g., profit increases, firm growth), prestige
Suppliers	Price, payment terms (e.g., due date, discount, credit limit, interest rate), quantity of goods or services supplied, purchase commitments	Timely payment, continuing demand for goods or services, specified image for goods or services
Competitors	No explicit claims besides in special cases (e.g., joint ventures)	Information about revenues, profits, cost structures
Government	Tax payments, goods and services	Going concern, future prospects, continuing tax revenues

¹¹ Modified and implemented from Bowen et al. (1995), p. 259.

5. THE TRADITIONAL DICHOTOMY BETWEEN USERS AND PREPARERS OF FINANCIAL REPORTS

The topic of earnings management is undeniably connected with Schmalenbach's (1925) classic theory of dynamic accounting. Its prime goal is the correct report of corporate profits according to the accrual principle. He does not claim that the resulting annual profit is universally 'true' which, as discussed earlier, only profits cumulated over the firm's existence can be. Annualized earnings have to rely on estimates and accounting choices which create managerial discretion and thus opportunities to manage earnings. Being aware of these issues, he demands that these choices are executed in a similar manner across periods ("Grundsatz der Vergleichbarkeit" (Schmalenbach (1925), p. 80)) and, if in doubt, prudently (i.e., conservatively) to not be caught by surprise by adverse future developments ("Grundsatz der Vorsicht" (Schmalenbach (1925), p. 84)). Contrariwise, the main objective of the older static accounting theory, regularly attributed to Simon (1886), is a correct valuation and reporting of assets and liabilities which, in turn, would equally lead to a correct valuation of changes in equity, and thus Hicksian income which annuitizes intrinsic firm value. Contemporary accounting standards take a neutral point of view and contain elements of both theories. Notwithstanding the apparent differences of accounting theories, their common tacit assumption is a rather strict dichotomy between preparers and addressees of financial reports which, on the one hand, are used to determine tax liabilities and residual payments to owners (i.e., distributable income), and, on the other hand, provide information to stakeholders.

This results in a rather one-sided process in which the preparers decide which information to provide as long as it conforms to generally accepted accounting principles (GAAP) and other related legal statutes determining the publication and content of financial reports. Moreover, GAAP generally prioritizes some stakeholders over others. Decision usefulness for actual and potential equity investors and lenders is the focal point of accounting standards. As such, an accounting system structured in this fashion "has little utility for developing reporting requirements that might help enact the accountability relationships that exist between a corporate entity and [its diverse stakeholders]" (Young (2006), p. 597). Consequently, earnings management research has traditionally also focused on equity investors and other capital markets participants, such as financial analysts and debt holders as prime targets thereof. Based on these remarks, it seems necessary to develop a more generalizable framework for potential influence of a broader spectrum of stakeholders on one of the most important means of corporate communication - the financial report.

6. AVENUES FOR STAKEHOLDER INFLUENCE ON EARNINGS MANAGEMENT BEHAVIOR

As such, there are four, possibly interconnected, routes to explain the general influence of a variety of stakeholders on earnings management behavior. First, the behavioristic approach potentially helps to gain insights in the reciprocal nature of the firm's

and its stakeholders' behavior. In this setting, financial reporting thus is information on which the agents trade. The value of this information is either enhanced, if the earnings management activities work in favor of the respective stakeholder, or decreased. Second, a related approach is based on organizational sociology. Theories involving collective voice might also help in explaining stakeholder influence. Third, catering theory argues that investors have a time-varying demand for earnings management. As there is empirical evidence that the price differential attributable to differences in the extent of earnings management is not arbitrated, it is rational for managers to cater to investors' fluctuating demand for earnings management. While catering theory traditionally is based on the firm's equity being publicly traded, it may help explaining stakeholders' demand for earnings management in a broader setting, as well. Fourth, on an international level the acceptance and favorability of earnings management might even be attributable to cultural factors. A line of research builds on national cultural dimensions and shows their association with earnings management behavior.

6.1. Behavioristic approach

In the behavioristic approach, following motivational psychology, the firm is described as an instrument that is used by a wide range of individuals to reach their own, personal objectives. In a sense, this is connected to the concept of the firm as a coalition. Individuals enter into relations with a firm, intensify, reduce or cut-off the relations, attributable to their own motives (Kern (1986), p. 396). Each individual thus modifies her interaction with the firm based on her goals and expectations how the firm will probably reciprocate. Thus firm and stakeholder behavior is a function of expectations of future counterparty reactions and the weight (i.e., valence) each individual places on these expectations (Kern (1986), p. 397f.; Vroom (1964)). It has to be noted that valence, as "anticipated satisfaction", is a highly subjective construct which can differ substantially from a presumably objective value (i.e., "the actual satisfaction" (Vroom (1964), p. 15). Measuring valences of outcomes and actions is a non-trivial task which inevitably has to rely on noisy proxies such as "decision time" (Vroom (1964), pp. 20-23).¹² In summary, "similar to the notion in decision theory (...) [,] people choose in a way that maximizes subjective expected utility" (Vroom (1964), p. 19).

$$\text{Behavior} = f(\text{expectations; valences}) \quad (1)$$

How can financial reporting or, more specifically, earnings management factor in this view of the firm and its stakeholders? Kern (1986) states a simple example. A creditor puts a positive weight (i.e., a valence of +1) on interest payments, a negative weight (-1) on other firm payments reducing its liquidity and is indifferent, with a valence of 0, towards transactions not influencing liquidity (p. 398). Hence, financial reports and the items they contain are information signals on which

¹²For instance, a short decision time indicates that an outcome is preferred strongly over another. Thus, it incurs a significantly higher valence.

the interaction partners form their expectations and adjust their terms of trade. While valences determine how favorable an individual regards alternative actions, outcomes and states of the world, expectations about the probability of these outcomes are equally important (Vroom (1964), p. 17).

$$\text{Expectations} = f(\text{information}) \quad (2)$$

Earnings management potentially influences the value of this information (Figure 4)). On the one hand, if a stakeholder does not uncover earnings management attempts, neglects their existence, or underestimates their extent, she might put an unreasonably high value on the information signal which in turn influences expectations, and sometimes even valences if there is little or no prior experience given similar situations (Vroom (1964), p. 23). Hence, stakeholders are misled and their behavior is altered compared to a truthful report of earnings. On the other hand, a stakeholder may potentially welcome earnings management if it results in other stakeholders trading with the firm on more favorable terms, therefore increasing her expected utility resulting from the stakeholder relationship. Continuing aforementioned example, one might argue that the creditor may welcome the firm using accounting discretion to boost earnings as this might convey favorable signals to other important stakeholders, such as suppliers. If this results in more lenient supplier credit terms which are favorable for liquidity, the creditor's claim in the firm improves. Hence, it seems possible that a specific stakeholder group proactively suggests certain accounting treatments which work in its favor.

6.2. Organizational sociology approach

A similar approach can be found in organizational sociology. Hirschman (1970)'s theory of 'exit, voice and loyalty' suggests three potential routes how stakeholders might exert their influence. As this theory is mostly applied in connection with

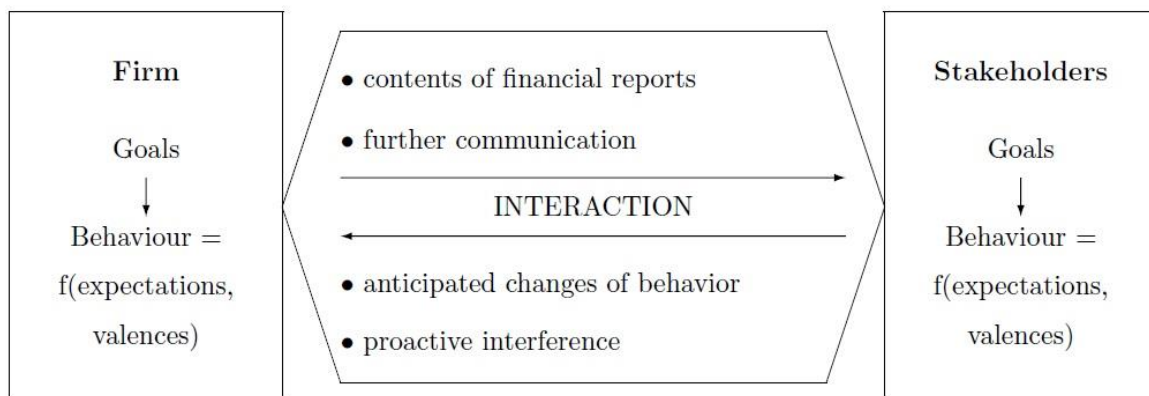
collective voice applied by labor unions, I will present the following paragraphs from the viewpoint of employees as a key stakeholder group.

Exit (Hirschman (1970), pp. 21-25): Employees can choose to voluntarily end their relation with their current employer if they are discontent with the way it conducts business. If only a few employees choose this measure, the actual threat to the firm might be minimal. Contrariwise, a general feeling of discontent resulting in substantial numbers of employees leaving employment or reducing, oftentimes largely unobservable, effort (i.e., inner resignation) may subsequently put the firm in peril. Moreover, as exits might result for a myriad of personal as well as organizational reasons, their signal is not overly precise.

Voice (Hirschman (1970), pp. 30-43): Discontent employees may also choose to speak up to influence management into changing its behavior. Alternatively employees can use other stakeholders, such as labor unions, as proxies to speak on their behalf (Portisch (1997), p. 51). Taking this notion a step further is the theory of the "stakeholder role set" (Freeman (2010), p. 58), in which employees themselves might belong to different stakeholder groups exponentially increasing their influence, and the "legitimacy theory" (Suchman (1995)), according to which employees are a major determinant of the firm's perceived public legitimacy. One may argue that 'voice' is the most informative employee behavior. On the downside, some employees openly exhibiting their discontent may point out weaknesses to previously unaware colleagues.

Loyalty: Hirschman (1970) largely attributes discontent employees not leaving the organization or speaking up to loyalty (pp. 76-98). Its foremost attribute is that it reduces the likelihood of 'exit'. Loyal employees just wait for the situation to improve. Generally, the dividing line between 'loyalty' and 'voice' does not seem to be clear cut (Portisch (1997), p. 51). Yet, although loyalists are less likely to exit the organization in the first place, the effect of them finally threatening the firm to quit is highest and, as a consequence, reinforces the 'voice' instrument (Hirschman (1970), pp. 82f.).

Figure 4. Behavioristic approach of stakeholder influence on earnings management¹³



¹³ Modified and implemented from Kern (1986), p. 415.

6.3. Catering approach

The economic theory of catering might also provide insight into stakeholder influence on firms' earnings management behavior. Originating from Baker & Wurgler (2004), the catering theory of dividends started a line of research which looks into new ways of explaining persistent and systematic differences in dividend payout ratios. It builds on two underlying assumptions. First, some investors, for whatever psychological, institutional, personal or tax reasons, demand dividend payouts while others prefer profits to be accrued, which ideally results in corresponding stock price increases. Exploiting this clientele effect is rational for managers. They cater to investors' demands for different and/or varying dividend payout levels to increase their firm's stock price. Second, market inefficiencies prevent stock price differences between these firms from being fully arbitrated.

Albeit catering, by definition, requires an active capital market for equity instruments which does not arbitrage existing price differences, there are potential conclusions to be drawn in a broader setting involving stake- instead of shareholders. First, a large subset of firms in the economy is not listed on a stock exchange (i.e., private firms). On the one hand, private firms are more opaque, attributable to a less well developed informational environment (Burgstahler et al. (2006)). On the other hand, agency conflicts between management and shareholders (i.e., owners) are far less pronounced than for publicly listed companies. Remaining cross-sectional differences in the earnings management behavior therefore should be less attributable to agency conflicts but to systematic differences in stakeholder claims in the firm.¹⁴ Second, while, according to financial theory, arbitrage is relatively easy and nearly instantaneous for shareholders, it has to be noted that stakeholder relations with firms cannot be altered that easily and nearly cost-free.

A small line of research looks at the catering use of earnings management, also from an equity capital market perspective. As such, Aghion & Stein (2008) show that if the market overprices growing firms, it is a rational strategy for managers to foster growing sales at the expense of profitability. Undoubtedly, this affects real cash flow choices, as presented in Figure (1). Additionally, there is evidence for benchmark beating behavior. Employing the difference between abnormal returns for firms beating and missing analyst forecasts in the previous quarter as a proxy for the price premium investors assign to beating analyst earnings forecasts, Chen et al. (2013) show that managers seem to cater to the marginal investor's demand for earnings management. Rajgopal et al. (2007) find evidence that there is time-varying stock market demand for accrual earnings management depending on overall market sentiment. During phases when markets overprice stocks following positive earnings surprises, the propensity and magnitude of income-increasing discretionary

accruals is greater. Cross-sectionally the effects seem to be greatest for comparatively more opaque companies, i.e. small, distressed, non-dividend paying, and high-tech firms, as well as firms exhibiting extreme growth or reporting losses (Rajgopal et al. (2007); Zhao (2010)).

6.4. Cultural approach

In an analysis whether cultural differences between countries influence and determine earnings management behavior, a line of research builds on seminal work by Hofstede (1980). In this respect, Lo (2008) posits that "earnings management could be an equilibrium outcome whereby managers' report inflated earnings because inflated earnings are [culturally] expected of them" (p. 354). Leuz et al. (2003) find that legal enforcement and outside investors' rights are negatively, insider ownership positively associated with earnings management. Low ownership dispersion is indicative of an insider-, stakeholder-oriented corporate governance model which can usually be encountered in code-law economies in contrast with presumably more market-based economies which typically developed common-law traditions (e.g., Ball et al. (2000)). Furthermore, legal frameworks, including investor protection, are inseparably connected with the respective country's culture (e.g., Hope (2003); Mautner (2011)). Law is not only shaped by culture, but influences culture itself (Mautner (2011)). Luhmann (1989) postulates that "the legal system is a differentiated functional system within society. Thus in its own operations, the legal system is continually engaged in carrying out the self-reproduction (...) of the overall social system as well as its own. (...) This means not only that the legal system fulfils a function for society (...) but also that the legal system participates in society's construction of reality" (p. 138). I briefly present the cultural dimensions based on Hofstede (1980) and Hofstede (2001) in the following paragraphs.

Uncertainty Avoidance: Members of societies with high uncertainty avoidance tend to worry about the future. They seldom, and rather reluctantly, change jobs. They expect management to consist of specialists in their respective field and prefer rules and guidelines to ad-hoc solutions (Hofstede (1980), pp. 176-187).

Individualism: Individualistic societies are characterized through less tightly knit groups of individuals with the effect that every individual is responsible for its own and its immediate family's well-being. Collectivist societies see individuals as parts of larger groups. An example are 'collectivist' employees who "expect [their employers] to look after them like a family and defend their interests" (Doupnik (2008), p. 323).

Power Distance: Societies exhibiting high power distance are more accepting of inequalities in terms of wealth, social status, prestige, privileges and power. Power in organizations, such as political parties or companies, is highly concentrated in the hands of little elite (Hofstede (1980), pp. 93-98). Low power distance societies foster a more co-operative system of corporate governance in which managers consult with employees before decisions, employees are less afraid of disagreeing with management and there are signs of formal and informal employee

¹⁴As such, the important remark by Phillips et al. (2003) that research on stakeholder theory has unnecessarily constrained itself by focusing almost exclusively on (large) publicly listed firms would also be addressed. "However, for stakeholder theory to truly come into its own as a theory of strategic management and organizational ethics, it will need to be applied to more than just the large, publicly held corporations" (p. 495).

participation in corporate decision-making (Hofstede (1980), p. 119).

Masculinity: Masculine societies exhibit a "preference (...) for achievement, assertiveness and material success" (Doupnik (2008), p. 323). Work plays an essential role in life and defines the status and role of individuals in society. Men and women typically follow different educational and career paths as "some occupations are considered typically male, others female" (Hofstede (1980), p. 296).

Long-term Orientation: Long-term oriented societies favor high savings rates and investment in real estate. They tend to observe traditions and preserve traditional values. Short-term success and profits are far less important than building long-term relationships and networks (Hofstede (2001), pp. 351-372).

Numerous studies employ these cultural dimensions in earnings management contexts. On a country-level, Desender et al. (2011) find that more individualist and egalitarian (i.e., low power distance) societies are associated with less loss avoidance as well as overall earnings discretion. In a similar study, Callen et al. (2011) find that the role of legal enforcement, reported in Leuz et al. (2003), is mediated by controlling for culture, but not by controlling for religion. Though, as religion is an important determinant of culture (Hofstede (1980), pp. 295-298), both constructs might partly proxy for the same effect. Indicative of this, most religion indicators seem to be highly correlated with cultural dimensions (Callen et al. (2011)). The influence of culture on the choice of auditors is examined by Hope et al. (2008). They combine three of Hofstede's cultural dimensions into an aggregate "secrecy" score. Societies which dislike uncertainty comparatively more, and, at the same time, are more accepting of class and power differentials and less individualistic, seem more culturally secretive. Following the notion that large audit firms provide higher audit quality, they show that firms in secretive societies are less likely to hire Big 4 auditors. Employing the same secrecy score, Geiger & van der Laan Smith (2010) provide evidence that individuals in secretive societies perceive real and accounting earnings management as generally more acceptable.

Critics of these approaches not only claim that Hofstede's cultural dimensions which are largely based upon a survey of IBM employees in the years from 1967 to 1969 might be too outdated to draw valid conclusions (e.g., Baskerville (2003); Desender et al. (2011)), not generalizable to the full population (e.g., McSweeney (2002)), but also that he in effect measures socio-economic factors rather than culture itself (Baskerville (2003)).

7. DISCUSSION

Stakeholder theory is widely discussed in both organizational and economics research. So far, stakeholders' influence on accounting practices, especially on earnings management, is a largely unexplored area. Earnings management is a profoundly ethical issue. It might induce transactions which would not have taken place if the true economic state of the company would have been known. But not only the firm may profit from earnings management. It is possible, and even likely,

that some stakeholders exert pressure onto the firm to manage earnings to improve the value of their explicit and implicit claims in the firm, at the expense of others.

Contemporary accounting textbooks still view financial reporting as a rather one-sided endeavor with clearly distinct preparers (i.e., managers) and recipients (i.e., stakeholders). As such, it is not surprising that earnings management research focuses on techniques, and contributing factors, how firms (respectively, their management) try to deceive capital providers. Further stakeholders are willfully, maybe for reasons of data availability, largely disregarded. This paper presents four generalizable approaches by which stakeholders might overcome this classic dichotomy. These approaches are taken from psychological (i.e., the behavioristic approach), management (i.e., the organizational sociology approach), economics (i.e., the catering theory approach), and sociological (i.e., the cultural approach) research. The list is by no means complete and leaves ample room for future contributions.

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