View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Research Papers in Economics

Tijdschrift voor Economie en Management
Vol. XLVIII, 2, 2003

Earnings Management in Belgium: a Review of the Empirical Evidence

by H. VANDER BAUWHEDE and M. WILLEKENS

Heidi Vander Bauwhede
KULeuven, Departement Toegepaste Economische Wetenschappen, Leuven

Marleen Willekens
KULeuven, Departement Toegepaste Economische Wetenschappen, Leuven

ABSTRACT

Earnings are an extensively used summary statistic of a firm's financial performance. Various corporate reporting scandals (such as Enron and Lernout & Hauspie) have raised concerns regarding the credibility of this performance measure. This paper first discusses the empirical evidence on earnings management practices by Belgian companies. This review indicates that Belgian companies manage earnings to avoid declines in earnings or losses, to influence relations with external financiers and to reduce taxes. Belgian companies quoted on the Brussels Stock Exchange also report significantly less income-decreasing earnings management than their non-quoted counterparts, presumably to meet or beat market expectations. Belgian earnings management studies further report that larger boards and Big6 auditors may constrain the extent of income-*decreasing* earnings management.

I. INTRODUCTION

Earnings are considered an important summary statistic of a firm's financial performance and are often used in firm valuation and contracting (such as, for example in debt covenants and management compensation contracts). Accounting and reporting scandals such as Enron in the U.S. and Lernout & Hauspie in Belgium have fuelled a huge debate concerning the credibility of earnings numbers, and have triggered some proposals for change in the financial reporting process (for example, the new Corporate Governance Law of August 2, 2002 in Belgium and the Sarbanes-Oxley Act in the U.S.). The question of how and why management *opportunistically* manages (or manipulates) earnings[1] and how this can be constrained is on top of many agendas. Extensive research has been done on earnings management incentives and constraints in Anglo-Saxon settings. Similar research in non-Anglo-Saxon environments is rather scarce.

In this paper we provide an overview of the evidence on earnings management practices in Belgium. In Section II we provide a discussion on some major elements that affect the financial reporting process in Belgium. We then describe various types of earnings management techniques in Section III, together with evidence on techniques that are used in Belgium. Section IV presents evidence on the incentives for earnings management by Belgian companies, and Section V reviews the evidence on constraints on earnings management in Belgium. In Section VI we compare the Belgian evidence with evidence from Anglo-Saxon countries. We conclude with a summary in Section 7.

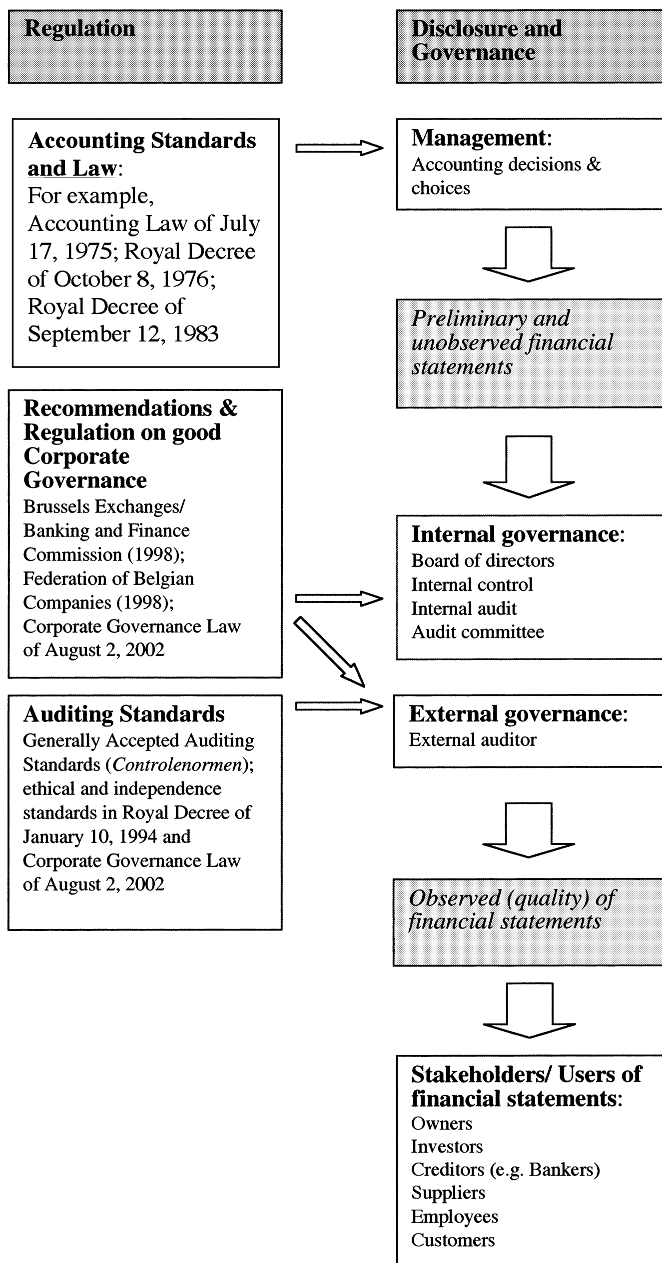
II. ELEMENTS AFFECTING THE FINANCIAL REPORTING PROCESS IN BELGIUM

Figure 1 provides an overview of some important elements of the financial reporting process that affect a company's accounting decisions and hence the quality of its financial statements.

"Management"[2] prepares an initial (unobserved) set of financial statements[3] and – in this context – makes accounting decisions and choices. These are obviously influenced by the Belgian accounting standards and company law. Belgian company law prescribes that financial statements are to be prepared in accordance with Belgian GAAP (Generally Accepted Accounting Principles), and the latter can be found in the

FIGURE 1

Important factors influencing financial reporting and its quality



Belgian accounting law (i.e. the Accounting Law of July 17, 1975 and Royal Decrees of October 8, 1976, and September 12, 1983).

The preliminary financial statements – as prepared by management – are then reviewed and approved by the board of directors and audited by an external auditor. Therefore the presence and quality of the board of directors and the external auditor is likely to affect management's accounting decisions. In particular, these two governance mechanisms are intended to work as constraints on opportunistic accounting decisions, as management will anticipate corrections if some accounting choices are deemed unacceptable or in conflict with GAAP.

The quality of a company's board of directors is likely to be affected by corporate governance regulations and recommendations. In Belgium, the role of boards in the corporate reporting process has been stressed in the late nineties with the issuance of recommendations for good corporate governance by the Brussels Exchanges (i.e. Brusselse Beurs), Banking and Finance Commission (i.e. De Commissie voor het Bank en Financiewezen – CBF) and the Federation of Belgian Companies (Verbond van Belgische Ondernemingen – VBO) and, even more recently, with the law on Corporate Governance of August 2, 2002. Belgian corporate governance reports include, amongst others, recommendations regarding the size and the composition of the boards and the establishment of various committees, such as an audit committee which overviews the financial reporting process. The Brussels Exchanges recommend, for example, that boards should not exceed 12 members and that the majority of the board members be non-executive directors. The rationale for limiting board size is that the effectiveness of boards reduces due to communication problems. The presence of non-executives is expected to be beneficial because they are able to give a more objective and independent opinion.

Belgian company law also prescribes that a member of the Belgian Institute of Auditors (het Instituut der Bedrijfsrevisoren – IBR) performs the external audit and provides an independent *opinion* on the fairness of the financial statements. This opinion (audit report) is added to the financial statements and made publicly available in order to inform users about the credibility of the financial statements. Before issuing an opinion, external auditors run a whole battery of tests to determine whether there is *reasonable assurance* that the financial statements are free of *material* errors and irregularities. The audit activities should be performed according to the Generally Accepted

Auditing Standards (GAAS or *Controlenormen*) issued by the Belgian Institute of Auditors, and be consistent with the ethical and independence standards prescribed in the Royal Decree of January 10, 1994 and the Corporate Governance Law of August 2, 2002.

Finally, the audited financial statements (*and* the audit report) are released to the general public which will use this information for decision making purposes. The presence and/or importance of certain stakeholder groups may therefore also affect management's accounting decisions, and may work as incentives or constraints on earnings management. For example, if a firm is planning a business expansion and therefore needs additional financing it may either be more conservative in the use of accounting flexibilities because capital providers will scrutinize the financial statements. On the other hand management may have an incentive to use accounting flexibilities to increase earnings and to impress future capital providers.

III. HOW DO BELGIAN FIRMS MANAGE EARNINGS?

There exist many techniques to influence the earnings number, but most of them can be reduced to three major types (see also Table 1). A first category consists of techniques based on exploiting the flexibility allowed by the accounting principles (GAAP). This is called "within-GAAP earnings management" in the accounting literature. Examples of flexibilities in the accounting principles include the choice between various inventory valuation and depreciation techniques, decisions whether to record certain provisions *and* at what amount, and the like. Note that GAAP allows for this kind of flexibility in order to give firms the opportunity to prepare financial statements that reflect economic reality as closely as possible. However, firms can be tempted to abuse this flexibility to manage earnings. A second category of earnings management techniques are clearly violating GAAP and are called therefore "without-GAAP earnings management". This category involves mere management fraud and typically occurs in firms that have completely exploited the flexibility inherent in the accounting principles to manage earnings. Early recognition of revenue is a typical example. Note that it is not always straightforward to distinguish between so-called "within-GAAP" (i.e. exploiting the flexibility within GAAP) and "without GAAP" earnings management or fraud (i.e. violating GAAP). Finally, a third

category of earnings management occurs more subtle through real transactions that influence the earnings number. Examples include earlier than necessary spending on maintenance or R&D when earnings are higher than expected such that the earnings number can be reduced; and the sale of assets below (above) book value such that earnings can be reduced (inflated).

TABLE 1
An overview of earnings management methods

Earnings management type	Specific method	Example
Accounting decisions: Within-GAAP EM	Exploiting the available flexibility within GAAP, Examples: ➢ Choice and changes in accounting principles	➢ LIFO Vs FIFO inventory valuation ➢ Accelerated Vs Straight Line depreciation ➢ Change in useful life of asset
	➢ Accruals estimation: Judgement in timing of the recording of and in the value of some accruals	➢ Recording / taking back provisions
Accounting decisions: Without-GAAP EM	Not applying / violating GAAP	➢ Early recognition of revenue (for example, before goods are shipped)
Real transactions	Managing earnings by managing real transactions	➢ Timing of: ➢ Asset disposals (investment decision) ➢ R&D expenses (operating decision) ➢ Maintenance expenses (operating decision) ➢ Manage purchases if report inventory under LIFO

Belgian studies on earnings management have focused on earnings management through: 1) discretionary choices regarding inventory valuation (Branson and De Rijcke (1999), 2) reporting of extraordinary items (Branson and Loits (1997), 3) depreciation and working capital accruals[4] (see Sercu, Vander Bauwhede and Willekens (2002); Vander Bauwhede and Willekens (2002); Konings, Labro and Roodhooft (1998)), and 4) the complete set of accruals (Vander Bauwhede, Willekens and Gaeremynck (2003)). Note that none of these studies attempts to distinguish between within-GAAP and without-GAAP earnings management. This is not surprising, as the border between these two types of earnings management is often not clear for external observers. Table 2 provides a summary of the Belgian findings as to earnings management opportunities, incentives and constraints together with a description of the sample and the earnings management instruments that are investigated.

A. *Earnings management through inventory valuation*

Inventory valuation offers tremendous potential for earnings management. Firms may influence reported earnings by effectively managing inventory levels (the number of units in inventory) or by changing inventory valuation methods (FIFO, LIFO or weighted average). Changing from FIFO to LIFO in periods of increasing prices, for example, reduces earnings because the products that were sold most recently (and are valued at higher prices) will appear in the "cost of goods sold" entry of the income statement. The oldest (and cheapest goods) will appear on the balance sheet under "inventory". Also, if firms value inventory according to LIFO in a period of increasing prices, and want to *increase* earnings, they may decide to use *or* sell out their entire inventory – and not purchase any new materials or goods – so that the value of the "costs of goods sold" remains low. Still other methods to manage inventory are, for example, recording non-existing inventory, using inappropriate prices for valuation, not (or not correctly) applying the-lower-of-cost-or-market principle, *or* exploiting the principle of inventory write-downs. Inventory should be valued at historical cost. However, if the market price is *lower* than the historical cost price, firms should adopt the lower of the two (i.e. the lower-of-cost-or-market principle) which reduces income. The market price is however not entirely objective, so that firms have some room to fill this in according to their own wishes. Likewise, firms that have any obsolete

TABLE 2

Overview of Belgian studies on earnings management

Study	Sample	Instruments to manage earnings	Major findings
Branson and Loits 1997	A sample of 517 large Belgian companies Years: 1993-1994 Individual financial statements	Extraordinary items	• Firms use extraordinary items to avoid declines in net income
Branson and De Rijcke 1999	A sample of large and a sample of small and medium sized Belgian firms Year: 1995 Individual financial statements	Inventory valuation: changes in level of inventory and write-downs on inventory	• Firms use flexibility available in inventory valuation (changes in the level of inventory and write-downs) to avoid to increase (decrease) earnings when operating profit (exclusive of changes in inventory or write-downs) decrease (increase) or are negative (positive).
Sercu,Vander Bauwhede and Willekens 2002	Sample of 1302 large firms Years: 1994-1996 Individual financial statements	Unexpected (abnormal) depreciation and working capital accruals	• Less income-decreasing EM by firms: – Which rely more on bank debt and trade credit; – In years before firms raise additional financing on capital markets; • Firms reduce income for tax reasons • No difference in level of EM of firms with Big6 and non-Big6 auditors

Vander Bauwhede, Willekens and Gaeremynck 2003	Sample of 31 listed companies matched on size and industry with a sample of 31 privately held companies Years: 1991-1997 Consolidated financial statements	Unexpected (abnormal) accruals (also including provisions, write-offs and write-downs and the like)	• Firms smooth income; • Listed firms increase income more than unlisted firms if (pre-managed) earnings decline; • Some evidence that clients of Big6 auditors decrease earnings less than clients of non-Big6 auditors
Konings, Labro and Roodhooft 1998	Sample of 193 firms with trade union activity matched on industry, number of employees and turnover with a sample of 193 without trade union activity	Unexpected (abnormal) depreciation and working capital accruals	• No evidence of lower reported earnings in Belgian firms with fierce trade union activity relative to firms without trade union activity

or damaged inventory should record a write-down on inventory, which affects current year earnings in a negative way. If, in later years, this write-down seems too exaggerated, the firm may (partly) reverse the write-down. Since the determination of obsolete or damaged inventory depends largely on judgement of the firm and its accountants, firms may also exploit this principle to manage earnings in the direction that is most beneficial to them.

Some of the above-mentioned approaches, such as change of inventory valuation method[5], seem rather innocent and can be classified as "within GAAP" earnings management. Others, such as recording non-existing inventory, can be classified as mere fraud ("without-GAAP" earnings management). Still other methods, such as management of inventory levels, are not the result of accounting decisions but of real transactions. Branson and De Rijcke (1999) examined whether Belgian companies exploit opportunities inherent in inventory valuation to manage earnings and find evidence supporting the use of such practices in Belgium.

B. *Earning management through extraordinary items*

Under Belgian Accounting Law, losses on assets disposals, write-offs on financial assets, and provisions for extraordinary risks and costs are to be reported as *extraordinary* items. However, management has a lot of reporting discretion regarding these items, both in terms of "timing" as well as "valuation". Firms may, for example, decide to sell some of their assets – below book value – in good years, in order to reduce income by recording a loss on asset disposals. Likewise, firms may strategically record provisions in good years – as this reduces net income – and decide to use them or take them back in bad years, in order to increase income. Branson and Loits (1997) examined whether Belgian firms exploit these possibilities to manage earnings and find evidence consistent with the use of extraordinary items to avoid large declines or increases in net income.

C. *Earnings management through accruals*

Inventory-related accruals (for example, write-downs on inventory) and extraordinary items are only some of the accruals that firms may use to manage earnings. Other possibilities include: depreciation accruals and working capital accruals (other than inventory-related accruals). Examples of the latter are: write-downs for bad debt and provisions for future risks and costs (note that these are reported as operating income items

in Belgium). Management of depreciation accruals is possible, through, for example, choice and changes in depreciation methods. Accelerated depreciation will result – at least in the first years of depreciation – in smaller earnings than straight-line depreciation. Firms that want to charge earnings as little as possible may also opt to extend the years of useful life of the asset or decide to put a high residual value on the asset.

Sercu, Vander Bauwhede and Willekens (2002) and Vander Bauwhede and Willekens (2002) focused on earnings management through "unexpected" depreciation and working capital accruals[6], while Vander Bauwhede, Willekens and Gaeremynck (2003) extend this approach by also including provisions and accruals related to extraordinary items. The advantage of using unexpected *accruals* as a measure of earnings management is that they simultaneously capture the effect of manipulations in *all* kinds of accruals and even of some real transactions (such as for example loss on asset disposals). The drawback is however that they offer no clear idea of what individual accruals are used mostly as instruments for earnings management. Sercu, Vander Bauwhede and Willekens (2002) provide evidence of the use of accruals for earnings management purposes by a representative sample of *non-listed Belgian firms of all sizes*. They report that the absolute value of the unexpected portion of the accruals is about five percent of total assets. Vander Bauwhede, Willekens and Gaeremynck (2003) examine a matched sample of the *largest listed and non-listed* Belgian firms. They report that the unexpected portion of the accruals for the entire sample is about ten percent of total assets. They also report a difference between listed and non-listed large firms as to the average level of unexpected accruals: for listed firms the unexpected portion of the accruals is 7.8 percent, whereas 12.2 percent for non-listed large firms.

IV. WHY DO BELGIAN FIRMS MANAGE EARNINGS?

Opportunity alone is not sufficient for earnings management to take place, motive is also needed. In this section we provide an overview of the Belgian evidence on earnings management incentives.

A. *To smooth income*

As decision making by various stakeholders is likely to be influenced by the firm's economic performance, firms – both listed and non-listed

– have strong incentives to avoid earnings declines or losses, as these are negative signals about performance. Similarly, firms have incentives to reduce income in extremely good years (in years with large profits and earnings increases) to create opportunities ("cookie-jar reserves") to increase income in bad years. The evidence presented in Branson and Loits (1997), Branson and De Rijcke (1999) and Vander Bauwhede, Willekens and Gaeremynck (2003) is all consistent with the income smoothing hypothesis as an incentive for earnings management in Belgian firms[7].

Branson and Loits (1997) examined for a sample of 517 large Belgian listed and non-listed companies whether there is an association between a *decline* in operating income *or* a *negative* operating income figure and the presence of *positive* extraordinary items in the income statement. Similarly they investigate the association between *increases* in or *positive* operating income and the presence of *negative* extraordinary items in the income statement. They find as expected that large Belgian firms use their discretion over extraordinary items to avoid *declines* (but not losses) in operating income. In addition, they report that firms prefer to manage earnings through extraordinary items that do not result from real transactions. That is, they prefer managing earnings through, for example, provisions for exceptional risks and costs over earnings management through recording losses from asset disposals.

Branson and De Rijcke (1999) studied a sample of 419 large and of 450 small and medium-sized Belgian firms from 9 industries where inventory is an important item. They hypothesize that firms report declines (increases) in inventory *levels* when gross margins (exclusive of "changes in inventory") increased (decreased) *or* are positive (negative). Similarly, they hypothesize that firms record inventory *write-downs* (take write-downs back) when they report increases (decreases) in *or* positive (negative) gross margins (exclusive of write-downs). The evidence is consistent with these hypotheses. Further, Branson and De Rijcke (1999) also report that the avoidance of *losses* (but not earnings declines) is especially pronounced among small and medium sized firms. Note that these firms are not subject to mandatory external auditing.

Vander Bauwhede, Willekens and Gaeremynck (2003) test the income smoothing hypothesis for a sample of 31 listed Belgian companies, matched on size and industry with an equally large sample of non-listed companies, and find strong evidence that firms *increase*

earnings in *bad* years and decrease earnings in good years. More specifically, they report that the sign of the unexpected accruals are significantly associated with the level of pre-managed earnings. That is, when pre-managed earnings are smaller than last year's earnings the unexpected accruals are positive and vice versa.

B. *To influence relations with some but not all stakeholders*

Sercu, Vander Bauwhede and Willekens (2002) examine for a large sample of *privately held* Belgian companies (1302 firm-year observations) whether the strength of a firms' relationships with various stakeholder groups is associated with income-increasing or income-decreasing behaviour[8]. The stakeholder groups that were examined are creditors, suppliers and employees. They find that the level of bank debt and trade credit, as well as an increase in external financing are significantly associated with earnings management behaviour by privately held firms. More specifically, they report that firms that rely more on bank debt and trade credit are characterized by less income-decreasing earnings management. The level of income-decreasing earnings management is also lower in years before firms raise additional debt financing. This is consistent with the argument that firms which are more dependent on external financing have more incentives to report good financial performance than firms that are less dependent on external financing. Sercu, Vander Bauwhede and Willekens (2002) do not find that a firm's relationship with its employees has an impact on earnings management. Note that the latter finding is consistent with Konings, Labro and Roodhooft (1998). This study investigates whether trade union activity affects earnings management, based on a matched sample (by industry and size) of 193 firms with trade union activity and 193 firms without such activity. No evidence is found of a relationship between unexpected accruals and trade union activity.

C. *To minimize taxes*

Sercu, Vander Bauwhede and Willekens (2002) also examine whether taxes play a role in the context of earnings management. In particular, they investigate whether tax motivations affect income-increasing and income-decreasing behaviour of their sample of large privately held Belgian companies. They find that tax paying firms (in particular, firms with no tax-loss carry-forwards) reduce earnings significantly

more than firms that do not pay taxes (in particular, firms with tax-loss carry-forwards). This finding is consistent with firms managing earnings downwards for tax reasons.

D. *To meet or beat stock market expectations*

The environments in which listed and non-listed firms operate are different. Financial statements of listed firms are also scrutinized by financial analysts and investors, and firms may suffer from stock price declines if they do not meet market expectations. Listed firms may not only have incentives to avoid earnings declines and losses, they also have incentives to meet or beat market expectations in order to prevent declines in stock price. Vander Bauwhede, Willekens and Gaeremynck (2003) examine whether there are differences in earnings management behaviour between listed and non-listed firms of comparable size, and hypothesize that listed firms have (even) more incentives to increase earnings than privately held firms (of comparable size). They do not find evidence supporting this hypothesis for the sub-sample of firms that have positive income smoothing incentives. These are firms that have pre-managed earnings below last year's earnings figure. However, consistent with their hypothesis, they do find that listed firms manage earnings less downwards than non-listed firms in the sub-sample of firms that have negative income smoothing incentives, that is firms that have pre-managed earnings above prior years' earnings.

V. WHAT IS CONSTRAINING THE EXTENT OF EARNINGS MANAGEMENT BY BELGIAN COMPANIES?

In Section II (and Figure 1) we discussed that the initial accounts prepared by management are screened by a number of controls before they are released to the public. Two important screening mechanisms are the boards of directors and the external audit.

A. *Boards*

Although corporate reporting scandals often suggest otherwise, it is the board of directors, and NOT the firm's external auditor, that bears first responsibility for the fairness of the financial statements[9]. In Belgium, the role of boards in the corporate reporting process has been stressed

since the late nineties with the issuance of recommendations for good corporate governance by the Brussels Exchanges (i.e. Brusselse Beurs), Banking and Finance Commission (i.e. De Commissie voor het Bank en Financiewezen – CBF) and the Federation of Belgian Companies (Verbond van Belgische Ondernemingen – VBO) and, even more recently, with the new law on Corporate Governance of August 2, 2002. However, evidence on the impact of board characteristics on earnings management in Belgium is scarce since information on board characteristics is not publicly available.

Sercu, Vander Bauwhede and Willekens (2002) provide evidence on the role of board *size* on earnings management, and found that the level of income-decreasing earnings management decreases in board size. This suggests that larger boards may restrict earnings management, and more specifically income-*decreasing* earnings management. This finding appears to contrast with concerns voiced by the Belgian Commission on Corporate Governance regarding board size. However, the sample in the study only included non-listed firms and the mean (median) number of directors in the sample was rather small, namely 3.89 (3). This is much lower than the cut-off of 12 set forth in the corporate governance recommendations of the Brussels Exchanges. With such small boards it is unlikely that an additional board member would cause communication problems, but boards may rather benefit from an additional member in terms of the expertise brought in. An alternative explanation for the finding might also be that, as boards grow larger, board members can no longer agree on an earnings management (accounting) policy which satisfies all of them.

B. *External Auditors*

External auditors only have secondary responsibility for the fairness of the financial statements, but they play an important role in providing high quality information to "the general public". Since *all* large Belgian companies are required to have their financial statements audited, it is almost impossible to investigate the *direct* effect of an external audit on the level of earnings management. However, prior studies investigated the audit effect *indirectly* by examining whether earnings management differences can be detected *between* firms audited by a large or a small auditor. Inspired by DeAngelo's (1981) theoretical arguments that the level of audit quality is positively

related to audit firm size, various studies have tested whether the level of earnings management is smaller for firms which are audited by larger auditors as compared to smaller auditors. There is however little evidence on the existence of quality differences between auditors of different sizes in Belgium, in the sense that different levels of earnings management would be observed in client firms. Sercu, Vander Bauwhede and Willekens. (2003) and Vander Bauwhede and Willekens (2002) do NOT find that audit firm size is related to the level of earnings management by privately held Belgian companies in their *individual* accounts. Vander Bauwhede, Willekens and Gaeremynck (2003) find some evidence that large (Big6 at the time) auditors restrain the level of income-*decreasing* earnings management in *consolidated* accounts of a sample of listed and large non-listed companies. They do however NOT find such evidence for income-increasing earnings management strategies. One explanation for these findings is as follows. Both smaller and larger auditors deliver the same level of audit quality in case consolidated earnings are overstated and potentially negative consequences for stakeholders are huge. However, when the potential negative impact of material misstatements on stakeholders is smaller, that is when firms are using income-decreasing strategies, smaller auditors become less stringent in restraining earnings management while larger auditors continue to be stringent.

VI. EVIDENCE ON EARNINGS MANAGEMENT IN BELGIUM VERSUS ANGLO-SAXON ENVIRONMENTS

The results of empirical earnings management studies based on Belgian company data differ to some extent from the results of Anglo-Saxon, mainly American, studies. A first important difference is that American studies mainly examined earnings management behaviour in listed companies. This has at least two reasons: stock markets are better developed in the U.S. and financial statement data are not publicly available for non-listed companies. Belgian earnings management research has, by contrast, focused mainly on samples of privately held companies. Two reasons, again, are that non-listed companies comprise the majority of Belgian companies, and individual financial statements are publicly available for Belgian non-listed companies. A second difference with Anglo-American research, which

follows directly from the Belgian focus on non-listed companies, is that incentives of and constraints on earnings management are studied in relation to corporate stakeholders. In American studies earnings management incentives are often studied in relation to stock markets (and hence shareholders) or from a contracting perspective (such as management compensation and debt contracts). A third remarkable difference between Anglo-Saxon and Belgian research is that there is hardly evidence of quality differences between large and small auditors in Belgian studies, while both Becker et al. (1998) and Francis et al. (1999) report clear evidence of differences in the level of earnings management of firms audited by Big6 versus non-Big6 auditors in the U.S..

However, there are also similarities between Anglo-Saxon and Belgian research findings. The evidence is similar regarding income smoothing (see for example Young 1998 for the U.K.), avoidance of earnings declines and losses (see Burgstahler and Dichev (1997) and Degeorge et al. (1999) for the U.S.), and income-increasing effects of stock-market participation (see Penno and Simon (1986) and Cloyd et al. (1996) for the U.S.).

VII. SUMMARY

In this paper we provide a discussion of the empirical evidence on earnings management in Belgian companies. Thus, this paper only includes what has been investigated and reported in research studies and does not cover all existing earnings management practices in Belgium. The evidence indicates that Belgian companies manage earnings through inventory valuation, extraordinary items and other accruals. Earnings management incentives in Belgium include: income smoothing and avoidance of earnings declines and/ or losses, influencing relations with stakeholders such as creditors and suppliers, obtaining additional external financing, reducing taxes, and to meet stock market expectations (for listed firms). As to earnings management constraints in Belgium, there is some evidence that firms with larger boards and that hire a Big6 auditor report less income-decreasing earnings management. Note that the latter evidence is only found for a sample of very large (listed and non-listed) companies, but not for a broad sample of non-listed, smaller firms. Also, the impact of a Big6 auditor does not seem to work in case firms manage earnings upwards.

NOTES

1. That is, manages the earnings statistic to its own benefit while impairing the interests of other stakeholders such as, for example, employees, investors, creditors and tax authorities.
2. Note that in Belgium the board of directors has the responsibility to "prepare" financial statements (and an activity report to shareholders). Although boards have the final responsibility for the companies' activities *and* financial statements, they may delegate the actual decision making to a management committee. A two-tier structure with on the one hand a management committee, and on the other hand a board of directors is allowed but not mandatory in Belgium. However, it is reasonable to state that the "executives" – here called "management" – and not the board as such prepares an initial set of financial statements, that then goes for approval to the board.
3. Firms are obliged to prepare and publish financial statements in case of limited liability of the owners. The amount of detail in the financial information provided depends on the size of the firm. If the firms meet two of the following criteria, total assets >3125000 Euro, turnover > 6250000 Euro and the number of employees > 50, it qualifies as a "large" firm and then the full version of the financial statements is to be submitted. Companies appointing more than 100 employees always classify as "large" firms.
4. Accruals are the difference between earnings and cash flows. These include depreciation and amortization, changes in non-cash working capital, provisions, write-offs and write-downs. Some of these accruals are, according to the Belgian income statement, reported as operating items (e.g. normal depreciation on tangible fixed assets), others are reported as extraordinary items (e.g. write-offs on financial assets, extraordinary write-offs and depreciation on intangible and tangible fixed assets, provisions for exceptional risks and costs). Studies that examine the complete set of accruals thus overlap in a certain sense with studies which restrict themselves to the examination of one specific set of accruals, such as, for example, extraordinary items.
5. The Accounting Law allows motivated changes in inventory valuation methods. The existence of these changes have to be mentioned and motivated in the footnotes to the financial statements, together with the estimated impact of these changes on the capital, financial position and results of operations of the company (see article 16 of the Royal Decree of October 8, 1976 as changed by the Royal Decree of September 12, 1983).
6. Unexpected or discretionary accruals are that portion of a firm's accruals that cannot be explained by the firm's normal operating activities. Unexpected accruals have been measured through various models in the accounting literature (see, for example, Jones 1991, DeAngelo 1986 and 1994).
7. Sercu, Vander Bauwhede and Willekens (2002) do not explicitly test the income smoothing hypothesis, but run different tests for firms with income-increasing and income-decreasing earnings management. The evidence presented in their study is implicitly consistent with the income smoothing hypothesis.
8. As income smoothing is apparent in Belgian firms, Sercu, Vander Bauwhede and Willekens (2002) make a distinction between income-increasing and income-decreasing earnings management and run their tests accordingly on two subsamples.
9. At least, this is a very popular idea in Anglo-Saxon countries, especially the U.S.. Since business failures often trigger corporate reporting scandals, the firm itself will not be able to pay damage awards to investors which take the firm (or its management) to court. Investors then try to sue the firm's auditors – who are believed to have "deep pockets" – in attempt to recover part of their losses.

REFERENCES

Arens, A.A. and J.K. Loebbecke, 1994, Auditing: an Integrated Approach. (Prentice-Hall Inc., Englewood Cliffs, New Jersey), Sixth Edition.

Becker, C., DeFond M.L., Jiambalvo J. and K.R. Subramanyam, 1998, The Effect of Audit Quality on Earnings Management, *Contemporary Accounting Research* 15: 1-24.

Branson, Joël and Christophe De Rijcke, 1999, Jaarrekeningbeleid door Belgische ondernemingen: het gebruik van voorraadbewegingen, *Accountancy and Bedrijfskunde Kwartaalschrift* 24, 1, 3-21.

Branson, Joël and Gunther Loits, 1997, Resultaatmanipulatie in België: het gebruik van uitzonderlijke opbrengsten en kosten, *Accountancy and Bedrijfskunde Kwartaalschrift* 22, 1, 3-31.

Brussels Exchanges/ Banking and Finance Commission, 1998, Corporate Governance for Belgian Listed Companies. December. 16 pp.

Burgstahler, D. and I. Dichev, 1997, Earnings Management to Avoid Earnings Decreases and Losses, *Journal of Accounting and Economics* 24, 99-126.

Cloyd, B.C., Pratt J. and T. Stock, 1996, The Use of Financial Accounting Choice in to Support Aggressive Tax Positions: Public and Private Firms? *Journal of Accounting Research* 34, 23-43.

DeAngelo, L. E., 1981, Auditor Size and Audit Quality, *Journal of Accounting and Economics* 3, 113-127.

DeAngelo, L. E., 1986, Accounting Numbers as Market Valuation Substitutes: a Study of Management Buyouts of Public Stockholders, *The Accounting Review* 61, 400-420.

DeAngelo, L. E., 1994, Accounting Choice in Troubled Companies, *Journal of Accounting and Economics* 17, 113-143.

Degeorge, F., Patel, J. and R. Zeckhauser, 1999, Earnings Management to Exceed Thresholds, *Journal of Business* 72, 1-33.

Federation of Belgian Companies (VBO/ FEB), 1998, Corporate Governance. Recommendations of the Federation of Belgian Companies (VBO/ FEB). 12 pp.

Francis, J., Maydew E.L. and H.C. Sparks, 1999, The Role of Big6 Auditors in the Credible Reporting of Accruals, *Auditing: a Journal of Practice and Theory* 18, 663-682.

Instituut der Bedrijfsrevisoren (IBR), 1999, Plichtenleer en controlenormen. (Kluwer/CED Samson and IBR, 7th edition).

Jones, J., 1991, Earnings Management During Import Relief Investigations, *Journal of Accounting Research* 29, 193-228.

Konings, J., Labro E. and F. Roodhooft, 1998, Earnings Management and Trade Union Activity: Results for Belgium, Research Report no. 9828, KULeuven.

Law on Corporate Governance, *Belgisch Staatsblad*, August 2, 2002.

Penno, M. and D.T. Simon, 1986, Accounting Choices: Public Vs Private Firms, *Journal of BusinessFfinance and Accounting* 13, 561-569.

Sercu P., Vander Bauwhede H. and M. Willekens, 2002, Earnings Quality and the Role of Stakeholder Monitoring and Governance Mechanisms in Privately Held Firms, Research report no. 0235, KULeuven.

Vander Bauwhede H. and M. Willekens, 2002, Is There Audit Quality Differentiation in the Private Client Segment of the Audit Market?, Research report no. 0240, KULeuven.

Vander Bauwhede, H, M. Willekens and A. Gaeremynck, 2003, Audit Quality, Public Ownership and Firm's Discretionary Accruals Management, Forthcoming in *The International Journal of Accounting* 38, 8, 1-22.

Young, S., 1998, The Determinants of Managerial Accounting Policy Choice: Further Evidence for the U.K., *Accounting and Business Research* 28, 131-143.