

Does investor protection affect the choice of earnings management methods through real activity manipulation and accrual manipulation? Asian comparison

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Abstract: This paper examines systematic differences in earnings management through real activity manipulation and accrual manipulation across 7 Asia countries. The study proposes arguments that in economies with high investor protection, managers prefer to manage earnings through real activity manipulation rather than through accrual manipulation because accrual manipulation is more likely to draw auditors or regulators scrutiny than real decisions about pricing and production. The study findings are consistent with prediction. Despite being in economies with high investor protection, managers still have bigger discretion in managing earnings through real activities rather than accrual manipulation.

Key words: earnings management; real activity manipulation; investor protection

1. Introduction

The protection of investor rights, particularly outside investors, is important in creating economic incentives for the development of financial markets (Hart, 1995). More developed financial markets create greater external financing opportunities for firms because legal systems protect investors by conferring on them rights to discipline insiders (e.g., to replace managers), as well as by enforcing contracts designed to limit insiders' private control benefits (e.g., La Porta, et al., 1998; Nenova, 2000; Claessens, et al., 2002; Dyck & Zingales, 2002). Thus, legal systems protecting outside investors reduce insiders' need to conceal their activities.

This paper focuses on investor protection as a significant determinant of earnings management activity. Leuz, et al. (2003) argues that strong and well-enforced outsider rights limit insiders' acquisition of private control benefits, and consequently, mitigate insiders' incentives to manage accounting earnings because they have little to conceal from outsiders. This insight suggests that the pervasiveness of earnings management is increasing in private control benefits and decreasing in outside investor protection.

Prior research documents greater financial transparency in countries with stronger investor protection

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