MANAGERIAL INCENTIVES FOR EARNINGS MANAGEMENT AMONG LISTED FIRMS IN EMERGING ECONOMIES, EVIDENCE FROM FIJI

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INTRODUCTION

The high profile corporate collapses of the past decade have greatly questioned the integrity of financial reporting. Earnings management has been of growing concern to many academics, practitioners and regulators. Despite an enormous amount of regulation and standards governing the financial reporting process, earnings management practices are accelerating at an alarming rate in organizations today. Fiji, like many other developed countries, has had instances of financial reporting failures in the past. One does not need to look further than the multi-million dollar saga involving the state owned Bank, the National Bank of Fiji, which was the largest known financial scandal in the history of Fiji and the Pacific Islands. This suggests that even emerging economies like Fiji have been introduced to earnings management practices long ago but was not that apparent. A large number of studies (DeAngelo, 1986; Cahan, 1992; Dechow, 2000; Beneish, 2001) have been conducted on managerial incentives for earnings management in USA, UK, Canada, Australia and New Zealand. While these were developed countries, very few studies have been conducted in emerging economies. Fiji's weak regulatory environment makes it subject to high level of earnings manipulation therefore it becomes important to study earnings management practices in Fiji. This study therefore will use a questionnaire-based approach to examine management policies that give rise to earnings management among listed firms in Fiji, highlighting the most prevalent incentive for earnings management.

These findings will provide FIA and other standard setters in emerging economies evidence on the most common driver for earnings management, which should assist them in formulating relevant financial reporting and corporate governance policies to ensure that management makes adequate disclosures. It should also assist users especially investors and financiers while reviewing annual reports to be cautious if the firm concerned displays characteristics that are aligned with the most prevalent incentive for earnings management.

METHODOLOGY

In order to obtain information about firm policies and practices that is not publicly available, we emailed questionnaires to CEO's of the listed companies. In some cases, where the CEO was unavailable we requested an interview with the company's CFO. The respondents completed the questionnaire in the presence of the researcher. Researchers were present in case the respondents needed clarification about any issues.

In the questionnaire, we had closed-ended questions, whereby the researcher provided a suitable list of responses. Closed questions provide little or no scope for the researcher to misinterpret the meanings of answers. For example, if an answer is restricted to "Yes / No / Don't Know" it is easy for the researcher to understand the exact intentions of the respondent. However, it also does not give an in-depth picture of

the question being researched, as it is possible that respondents had some other answers to the research questions. That is another reason researchers were present before the respondents so they could discuss and note any other important points being raised.

Our intended group of recipients for the questionnaire was the management team from each listed company. This is because we felt that a member of the management team would be the best person to answer the questionnaire as he/she has access to inside company information. Managers are in-charge of the day-to-day operations of the company and therefore possess more knowledge about their management policies and practices.

There are 16 companies listed on the South Pacific Stock Exchange. This was our initial sample for the study that was later reduced to 14. This was because one of the listed firms was a financial institution and consistent with prior studies financial institutions were excluded due to their unique working capital structures. Another listed company was unavailable for interview and failed to return our questionnaire despite several calls and emails.

RESULTS AND DISCUSSION

Agency theory provides a solid framework for understanding earnings management as it provides the agents with economic incentives to manipulate financial results. These incentives with research results are provided below.

Managerial Compensation Incentives

One of the most common incentives for managing earnings is the manager's remuneration package. In most businesses, managers are entitled to cash bonuses or share options upon achieving predetermined reported earnings. It is quite common for management employment contracts to include accounting based constraints that determine compensation opportunities, such as annual salary increases, bonus, performance evaluation, and reaching targets set in compensation contracts (Singh, 2008).

The results show that management compensation is the most common incentive for earnings management in listed companies in Fiji. In the entire sample of companies, members of the management team are entitled to other incentives apart from normal salary, for instance, bonuses, annual salary increments, share options etc. In 86% of listed firms, the Board of Directors and other senior executives set the management compensation plans, while in the other 14% of firms, it is the Human Resources Department. From the firms studied, 93% of them revealed that the performance evaluation criteria for rewards are stated in the management contracts. Profit and sales figures was the most common benchmark for rewards in the management compensation policies amongst all listed companies. Therefore, if management remuneration is based on entity profit or sales for the period, managers may manipulate firm's earnings so they can reach their sales/profit targets and get additional rewards.

Borrowing Cost Effects

The firm's closeness to violating its debt covenant provides its management with another incentive to engage in earnings management.

The results show that the debt financiers have imposed some form of debt covenant on 57% of the listed firm's loan agreements. Results disseminate that 43% of the listed firms did not have a loan agreement with anyone. None of the respondents admitted to violating any debt covenants.

Equity Offerings

Share issues provide a direct incentive for management to engage in earnings management as higher earnings would result in increased share prices implying an increase in market valuation and a reduction in cost of capital. We found that equity offerings are probably the least common incentive for earnings management in Fiji, probably, due to the highly inactive capital market in Fiji.

Management Buyout

In case of a management buyout, earnings are managed downwards. Usually, in such a situation, management faces a conflict as they have a fiduciary duty to the shareholders to get the best price for the firm and as buyers, managers would not want to pay a high price. Hence, managers have an incentive to reduce reported earnings prior to the buyout.

There has not been any instance of management buyout in any of the listed firms in Fiji. However, we cannot rule out the possibility that this can never be an incentive in the near future. Usually, management buyout is considered by government as one of the methods for privatizing state owned entities. An example of an attempt of management buyout in Fiji is the case of Rewa Rice Limited in 1999 when the government was planning to sell off its shares. However, the management's offer was declined.

Meeting Targets/Expectations

Financial analysts or management usually forecast firms' expected earnings prior to year-end. In Fiji, we do not have analysts who forecast or make predictions about firm performance. Therefore, our results solely focus on internal forecasts. In all the listed firms, Board of Directors, CEO's and managers set targets for various divisions in the company. Various factors such as past trends, non-financial measures, competition levels, demand for products/services and current economic conditions are all considered when setting company targets. "Economic conditions such as devaluation and political upheavals in Fiji in the past have led to non achievement of forecasts," commented one of the respondents. With the presence of unpredictable events such as these, managers may not be able to meet their targeted expectations and this may lead to managing earnings upwards.

One respondent also stated that if management does not meet their forecasted earnings, and they do not have a valid reason for this, their employment is at risk in the company. This means that to save their employment, the managers might have to engage in earnings management.

Reduce (Increase) Regulatory Cost (Benefits)

Regulatory concerns can also induce management to engage in earnings management. Usually firms that are vulnerable to anti-trust investigations or other adverse political consequences or firms seeking government subsidy have enormous incentives to manage earnings to appear less profitable.

A number of firms receive some form of assistance from the government such as grants or subsidies. One respondent stated that they receive concessionary rates of duty on capital investments. Another stated that they receive tax exemptions on local production of wood chips. One respondent stated that they had tax exemptions when they were listed in 2000, however now, this has expired and they no longer receive any assistance from the government. Our findings reveal that 79% of listed firms do not receive any form of assistance. This indicates that only a few listed firms would be inclined to report conservative earnings so that they can qualify for subsidies and other grants from government.

Therefore, after examining provisions in management policies and practices, we find that management compensation incentive, meeting firm targets/expectations, reduction in regulatory costs, increase in regulatory benefits and borrowing cost incentives are common drivers of earnings management in Fiji. Out of these, we find that management compensation is the most prevalent incentive for earnings management in Fiji. The least common ones are: equity offerings attributable to a highly inactive stock market; and management buyout.

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