

Abstract

This bachelor thesis aims to establish a relationship between earnings management in proximity to debt covenant violation and the presence of litigation risk. Central testable concept is Watts and Zimmerman (1990) debt covenant hypothesis according to which managers tend to manipulate earnings to reduce the possibility of violation of their company's debt agreement. This setting allows investigating whether the risk of litigation is an effective regulatory mechanism which improves the contracting usefulness of accounting numbers and better align the interests between creditors and company managers, thus making debt covenants more reliable as monitoring mechanisms. Due to inconclusive results, this thesis was unable to establish whether the threat of litigation can discipline managerial reporting practices and deter misreporting for the companies with substantial debt covenant incentives.