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Earnings Management in Public and Private Companies – Evidence from Finland

This paper studies earnings management in public and private companies and in particular whether earnings management is a function of a company's leverage. Public and private firms differ in two respects that potentially have implications for their financial reporting. First, the lower concentration of ownership in public firms and the lower managerial ownership implies that accounting has a more important role in performance evaluation. The possible effect of this is that managers of public companies are more likely to manage earnings in order to either maximize accounting-based bonuses or avoid reporting a poor profit that would result in dismissal of the manager. A second consequence of the more diffuse ownership in public firms is that accounting has a more important role in communicating with current and prospective shareholders. Based on the differences, a number of papers have studied whether earnings quality differ between private and public companies. However, the results in these prior studies are mixed.

In order to redress this apparent ambiguity, this paper studies differences in accounting between 99 public and 99 private Finnish companies during the period 1997 – 2001. As earnings management is difficult to measure, several different approaches are used in the paper to identify earnings management. Firstly, following prior studies, a number of "aggregate measures" aimed to capture a large range of different earnings management activities are used. Secondly, a number of specific accruals are studied, namely, depreciation policy, the amortization of goodwill, and the recognition of impairment losses. Thirdly, whether companies use the timing of asset sales and other gains reported as a non-operating income or an extraordinary item as a way to manage earnings is explored.

The advantage of using an "aggregate measure" is that the examination of only one accounting choice at a time may obscure the overall effect of earnings management. However, an advantage of the study of specific accounting choices and real transactions is that it improves the possibilities to separate earnings management stemming from the use of judgment in reporting from earnings management via real transactions. High quality accounting standards and auditing can reduce earnings management stemming from accounting choices but not earnings management stemming from real transactions. Thus, compared to prior studies, more fine-tuned measures to identify earnings management are used in this paper in order to identify reporting differences between private and public companies.

A main finding is that there are no significant differences in the tendency to manage earnings between public and private companies in Finland. This finding contrasts with previous evidence from the U.K, U.S. and other Europeans countries, where, for example, Ball and Shivakumar (2005) and Burgstahler et al. (2005) found that the quality of earnings is higher in public companies than in private ones, and Beatty and Harris (1999) and Beatty et al. (2002), who studied U.S. companies, found that public companies are more likely to manage their earnings than private companies. A further main result in this paper is that that leveraged companies are more likely to manage their earnings upwards. This corresponds with prior studies (e.g., Sundgren and Johansson, 2004; Holthausen and Leftwich, 1983). A final contribution is that it is shown that the impact of leverage on accounting choices is approximately similar for public and private companies. ■