

Chapter 4

Earnings Management and Stock Liquidity: Evidence From Turkey

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ABSTRACT

This chapter tests whether the earnings management practices in Turkey are considered informative or opportunistic by outside investors by examining its effect on stock liquidity. Earnings management is measured by discretionary accruals calculated by two different competing methods. Stock liquidity is also proxied by two different measures: the illiquidity measure of Amihud and the turnover ratio. Amihud's illiquidity measure indicates firms' daily price responses associated with the trading volume and the turnover ratio indicates how many times a stock changes its owner in a year. Relevant control variables are also included in the models. A positive association between earnings management and stock liquidity implies informative earnings management and vice versa. Earnings management is found to be positively associated with stock market liquidity. Results favor the informative earnings management view for Turkish firms and are robust to alternative specifications of earnings management and stock liquidity measures.

1. INTRODUCTION

Earnings management can be defined as the managers' purposeful interventions to mislead some stakeholders about the firm's true performance (Schipper, 1989; Healy and Wahlen, 1999). The fact that this "true performance" does not always necessarily mean "a bad performance" is the central intuition behind this study.

Earnings management is a heavily researched phenomenon, and a lot is known about the adverse effects of earnings management. The characteristic feature of definitions of earnings management is that they draw attention to its adverse effects. The vast majority of the previous literature has indeed

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provided abundant evidence on these adverse effects. The concise bottom-line of the literature is that earnings management is not favored due to its misleading nature. However, in this chapter, whether there might be some favorable outcomes of earnings management or not is inquired. In a sense, the stream of research, including this one and its antecedents, attempts to reveal some favorable outcomes of earnings management.

It is known both intuitively and from agency costs literature that managers are better informed about firms' prospects, and they have different motivations for engaging in earning management practices. Another known fact from the literature is that using discretionary accruals is the most common way of managing earnings. Managers might manage their earnings not only to conceal their bad performance but also to reveal their good performance based on their motivation.

This chapter draws investors and scholars' attention to one of the very few favorable outcomes of earnings management. Earnings management is not solely "opportunistic", but it is sometimes "informative". That is, it can be beneficial to shareholders even by concealing information. This study is the first to examine the relationship between earnings management and stock liquidity for Turkey where there is a relatively weaker equity culture, a dominant of long-term debt finance and less legal protection. Results contribute to the scarce literature by providing additional evidence for a debated issue of the "informative" versus "opportunistic" earnings management from an emerging market.

Disentangling earnings management into opportunistic and informative parts enables scholars and practitioners to better understand the effectiveness of the mechanisms employed to prevent or at least minimize the overall earnings management. From an academic point of view this may be one of the possible explanations of the conflicting results in earning management literature. When some of the mechanisms that serve to both aspects of earnings management at various degrees, they would be inappropriately labeled as having no effect on overall earnings management. From the practitioners' point of view, the financial consequences of their reporting actions would be more predictable as they comprehend informative earnings management. On the other hand, as investors become more aware of informative earnings management, they would prioritize their investments on companies with informative earnings management as opposed to opportunistic earnings management.

The objective of this chapter is to examine the effect of earnings management on stock liquidity in an emerging country market. Since the liquidity of stocks proxies the degree of informativeness about the stock, the association between earnings management and stock liquidity enables us to test whether the earnings management practices in Turkey are considered as informative or opportunistic by the outside investors.

2. EARNINGS MANAGEMENT IN TURKEY

There is a bunch of literature on Turkey that modeled earnings management as the dependent variable and investigated the effects of particular characteristics on earnings management.

The relationship between corporate governance and earnings management was heavily investigated for Turkey. Their findings on the effect of various aspects of corporate governance on earnings management are mixed. Önder (2012) reports that while; block ownership, managerial ownership, audit committee size and management board size increase earnings management, the independence of the audit committee and the independence of management board decrease earnings management practices. Memiş and Çetenak (2012) investigated the association between corporate governance characteristics

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