

What Are the Determinants of Earnings Management for Misrepresentation? Evidence from Japan

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Accounting fraud is earnings management that exceeds the scope of GAAP (Dechow and Skinner 2000, 238).¹ Suppose fraudulent financial reporting is regarded as an extreme form of earnings management, earnings management for misrepresentation occurs when incentives/pressures, opportunities, and attitudes/rationalizations coexist, following the fraud triangle theory (Cressy, 1953). The determinants of earnings management for misrepresentation require further study and clarification. Nakashima (2019) found that Japanese managers are motivated to commit accounting fraud because of internal (73.68%) and external (59.65%) pressure to meet profit targets. Although many studies focus on the incentives/pressures of earnings management (Gordon, 1964, 262; Suda, 2000, 262; Shuto 2010), few emphasize attitudes/rationalizations.

Fraudsters justify their behavior by using a neutralization or disengagement technique to preserve their self-respect (Mintchik, 2019). Understanding the factors affecting the attitudes/rationalizations before acts of earnings management for misrepresentation may help regulators and auditors detect fraudulent financial reporting. Further, this study examines the aspects influencing attitudes/rationalizations before acts of earnings management for misrepresentation to capture a manager's psychological aspects by employing responses from a questionnaire survey of CFOs from public firms in Japan.

Earnings quality consists of two parts: where management discretion does not work and where management discretion works (Francis et al., 2015, 18). Earnings quality is measured by several attributes, such as accruals quality and abnormal accruals (Francis et al., 2015, 37-38). In other words, earnings quality is evaluated through earnings management. This study focuses on the discretionary behavior of earnings as a part of earnings quality where management discretion works and elucidates the determinants of earnings management.

This study explores whether the six categories of earnings management determinants—decision usefulness, financial performance, accounting standards, governance and internal controls, auditors, and law enforcement—influence

¹ Dechow and Skinner (2000, 239) suggested that earnings management is conceptually different from fraudulent financial reporting, and while earnings management falls within GAAP, fraudulent accounting is considered as earnings management that explicitly violates GAAP. Since Ball (2009, 280) defined fraudulent financial reporting as knowingly failing to comply with GAAP and earnings management as managers' intervening in the reporting of their own financial performance, he suggested that earnings management encompasses fraudulent financial reporting.

earnings management for misrepresentation simultaneously to validate the relationships². Financial performance is a firm operating characteristic that includes debt, growth and investment, and size (Dechow et al., 2010, 379). Although Dechow et al. (2010, 379) indicate that financial reporting practices include accounting methods, other reporting practices, and accounting principles, this study focuses on accounting standards that are defined as provisions for the preparation of financial statements.

Governance and internal controls are the systems in which the board of directors and internal auditors monitor the financial reporting system. Auditors mitigate intentional and unintentional misstatements (Dechow et al., 2010, 383). Law enforcement is the regulatory scrutiny that regulators and regulation monitor, investigate, and impose on firms to manage earnings (Dechow et al., 2010, 386). Although Dechow et al. (2010, 384–385) indicate equity market incentives as determinants, this article focuses on management decisions as determinants of earnings management, since management's financial reporting decisions from an earnings management perspective examine both incentives for earnings management and its consequences (Francis et al., 2015, 25). Management decisions are the choices to implement discretionary activities in this study. This study discusses the following two features: perceived earnings management for misrepresentation of self and of other CFOs, to examine the determinants of earnings management for misrepresentation.

This article contributes to the literature in several ways. First, it employs structural equation modeling (SEM) based on the survey results to explore the relationship between the determinants of earnings management for misrepresentation and perceived earnings management. Since it is difficult to determine earnings management from publicly available information, this study uses the survey results of management perception.

Second, this article presents a new framework that incorporates theoretical concepts, namely, the theory of planned behavior, protection motivation theory, and deterrence theory, to explain how variables influence earnings management for misrepresentation. Although there are many studies based on the fraud triangle theory and the significant associations between three factors—incentives/pressures, opportunities, and attitudes/rationalizations and fraudulent financial reporting, few studies have examined the determinants of earnings management for misrepresentation based on planned behavior theory, protection

² Francis et al. (2005) identified six determinants of earnings quality as management decisions, information system, auditing, governance structure, and regulatory scrutiny and financial reporting standards. Dechow et al. (2010, 379) indicated that there are six categories of determinants of earnings quality: firm characteristics, financial reporting practices, governance and controls, auditors, equity market incentives, and external factors.

motivation theory, and deterrence theory.

Third, the finding that accounting standards, governance, and internal controls are significantly associated with earnings management for misrepresentation can help regulators reconsider a reform of the internal control system. These findings are consistent with Francis et al.'s (2008) theory and the study by Nakashima (2010 and 2015) and Nakashima and Ziebart (2015 and 2016), suggesting that management is not independent of the board of directors and that governance does not function effectively in Japan. Fourth, the results imply that accounting standards and law enforcement are crucial in mitigating earnings management for misrepresentation. The findings indicate that the way forward in Japan is rigorous standards such as the U.S. Generally Accepted Accounting Principles (GAAP) and not principle-based standards such as the International Financial Reporting Standards.

The remainder of this article is organized as follows. Section 2 reviews the previous studies and develops the hypotheses. Section 3 describes the methodology used in this study. Section 4 discusses the empirical results. The final section summarizes and concludes the study.

Research Framework and Hypothesis Development

Research Framework

Management's Decisions

Following the theory of planned behavior (Ajzen, 1991), intentions are assumed to capture the motivational factors that influence a behavior: they indicate how hard people are willing to try and the amount of effort they are planning to exert to perform the behavior (Ajzen, 1981, 181). A behavioral intention can find expression in behavior only if the person can decide at will to perform or not perform the behavior (Ajzen, 1981, 182). This study expounds that management's decisions impact the behavior of misrepresentation.

This study explores whether determinants of earnings management, such as decision usefulness, financial performance, accounting standards, governance and internal controls, auditors, and law enforcement affect earnings management for misrepresentation. This study incorporates several factors in the entire framework by applying the planned behavior theory, protection motivation theory, and deterrence theory. Incentives/pressures, financial performance, and governance/internal controls are based on the fraud triangle theory, accounting standards and auditors are based on the

protection motivation theory, and law enforcement is based on the deterrence theory.

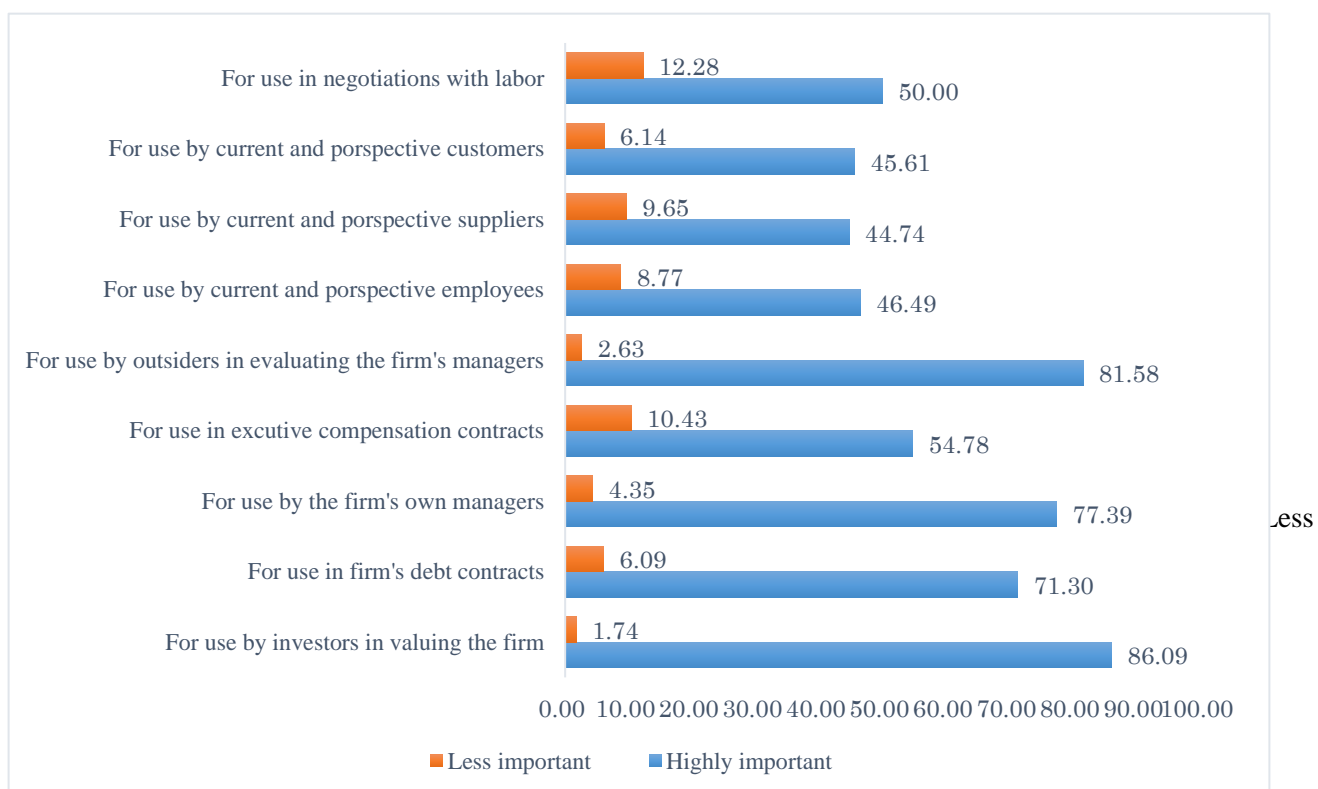
Hypotheses Development

Perceived Decision Usefulness

Nakashima (2019) surveys CFOs about the extent to which they consider the use of earnings as important information. Figure 1 reports the results in percentage rank order of importance to the CFOs on a scale of 5 to 1, ranging from the degrees of importance to less important, and grouped by importance levels of 5 or 4 and 2 or 1. At the time of valuing the firms, the mean average rating of Japanese CFOs is 86.09% and that of U.S. CFOs is 94.60%, with regard to those who consider that earnings information is important for investors. Furthermore, 71.30% of Japanese CFOs and 82.15% of U.S. CFOs consider that earnings information is important in a firm's debt contracts. In addition, 81.58% of Japanese firms answered "for use by outsiders in evaluating the firm's managers" compared to 62.72% of U.S. firms.

CFOs consider earnings to be important for investors and creditors while valuing their firms. CFOs believe that earnings are more important for outsiders' uses (81.58%) than for debt contracts (71.30%). Note that 77.39% of Japanese CFOs use earnings. Following Dichev et al. (2013, 10), both Japanese and U.S. CFOs stress the use of one number for both external and internal communications.

Figure 1: Decision-Usefulness for Earnings



Management's perception of earnings usefulness likely drives the disclosure of earnings by management. As per Statement of Financial Accounting Concepts No. 8, the qualitative characteristics of accounting information and decision usefulness are described as follows:

If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely, and understandable (FASB, 2010, QC4).

The fundamental qualitative characteristics are relevance and faithful representation.

Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena but also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics: complete, neutral, and free from error. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximize those qualities to the extent possible (FASB, 2010, QC12).

Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon, nor an unfaithful representation of a relevant phenomenon, helps users make good decisions (FASB, 2010, QC17).

Rezaee and Riley (2010, 40) indicate that the representational faithfulness of financial information refers to the extent to which it reflects the economic reality, resources, and obligations of the firm as well as the transactions and events. Following the protection motivation theory (Rogers, 1983), the perceived effectiveness of decision usefulness in the conceptual framework increases the probability of adopting an appropriate behavior. I show that non-fraud managers attempt to present earnings faithfully. Therefore, the following hypothesis is proposed:

H1: Perceived decision-usefulness influences earnings management for misrepresentation.

Financial Performance

The following financial performances are considered incentives/pressures to commit fraud, a factor of the fraud triangle theory (Cressy, 1954).

Growth: Beasley (1996, 453) indicates that if a firm experiences rapid growth, managers may be motivated to misstate financial statements to give the appearance of stable growth, which is associated with the fraud. Summers and Sweeney (1998, 136) suggest that unethical managers may be induced to misstate financial statements when growth slows or reverses to maintain the appearance of consistent growth, and that rapid growth leads to weaknesses in internal controls.

External Leverage: Persons (1995, 40) states that if income-increasing accounting policies cannot avoid a violation

of debt covenants, managers may be motivated to understate liabilities or overstate assets. Skousen et al. (2009, 8) document that managers feel pressure because of the need to obtain additional debt to stay competitive and new financing may be necessary to expand plants and facilities.

Financial Targets: Persons (1995, 40), Beasley (1996, 453), and Loebbecke et al. (1998, 10–11) suggest that poor financial performance may provide managers with an incentive to overstate revenues or understate expenses. Some empirical studies document that managers manage earnings to meet or beat losses, negative earnings, or earnings targets. Other studies find that managers manage earnings to avoid or decrease losses to meet earnings benchmarks (Burgstahler and Dichev 1997; Suda and Shuto 2008, 80). Earnings management has been implemented to respond to expectations (Suda et al. 2007, 34). Shuto (2010, 250–251) suggests that managers in Japan have an incentive to manage earnings to meet nonzero earnings to increase their compensation and avoid turnover.³ This study predicts that financial performance can increase managers' attempts to manage earnings for misrepresentation. Thus, the following hypothesis is proposed:

H2: Financial performance affects earnings management for misrepresentation.

Governance and Internal Controls

Following Cressy's (1954) fraud triangle theory, opportunities to commit fraud are another factor of the fraud triangle theory. If managers fail to set governance and internal control systems, it is likely that earnings management for misrepresentation occurs.

The Japanese government has been working on strengthening governance policies to improve the corporate governance system in public firms in Japan, thereby improving investors' confidence in Japanese capital markets and increasing economic growth. One of the reforms include the issuance of the corporate governance code and the creation of audit committee-style firms ("kansatoinkaki") through the Revision of Corporate Law of 2014.

The Tokyo Stock Exchange (TSE) incorporates the fundamental principles for corporate governance established in Japan's "Corporate Governance Code" into its listing rules to help ensure effective corporate governance in Japan. Japan's

³ Shuto (2010, 250–251) examines the incentives of managers to manage earnings focusing on contract relationships and capital market and suggests the following reasons for earnings management: loss avoidance, decrease avoidance, and meeting earnings target, and further suggests that earnings management to avoid loss is associated with managerial compensation, turnover, and financial covenants and earnings management to avoid decline and to meet targets is associated with factors regarding the market such as equity incentive, earnings relevance, growth, and direct financing.

Corporate Governance Code is as follows:

This Corporate Governance Code establishes fundamental principles for effective corporate governance at listed companies in Japan. It is expected that the Code's appropriate implementation will contribute to the development and success of companies, investors, and the Japanese economy as a whole through individual companies' self-motivated actions to achieve sustainable growth and increase corporate value over the mid- to long-term (TSE 2018, 1).

In the Corporate Governance Code, the responsibilities of the board are as follows:

Given its fiduciary responsibility and accountability to shareholders, in order to promote sustainable corporate growth and the increase of corporate value over the mid- to long-term and enhance earnings power and capital efficiency, the board should appropriately fulfill its roles and responsibilities, including the following:

(1) Setting the broad direction of corporate strategy; (2) Establishing an environment where appropriate risk-taking by the senior management is supported; and (3) Carrying out effective oversight of directors and the management (including shikkoyaku and so-called shikkoyakuin) from an independent and objective standpoint (TSE, 2018, 3).

Razaee and Riley (2010, 12) indicate that the effectiveness of the function of oversight depends on directors' independence. The board of directors should provide consultation, advice the management, and oversee managerial performance (Razaee and Riley 2010, 129).

Hermalin and Weisbach (1998) indicate that the effectiveness of the board of directors is a function independent of the CEO. Since the chairperson of the board is charged with running director meetings and evaluating and compensating the CEO, Jensen (1993) argues that the positions of the chairperson and CEO should be separated. Combining these positions reduces board independence and impairs the monitoring of CEOs. Inefficient oversight may allow a CEO to misstate earnings to increase compensation (Jansen, 1993). Dechow et al. (1996, 1) find that firms that manipulate earnings are more likely to have boards of directors dominated by management.

There are currently three management styles followed by public firms in Japan: (a) the board of "statutory auditor-style" firms, (b) three-committee style firms, and (c) the board of "audit committee-style" firms. Of the 2,102 TSE Section 1 firms, (a) 1,529 are "statutory auditor-style" board firms (72.7%), (b) 60 are three-committee style board firms (29%), and (c) 513 are "audit committee-style" board firms (24.4%) (The Japan Association of Corporate Directors 2018). "Shikkoyakuin" executive officers, including CEOs and CFOs who are appointed by the board of directors, have a responsibility to execute business as a rule of law.

However, in practice, CEOs and CFOs are positioned at the top of the management and make decisions for business

execution, seeking agreement from the board of directors as well as other directors (Hirata 2003, 163, 166). There are several inside directors, and no distinction is made in the functions of decision-making, monitoring, and business execution. The business execution system in which the CEO or the president is positioned at the top of the hierarchy is maintained in Japan, and the board of directors does not monitor or make decisions (Hirata 2018, 166).

Nakashima and Ziebart (2015) examine whether Japanese internal control regulation (The Financial Instruments and Exchange Act of 2006, J-SOX)⁴ impacted both earnings management and earnings quality in Japan. They find that while accruals management and real management remain unchanged for control firms, accruals management increases for material weakness-disclosing firms. The results of earnings management are inconsistent with the results for U.S. and SEC-standard Japanese firms and conclude skeptically regarding the extent to which J-SOX improves corporate governance and observes that further effective enforcement is needed in Japan.

Establishing a firm's internal control system is the universal responsibility of management. However, there is a difference in the internal control auditing system between Japanese and Western countries.⁵ While an external auditor audits a firm's internal control system directly in Western countries, an external auditor in Japan merely audits whether the internal control report prepared by management is presented fairly based on "the three pieces" provided by the management, which include a business description, a figure of the workflows, and risks and controls (Financial Service Agency 2007, 17).

The external auditor's responsibility is the managerial assessment of the effectiveness of internal control in Japan (Financial Service Agency, 2007, 5). Therefore, it is likely that when management commits fraud, and the set of "three pieces" is prepared by the management and can access their internal control systems, it is difficult for external auditors to detect fraud (Nakashima, 2018). Therefore, governance/internal controls cannot restrain earnings management for misrepresentation, and the following hypothesis is proposed:

H3: Governance and internal controls affect earnings management for misrepresentation.

⁴ Internal control reporting regulation has been enacted in Japan for public firms to organize and implement their internal control system. Although the internal control system does not intend to detect fraud, if an effective internal control system were implemented, it is hypothesized that unintentional and intentional errors would be decreased. In practice, the number of the firms that disclosed material weaknesses has decreased in Japan. Nakashima and Ziebart (2015) document that the effective internal control systems help improve earnings quality in the post-J-SOX period, and the results of earnings quality are consistent with the results for the U.S. and the U.S. stock market-listed Japanese firms.

⁵ Following Nakashima (2018), Japan did not learn the history in the pre-SOX in which external auditors relied on the client's internal controls, which managers manipulated and that this led accounting fraud in the U.S. If the direct reporting is applied in Japan, external auditors could investigate a firm's book. This leads a check and balance for discretionary actions by managers.

Protection Motivation Theory

Protection motivation theory explains the motivations for changing those behaviors in people who engage in unhealthy practices. The modified theory of protection motivation indicates that people protect themselves based on four factors: the perceived severity of a threatening event, the perceived probability of the occurrence, or vulnerability, the efficacy of the recommended preventive behavior, and perceived self-efficacy (Roger, 1983). The modified theory of protection motivation comes from both threat appraisal and coping appraisal based on the original protection motivation theory (Rogers, 1975).

Threat appraisal evaluates the severity of the situation and explores the severity of the situation. Coping appraisal refers to how people react to a situation. Coping appraisal consists of both efficacy and self-efficacy. Efficacy is the individual's expectancy of whether the recommendations can remove the threat. Self-efficacy is the belief in people's ability to successfully carry out the recommended behavior (Roger, 1983).

Accounting Standards

Accounting standards mitigate both the opportunity and rationalization of fraudulent financial reporting (Hogan et al., 2008, 236). Nelson et al. (2002, 179–181) find that the precision of accounting standards affects managers' incentives to manage earnings. They find that managers are more likely to attempt earnings management when transactions are structured with respect to precise standards. Learning from accounting fraud committed in the United States, IFRS takes the principle-based standard as a policy, confronting the precise US GAAP. According to the protection motivation theory (Roger, 1983), a manager fears the violation of accounting standards. Therefore, accounting standards can limit managers' attempts to manage earnings for misrepresentation. Thus, the following hypothesis is proposed:

H4 (a): Accounting standards affect earnings management for misrepresentation.

Auditors

If quality auditing is implemented, a manager is fearful of fraudulent financial statements being detected. Several studies suggest a significant association between audit quality and accounting fraud. Lennox and Pittman (2010) show that the

occurrence of fraudulent financial reporting is consistently lower for the Big Five⁶ clients. Becker et al. (1998) find that clients of non-Big Six auditors report discretionary accruals that are higher than the discretionary accruals reported by the clients of Big Six auditors. This suggests that the Big Six restrains earnings management for misrepresentation, and there is an association between higher audit quality and earnings management. Following the protection motivation theory (Roger, 1983), a manager feels the threat of detection of fraudulent financial reporting by an external auditor. Therefore, auditors can restrain managers' attempts to manage earnings for misrepresentation. Thus, the following hypothesis is proposed:

H4 (b): Auditors influence earnings management for misrepresentation.

Deterrence Theory

Deterrence theory, defined as proponents of deterrence, believes that people choose to obey or violate the law after calculating the gains and consequences of their actions (DiIulio, 2010)⁷. Legal sanctions deter people from engaging in criminal behavior. The severity of legal penalties influences the intention to commit to criminal behavior (Becker, 1968).

Studies have proven the deterrence theory by finding that earnings management decreases in countries with strong legal protection. Leuz et al. (2003) and Enomoto et al. (2018) prove that earnings management decreases in legal protection because, when investor protection is strong, insiders enjoy fewer private control benefits and, consequently, have little incentive to conceal firm performance. Burgstahler et al. (2006, 985) document that earnings management is more pervasive in countries with weaker legal systems and enforcement. They indicated that enforcement mechanisms are significant for accounting quality. Therefore, legal enforcement restrains earnings management, and the following hypothesis is proposed:

H5: Law enforcement influences earnings management for misrepresentation.

Methodology

Sample

⁶ The Big Four in Japan means the following four auditing firms: EY ShinNihon that has a partnership with Ernst & Young, Azusa that has a partnership with KPMG, Tohmatsu that has a partnership with Deloitte Touche Tohmatsu, and PwC Arata that has a partnership with PricewaterhouseCoopers.

⁷ People are deterred from committing crime by the threat of punishment. There are two different phases of punishment influencing deterrence: the certainty of punishment by increasing the likelihood of punishment, and the severity of punishment. Especially the higher level of severity of the punishment may influence offender's behavior by considering the balance between the punishment and worth of the risk of getting caught (Wright, 2010).

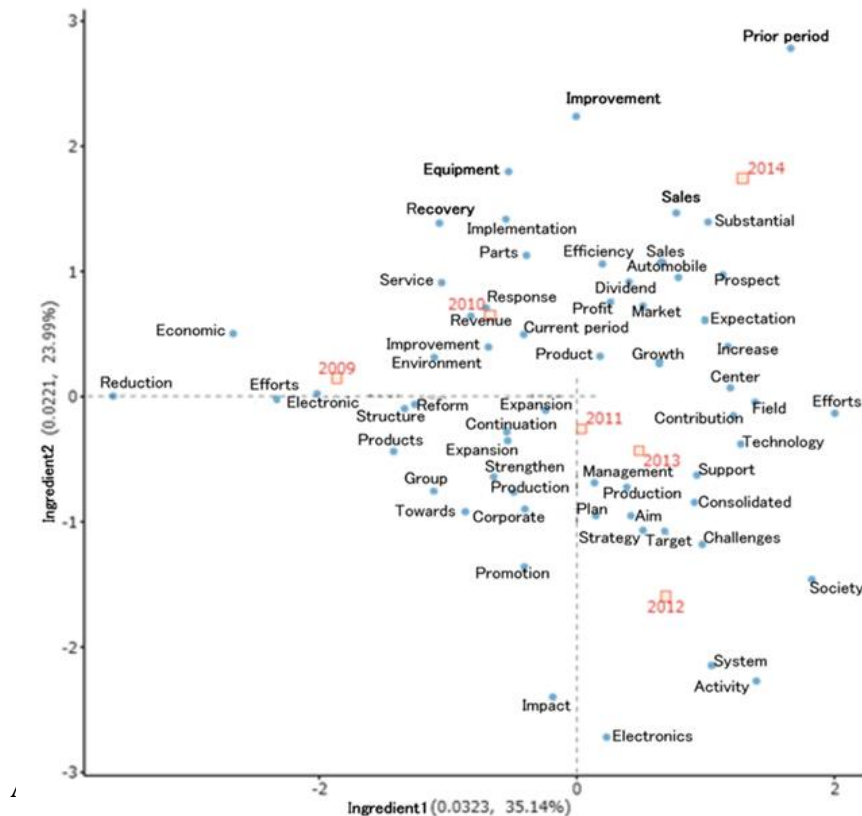
This study employs responses from Nakashima's (2019) survey of 115 CFOs.⁸ The questionnaire is based on the study by Dichev et al. (2013) and comprises the following six parts: (1) managers' visions for earnings quality, (2) higher quality earnings, (3) determinants of earnings quality, (4) earnings management, (5) accounting policies and standards that influence earnings quality, and (6) misrepresented earnings. The respondents were asked to indicate their level of agreement with each statement on a five-point Likert scale ranging from 1 (strongly disagree) to 5 (strongly agree) for each question.

It is likely that the sample comprises management from non-fraudulent firms that do not detect accounting fraud at this point. To investigate whether the sample firms are non-fraudulent firms, I perform a correspondence analysis of the terms used in the MD&A of the sample firms; Nakashima (2022) documents that the terms used in the MD&A of fraudulent firms are plotted away from their origin. Figure 2 is the result of correspondence analysis of the MD&A disclosures of the sample firms. The correspondence analysis is a visualization based on crosstabulations, where common terms are plotted at the origin and distinctive terms are plotted away from the origin. This correspondence analysis of MD&A for this sample of firms, with the years aggregated together to show the association. The results indicate that the firm is attempting to communicate with investors using general terms as they are plotted near the origin.⁹

⁸ Questionnaires are sent to 3,525 CFOs of public firms in Japan through regular mail on July 1, 2017. In total, 131 Japanese firms respond to the survey, with a response rate of 4.0%. Of these 131 firms, 6 firms do not respond to the questions with specific reasons and were removed. The six firms indicate their exact names of the firms and CFOs and that they cannot participate any survey following a corporate policy. Among 116 firms with names, one firm contains no data and is removed. In addition, among 125 firms, 115 firms provide their names.

⁹ Nakashima (2022) presents the results of a correspondence analysis between Toshiba and non-fraudulent firms, showing that there is a difference in the plot of the term plots between Toshiba and non-fraudulent firms. In other words, non-fraudulent firms are plotted closer to 0, indicating that they use more general terms.

Figure 2: Correspondence Analysis of the Sample Firms



d. The results of correspondence analysis

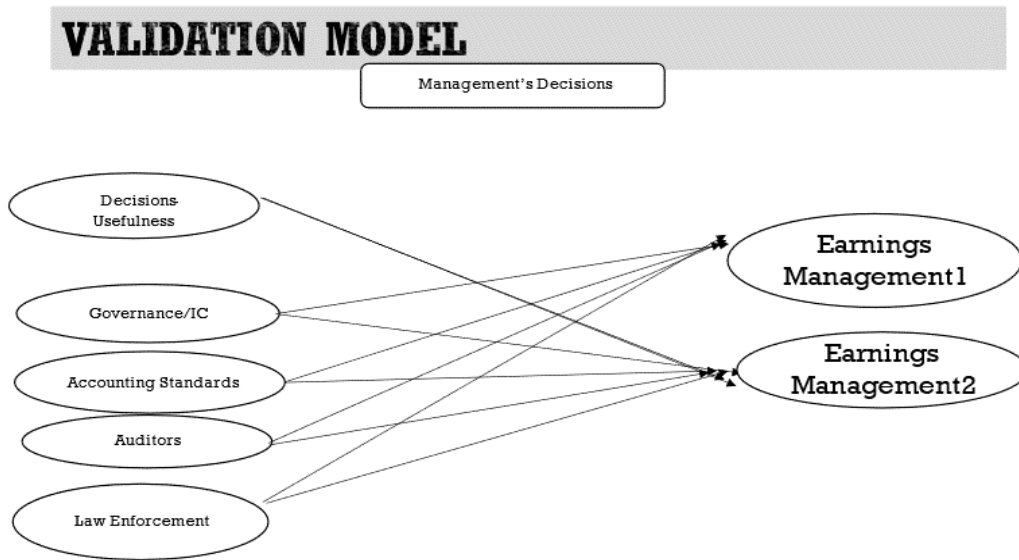
suggest that the terms of non-fraudulent firms are closer to zero and use more general terms, suggesting that managers do not attempt to confuse investors. Taken together, it is likely that sample firms are non-fraudulent firms.

Validation Model

This study examines the relationship between the determinants of earnings management and earnings management for misrepresentation in this study. Data analysis is implemented using SEM to explain the relationships among multiple variables (Hair, 1998, 546). SEM is selected for the following three reasons: SEM can estimate multiple and interrelated relationships simultaneously; the covariance structure analysis can represent unobserved concepts in the relationships, and the covariance structure analysis can define a model to explain the entire relationship (Hair, 1998, 547).

This study hypothesizes that management's decisions that are composed of decision usefulness, incentives/pressures, financial performance, accounting standards, auditors, governance/internal controls, and law enforcement affect earnings management for misrepresentation, as shown in Figure 3.

Figure 3: Validation Model



The latent variable decision usefulness is indirectly measured using Q2. Financial performance was measured indirectly using the Q3.8. Earnings management for misrepresentation is measured indirectly by Q4.1 and Q7.1. Earnings management within GAAP is measured directly by Q3.7. Accounting standards were measured indirectly by Q3.2, Q4.3, Q6.1, and Q6.2. Auditors are measured indirectly by Q3.9, and Q3.12. Governance/internal controls are measured indirectly by Q3.5, and Q3.6. Law enforcement is measured by Q3.13, and Q3.14. Decision usefulness, financial performance, accounting standards, auditors, governance/internal controls, and law enforcement influence earnings management for misrepresentation. Based on the conceptual model:

EM: Q3.7, Q4.1, and Q7.1

Decision-Usefulness: Q2

Incentives/Pressures: Q7.4

Financial performance: Q3.8

GrowthRate Sales in the beginning of the year/sales in the end of the year

PriceEarningRatio (Stock price/earnings per share)*100

Revenue Sales/total assets

Debt Total liabilities/total assets

Descriptive Statistics

Table 1 presents the descriptive statistics of the sample firms. Revenues, sales growth, and debt of the respondent firms are 1.225, 1.055 (mean, median), 5.173, 0.630 (mean, median), and 0.549, 0.553 (mean, median), respectively. This suggests that the sample firms have positive sales and fewer debts. Moreover, ownership by financial institutions and inside ownership is 16.310%, 13.750% (mean, median), and 12.411%, 3.670% (mean, median), respectively. According to the Tokyo Stock Exchange, although the average ratio of financial institution ownership in TSE was 30% in 1960, financial institution ownership decreased, and the average ratio of financial institution ownership was 25.6% in 2016 (TSE 2016, 12). The financial institution ownership of the sample firms is lower than the average for all public firms. This suggests that it is likely that pressure or control by main banks is relatively lower for sample firms.

TABLE 1: Descriptive Statistics (N=115)

	Mean	Median	S.D.	Min	Max	Percentile		
						25	50	75
<i>Revenue</i>	1.225	1.055	0.628	0.244	3.259	0.803	1.055	1.445
<i>Sales Growth</i>	5.173	0.630	17.761	-22.190	135.080	-0.188	0.630	6.110
<i>Debt</i>	0.549	0.553	0.195	0.158	0.878	0.390	0.553	0.718
<i>Price/Earnings ratio</i>	13.621	8.800	26.013	0.000	240.400	0.000	8.800	16.050
<i>Intuitional ownership</i>	16.321	13.750	12.292	0.000	48.500	6.085	13.750	24.930
<i>Insider ownership</i>	12.411	3.670	18.524	0.010	110.690	0.310	3.670	19.350

Variable Definitions:

all variables are deflated by total assets in the end of the year.

<i>Revenue</i>	Sales / Total assets
<i>Sales Growth</i>	Sales in the beginning of the year / Sales in the end of the year
<i>Debt</i>	Total liabilities / Total assets
<i>Price/Earnings ratio</i>	(Stock Price/Earnings per share)*100
<i>Intuitional ownership</i>	The number of share of financial institutions/ total share
<i>Insider ownership</i>	The number of share of directors and employees / total share

Correlation of Latent Variables

This study examines the relationship between the determinants of earnings management for misrepresentation and earnings management in this study. Table 2 indicates that earnings management for misrepresentation is significantly positively correlated with governance/internal controls and significantly negatively correlated with financial institution ownership. However, earnings management within GAAP is significantly positively correlated with financial performance, auditors, and law enforcement.

Table 2: Correlation Analysis

	Earnings Management_Misrepresentation	Earning Management WithinGAAP	Earnings Management_total	Decision-Usefulness	Financial Performance	Growth	PriceEarnings	Revenue	Debt	Accounting Standard	Auditors	Governance InternalControls	FinancialInstitution_ownership_ OWNERSHIP	InsideDirectors_ OWNERSHIP	Law Enforcement
EarningsManagement_Misrepresentation	1.000	.107	1.000**	-.008	.018	.043	-.041	.090	.029	.098	.133	.198*	-.186*	.062	.062
		.252	.000	.937	.849	.656	.664	.403	.788	.297	.154	.033	.048	.515	.509
Earning Management WithinGAAP	.128	1.000	.136	.102	.356**	.237*	-.029	-.022	.148	.084	.514**	.340**	-.112	.098	.231*
	.171		.145	.282	.000	.012	.762	.836	.167	.368	.000	.000	.237	.302	.013
EarningsManagement_total	.996**	.192*	1.000	-.003	.029	.049	-.041	.088	.035	.099	.149	.209*	-.188*	.064	.071
	.000	.039		.972	.762	.611	.669	.413	.745	.292	.110	.025	.046	.504	.450
DecisionUsefulness	.030	.089	.030	1.000	.299**	.121	-.029	-.100	.075	.145	.191*	.276**	.175	-.189*	.226*
	.755	.349	.753		.001	.208	.761	.355	.489	.123	.042	.003	.066	.047	.016
Financial Performance	.012	.349**	.023	.280**	1.000	-.004	-.143	-.066	.118	.049	.385**	.387**	.051	-.088	.347**
	.896	.000	.805	.003		.969	.133	.540	.273	.600	.000	.000	.596	.354	.000
Growth	.110	.170	.124	.087	-.023	1.000	-.006	.076	.184	.024	.169	.178	-.143	.046	-.004
	.249	.072	.194	.366	.811		.953	.477	.084	.804	.074	.060	.134	.630	.967
PriceEarnings	-.172	-.121	-.180	.011	-.007	.139	1.000	-.103	.008	.031	-.056	-.143	.354**	-.224*	-.048
	.070	.205	.057	.908	.941	.143		.339	.939	.746	.560	.132	.000	.018	.618
Revenue	.081	.017	.080	-.070	.014	.087	-.085	1.000	.097	-.092	.053	.055	-.238*	.138	-.077
	.450	.874	.454	.521	.898	.416	.428		.365	.391	.622	.610	.025	.197	.474
Debt	.031	.136	.032	.063	.083	.138	-.385**	.094	1.000	-.122	.039	.171	.020	.117	.171
	.773	.203	.764	.561	.445	.198	.000	.380		.253	.718	.110	.854	.277	.110
AccountingStandard	.070	.141	.086	.171	.059	-.020	.130	.013	-.113	1.000	-.024	.144	.077	-.049	-.151
	.455	.130	.360	.070	.529	.836	.171	.907	.291		.796	.122	.415	.604	.105
Auditors	.164	.492**	.195*	.150	.358**	.086	-.097	.106	.028	-.001	1.000	.465**	-.131	-.047	.457**
	.078	.000	.036	.110	.000	.365	.309	.321	.796	.992		.000	.166	.621	.000
GovernanceInternalControls	.227*	.371**	.252**	.260**	.356**	.121	-.168	.074	.165	.217*	.451**	1.000	.075	.006	.385**
	.014	.000	.006	.005	.000	.204	.077	.488	.122	.019	.000		.428	.947	.000
FinancialInstitution_OWNERpercent	-.224*	-.109	-.226*	.124	.017	.012	.456**	-.220*	-.018	.117	-.192*	-.003	1.000	-.396**	.030
	.017	.249	.016	.195	.856	.901	.000	.038	.870	.217	.041	.974		.000	.754
InsideDirectors_OWNERpercent	.105	.013	.108	-.215*	-.136	.029	-.453**	.196	-.121	-.042	-.030	-.028	-.585**	1.000	-.074
	.270	.889	.255	.023	.151	.761	.000	.065	.259	.662	.752	.765	.000		.437
Law Enforcement	.106	.240**	.108	.173	.330**	.172	-.123	-.040	.102	-.171	.444**	.334**	.035	-.076	1.000
	.257	.010	.247	.065	.000	.070	.196	.708	.341	.066	.000	.000	.715	.421	

Correlations above (below) the diagonal are Pearson (Spearman) correlations. The bottom number in each is a two-tail p-value. * significant at 5% level; ** significant at 1% level.

See Table 1 and 2 for definition of each variable.

EarningsManagement1 :	Q4.1: How much discretion in financial reporting does the current accounting standard-setting regime in Japan allow:
EarningsManagement2 :	Q7.1: From your impressions of companies in general, in any given year, what percentage of companies use discretion within GAAP to report earnings that misrepresent the economic performance of the business?
EarningsManagement3 :	Q3.7: Your company's reporting choices
Decision-Usefulness	Q2: Earnings can be used in different ways by various constituents. Please rate the importance of the following uses of reported earnings: Q2.1: For use by investors in valuing the company, Q2.2: For use in debt contracts, Q2.3: For use by the company's own managers, Q2.4: For use in executive compensation contracts, Q2.5: For use by outsiders in evaluating the company's managers, Q2.6: For use by current and prospective employees, Q2.7: For use by current and prospective suppliers, Q2.8: For use by current and prospective customers, Q2.9: For use in negotiations with labor.
Financial Performance	Q3.8: How fast the operating cycle converts accruals to cash flows at your company: GrowthRate: Sales in the beginning of the year / Sales in the end of the year, PriceEarningRatio: (Stock Price/Earnings per share)*100, Revenue: Sales / Total assets, Debt Ratio: Total liabilities / Total assets
AccountingStandards	Q6.1.3: Policies that minimize long-term projections and revaluations as much as possible, Q6.1.5: Policies that minimize the volatility of reported earnings, Q6.1.6: Policies that rely on historical costs as much as possible, Q6.2.1: Issue fewer new
Auditors	Q3.9: Your company's audit committee, Q3.12: Your company's external auditor
GovernanceInternalControls	Q3.5: Your company's internal controls, Q3.6: Your company's board of directors
Law Enforcement	Q3.13: The SEC's enforcement process, Q3.14: Prospect of litigation

Results

Hypotheses Test

SEM is used to test the hypotheses by considering the p-value for significance and the S.E. value to study the relationship direction (positive or negative).

The absolute value of C.R. of more than 1.96 suggests that the test is significant (Yamamoto et al., 2001, 121). Table 3 shows that from accounting standards to earnings management 1, from governance/internal controls to earnings management, from auditors to earnings management, and from governance/internal controls to earnings management, C.R.=2.437, 3.789, 4.901, and 2.035, respectively, and all are significant.

Table 3: Estimation of Structural Model				
			Estimate	P
Decision-Usefulness	<---	GovernanceInternalControls	0.212	0.064
EarningsManagement1	<---	FinancialPernance	0.104	0.316
EarningsManagement1	<---	AccountingStandards	-0.392	0.001 ***
EarningsManagement1	<---	Auditors	0.010	0.929
EarningsManagement1	<---	GovernanceInternalControls	0.373	0.002 **
EarningsManagement1	<---	LawEnforcement	-0.180	0.120
EarningsManagement3	<---	FinancialPernance	0.099	0.317
EarningsManagement3	<---	AccountingStandards	-0.033	0.740
EarningsManagement3	<---	Auditors	0.543	0.001 ***
EarningsManagement3	<---	GovernanceInternalControls	0.101	0.376
EarningsManagement3	<---	LawEnforcement	-0.077	0.489
EarningsManagement1	<---	Pressure	0.044	0.668
EarningsManagement3	<---	Pressure	0.066	0.507
EarningsManagement3	<---	Decision-Usefulness	0.054	0.598
EarningsManagement1	<---	Decision-Usefulness	-0.103	0.331
EarningsManagement2	<---	FinancialPernance	0.151	0.177
EarningsManagement2	<---	AccountingStandards	-0.141	0.209
EarningsManagement2	<---	Auditors	0.161	0.198
EarningsManagement2	<---	GovernanceInternalControls	0.263	0.042 **
EarningsManagement2	<---	LawEnforcement	-0.028	0.823
EarningsManagement2	<---	Decision-Usefulness	-0.105	0.361
EarningsManagement2	<---	Pressure	0.028	0.805
*, ** and *** indicate that significant at 0.1 level, 0.05 level and 0.001 level respectively.				
See Table 1 and 2 for definition of each variable:				

Based on Figure 4, the results show that accounting standards have a negative effect on earnings management for

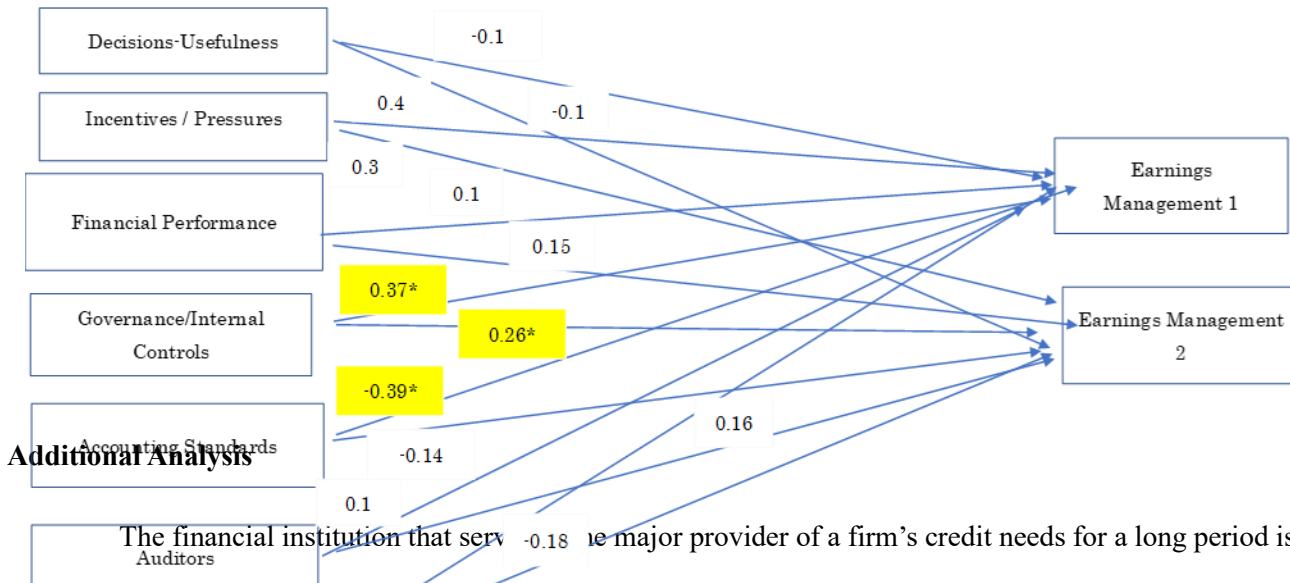
misrepresentation (estimate=-0.392), and governance/internal controls have a positive influence on earnings management for misrepresentation (estimate=0.373, 0.263). Auditors have a positive influence on earnings management within GAAP (estimate=0.543).

This result supports H3, “Governance and internal controls affect earnings management for misrepresentation” and H4 (a), “Accounting standards affect earnings management for misrepresentation.” The findings support Efendi et al.’s (2008) theory and the results of Nakashima (2010) and, the implications of Nakashima and Ziebart (2015). This suggests that it is likely that there is a weak independent relationship between a CFO and the board of directors, and it is difficult for a board of directors to restrain earnings management by managers in Japan. However, it is likely that although a manager seeks the auditor’s advice for discretionary activities within GAAP, management does not pursue the auditor about earnings management for misrepresentation.

Model Fit

This study provides an assessment of how appropriately the theory fits the sample data. The goodness-of-fit index (GFI) was 0.936 (Figure 4). The possible range is 0 to 1, with higher values indicating a better fit. The GFI in this model of 0.93 is greater than .90, which is considered good (Hair 1998, 584). The root mean square error of approximation (RMSEA) has become one of the most widely used assessments of misfit/fit in the applications of SEM (Hair 1998, 584; Kelley and Lai 2011, 2) and RMSEA is smaller (0.000). The indices indicate that the model fit is good.

Figure 4: The Results of SEM Modeling



the firm's main bank; this is known as the main bank system in Japan. Financial institutions play a role in overseeing management in Japan (Osano, 2005, 102, 102–163). Shuto (2010) find that firms with higher ownership by financial institutions do not manage earnings. However, Song et al. (2016, 34) found that the ratio of ownership by cross-shareholdings among groups had significant results, while the ratio of ownership by financial institutions had no significant results. These results suggest that while governance by the main bank does work for non-fraudulent firms, governance by the main bank does not work for fraudulent firms in Japan. This additional analysis employs the ownership of financial institutions as governance/internal controls. However, there is no significant effect on earnings management.

Conclusions and Future Research

This study examines whether the six aforementioned factors affect earnings management to misrepresent earnings using SEM. First, although accounting standards significantly negatively affect earnings management to misrepresent earnings, governance/internal controls significantly positively impact earnings management.

In the case of Japanese firms, the CEO and CFO are elected by the board of directors and conduct management activities according to the latter's will. However, in the case of Japanese companies, the CEO and CFO are elected by the board of directors and conduct management activities according to the board's intentions. The fact that the board of directors

does not monitor executive officers' management activities and does not conduct management activities according to the board's intentions imply that the executive officers are not independent from the board of directors.

Taken together, accounting standards can restrain earnings management, but the board of directors drives earnings management for misrepresentation. Therefore, based on the results, accounting standards should be rigorous and that a board of directors should be independent from the CEO or CFO to prevent fraudulent reporting.

This study has the following limitations: the models used in this study are based on the survey results. The models are used to test the hypotheses developed and are only an interpretation. In addition, board composition was significantly associated with the occurrence of fraud (Beasley 1996; Uzun et al. 2004; Chen et al. 2006), although this study does not use the proportion of external directors or the size of board directors for the governance/internal control variable. Because Nakashima and Ziebart (2015; 2016) find a relationship between fraud and governance, the percentage of outside directors and percentage of independent directors as governance variables need to be verified.

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