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Company Size, Auditor Type, and Earnings Management

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This paper investigates whether or not earnings management is related to the level of information asymmetry between managers and market participants for firms that are suspected of avoiding losses. Company size is used as a proxy for information asymmetry in the predisclosure information environments, as managers of small companies are able to retain their private information more successfully than are their counterparts of large companies. Prior research (Becker et al. 1998) provides evidence that earnings management is related to auditor type. Since company size and auditor type are positively related with each other, we also examine whether or not auditor type is still a determinant in explaining the cross-sectional variation of earnings management when company size is controlled. Our findings show that small companies tend to more frequently manage earnings to avoid losses than do large companies. We find mixed results regarding the relation between earnings management and auditor type. When company size is controlled, however, auditor type becomes insignificant in explaining the cross-sectional variation of earnings management to avoid losses. The inverse relation between company size and earnings management remains significant after auditor type is controlled. Thus, company size, not auditor type, appears to play a primary role in discriminating between companies that do and do not manage earnings to avoid losses.

INTRODUCTION

Prior studies have examined earnings management by focusing on two major categories: incentives for managers and the quality of monitoring functions. The studies assume that earnings are managed to achieve personal or operational goals of managers. Earnings management, however, is constrained by a variety of monitoring functions that are built-in to deter managers from arbitrarily including or excluding relevant financial figures in computing earnings (e.g., auditing and internal control). In addition, earnings management is negatively associated with a probability of manipulation being observed and potential fines, and is feasible in the presence of information asymmetry between managers and market participants. Thus, the predisclosure information environment should be another factor that explains a variation in earnings management from company to company.