Earnings Management: Conceptual Framework and Research Developments

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Financial reports are prepared to ensure timely availability of reliable information regarding companies' state of affairs to its users. But when financial statements fail to meet the information expectations of the stakeholders due to lack of qualitative characteristics (ICAI, 2000) like understandability, relevance, reliability, comparability and faithful representation, it raises a question mark on the authenticity of financial reports by corporate houses. The absence of true and fair financial reporting indicates the presence of manipulation in accounting numbers, which can be in the form of fraud, creative accounting and earnings management. Earnings management is modifying the reported accounting figures by using the discretion provided by the accounting standards in such a way that there is no impact on the overall value of the firm. Earnings management is the first step which, if not paid attention to, gets aggravated and becomes fraud. The present paper approaches earnings management keeping research developments and the concepts related to earnings management in view.

Introduction

Accounting numbers are a record of transactions that occur in a business organization. Accounting information is crucial to all the stakeholders and its relevance varies from one stakeholder to another. Traditionally, accounting information has a dual role to play: informative and stewardship (Ronen, 1979). Informative role of accounting is meant for investors' prediction of future cash flows and risk assessment, whereas stewardship role induces a manager to act in the best interest of the shareholders. In the case of stewardship, managers look after the property (organization) of the owners and are liable (accountable) for their actions to the owners. Managers fulfill the information need of the owners and other stakeholders in the form of financial reports. But personal motives, contractual incentives or organizational obligations may induce the managers to indulge in undesirable manipulation of books of accounts. In such a situation, the only option left with the owners is to demand

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accounting information in the form of financial reports. Manipulation is skillful alteration in accounts practiced by internal parties of an organization to mislead external parties in order to derive personal benefits. Earnings management is the initial form of manipulation. It is about modifying the reported figures using the discretion provided by the accounting standards in such a way that there is no impact on the overall value of the firm. Since the late 1960s, right from the very evolution of the idea to development of models for its identification, earnings management has been one of the most comprehensive focuses of research. Accounting researchers, academicians and regulators explored various contexts that lead to the creation of a body of literature that defined the concept of earnings management; what earnings management is; how it can be done; its consequences and the methods or models to identify it. But the dilemma is that the word "earnings management" in itself does not provide any particular denotation, and the reason behind this ambiguity is weak and inconsistent empirical and non-empirical research explanation in the available literature. Till date, it is not clearly defined whether earnings management is harmful or not. It is like an illusion; whatever is shown to the audience, they interpret it that way without knowing the idea behind it. There is a thin line of difference between fraud and earnings management. Fraud is one step ahead of earnings management. It can be said that fraud begins where earnings management ends and intentions play a major role in distinguishing the two. The present paper makes an addition to the prevailing literature on earnings management by presenting a distinctive outlook of earnings management by divulging its meaning, research developments, fundamental conditions and forms of earnings management.

Earnings management is altering the accounting figures within the framework of accounting standards. The accounting standards leave certain issues for managerial judgment or discretion in the light of the existing circumstances. These are the instances where the standards are silent or mention "as the accounting authority thinks fit". The available literature discusses earnings management in an extensive manner, which makes it clear that the meaning of earnings management has not only extended but has become more specific with research and time.

Davidson *et al*. (1987) (cited in Schipper, 1989) define managing earnings as accounting magic, i.e., "the process of taking deliberate steps within the constraints of Generally Accepted Accounting Principles (GAAP) to bring about a desired level of reported earnings." This argument does not provide any specific reason or form of earnings management but explains how it takes place. The study clearly outlines that earnings management is an intentional activity which is within the four walls of GAAP. Its ultimate objective is to alter the real earnings in predestined manner. Schipper (1989) discusses earnings management as disclosure management "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain." "A minor extension of this definition would encompass 'real' earnings management, accomplished by timing investment or financing decisions to alter reported earnings or some subset of it." The definition provides base for the differentiation in accrual earnings management and real earnings management. Real earnings management is one in which real actions are taken to deviate normal business decisions like expanding sales, supplementing the operating margin, overproducing or underproducing, etc. These activities are directly related to firm's cash flows. On the other hand, accrual-based earnings management

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is one in which figures that do not present cash flow generation are altered without taking any real time action like changing accounting method and managing provisions and reserves. It is also referred to as paper-based earnings management. Apart from it, Schipper (1989) describes it as an external disclosure phenomenon.

The motives or intentions behind earnings management were outlined by Healy and Wahlen (1999) who were of the view that "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." This definition is illustrated as best by Ronen and Yaari (2008) because it presents the manager's intentions by using words like 'mislead' and 'influence'. These words pinpoint towards opportunistic intention behind management of earnings. It further gives a base for discussion whether the managerial intentions are really opportunistic or not. Opportunistic intention is about manager's use of available discretion to mislead the outsiders by reporting unreliable information. The term 'opportunism' was first used by Watts and Zimmerman (1978) describing the behavior of managers to influence reported earnings so as to have favorable contractual benefits and gains. This kind of behavior results in advantage to contracting party and management. Dye (1988) and Fudenberg and Tirole (1995) illustrate that risk-averse managers engaged in earnings management have no access to capital market. Scott (1997) called it 'unexpected' managerial discretion leading to net loss in shareholders' wealth. As mentioned in positive accounting theory, it is used by managers to shift maximum benefits from owners and by owners to shift the benefits from external parties. Ronen and Sadan (1981) and Holthausen and Leftwich (1983) clearly state signaling as another intention of earnings management. Informative intention is about providing the firm's hidden information by managers as a signal of their future expectations. As mentioned by Beneish (2001), managers reveal their personal expectations about future cash flows of the firm through accounting numbers. The term signaling approach was first used by Holthausen and Leftwich in 1983. Researchers are of the view that with this approach managers are able to affect the stock prices by communicating insider information to the investors or potential investors. This results in better value relevance of financial reporting and enhances the investors' ability to predict the performance of the firm. Dye (1988) provides evidence that shareholders or owners demand earnings management so as to have high price benefit on selling the shares and for reduction of cost of capital. This view is also supported by Beidleman (1973) and Easton and Zmijewski (1989).

Subsequently in the year 2005, Yaping articulated that "It is a deliberate step of management to bring reported earnings to a desired level by exercising the discretion accorded by accounting standards and corporate laws, and/or structuring activities in such a way that expected firm value is not affected negatively." This articulation differentiates earnings management from its counterparts by bringing it to light that earnings management has no impact on firm's value. He reaffirmed his viewpoint for a second time in his article (Yaping, 2006) making comparison of earnings management, creative accounting and earnings fraud. As per Yaping (2005), earnings manipulation is about altering the reported figures of financial statement, and earnings management, creative accounting and earnings fraud are its types (see Figure 1). Earnings

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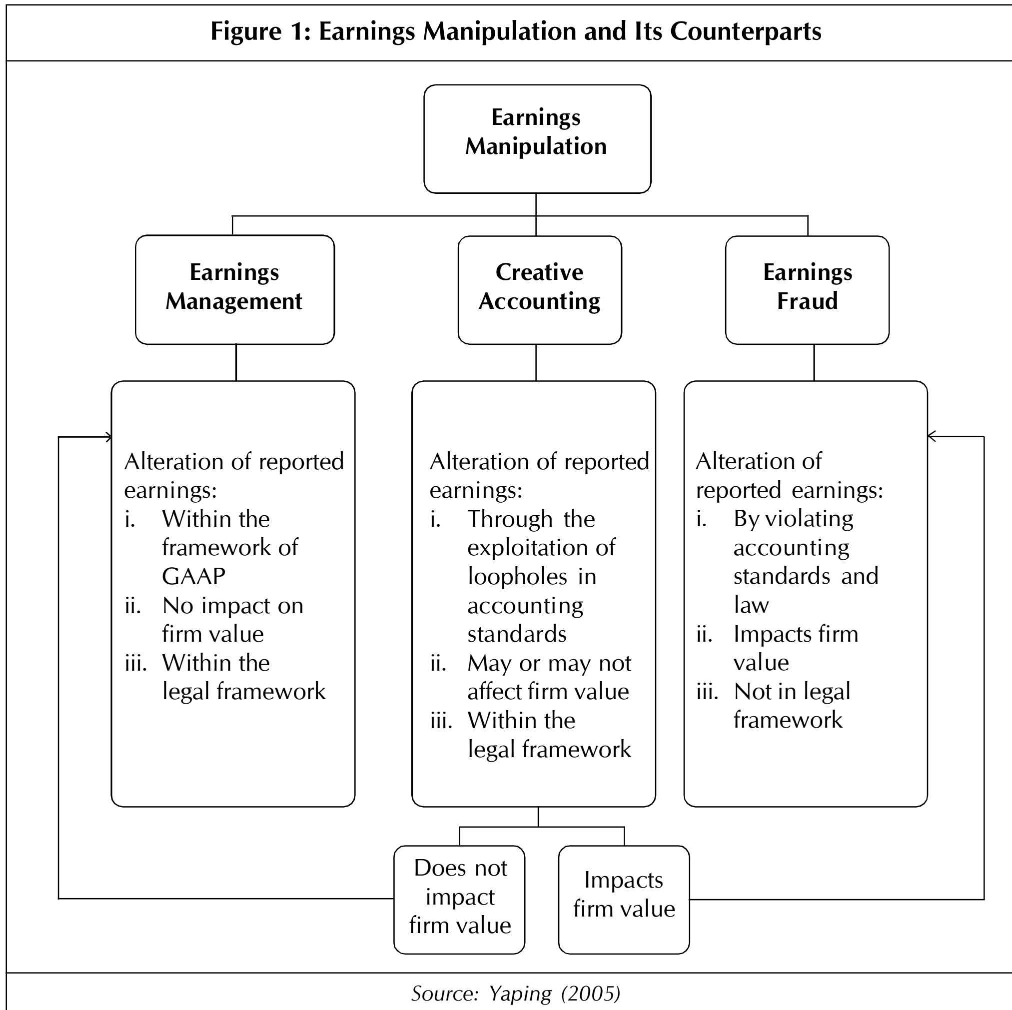
Figure 1: Earnings Manipulation and Its Counterparts



Source: Yaping (2005)

management is modifying the reported figures by using the discretion provided by the accounting standards in such a way that there is no impact on the overall value of the firm. Creative accounting is taking advantage of existing loopholes in the accounting standards and the issues about which there is no provision in accounting standards or law. Earnings fraud is changing the reported figures that are going to affect the value of firm. Earnings fraud is worst in all three as it is an illegal practice while earnings management is not. Creative accounting, on the other hand, is referred to as earnings management if it does not affect firm's value and as earnings fraud if it affects the value of the firm. On the basis of discussion, it can be concluded that earnings management is not fraud or creative accounting. It is the practice of achieving optimum firm value by the managers using accessible opportunities within the framework of accounting standards in the form of discretion.

Stages and Concept Development

Stage I: Pre-1980 – It was the period when earnings management research revolved around capital market issues. Earnings management was then viewed as impact of accounting changes

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on stock prices. Early studies in this area primarily focused on mechanistic hypothesis of accounting (Ball, 1972) which proposes a mechanical relation between stock prices and accounting earnings. It describes that the investors can be systematically misled by firms' accounting practice as investors' decisions are exclusively based on firms' financial reports. Changes in accounting earnings (northward or southward) leads to a corresponding change in stock return (northward or southward), irrespective of any change in the present value of future cash flows. Ball and Brown (1968) reported that only a fraction of information is available in the form of accounting reports to the stakeholders. According to Ball (1972) and Kaplan and Roll (1972), market cannot differentiate between accounting effects and real effects on reported earnings. Accounting effects refer to the effect of accounting choices available to managers and is consistent with mechanistic hypothesis which is also referred to as monopolistic hypothesis by Ball (1972). Contradictorily, efficient market hypothesis by Fama (1970) states that stock prices are unbiased and reflect all the available information in an efficient capital market. Therefore, the earnings management decision by the corporate managers would not significantly influence the stock prices and would not lead to abnormal profits or losses to an investor. Thus, efficient market hypothesis and mechanistic hypothesis are collectively known as competing hypothesis (Ball, 1972). Hines (1982) examined the usefulness of annual reports in an efficient market to earn excess returns. The results revealed that investors would not earn excess return in an information-efficient market. Concentrating on the consequences of the accounting choices on contracting and monitoring, Holthausen and Leftwich (1983) conclude that earnings management behavior is irrelevant to stock prices. They opined that managers have no reason to engage in earnings management in an efficient capital market. Conclusively, studies in this phase demonstrate that accounting choices have no major impact on the stock market behavior of an organization. Thus, it may be inferred that earnings management behavior has no influence on the stock prices of a company.

Stage II: 1980-2000 – This period has seen some of the best developments in the field of earnings management research and is known for its non-capital market focus. The ambiguity about involvement of companies in earnings management due to capital market motives led to the shift of focus to non-capital market incentives of earnings management. The "Positive Accounting Theory" (based on agency theory) by Watts and Zimmerman (1986) highlights the firm's internal incentives as an alternative to capital market theory. It is based on agency theory of Jensen and Meckling (1976). The positive accounting theory describes that, like any rational human being, managers and investors will choose an accounting practice for their own benefit if provided a choice. Scott (1997) referred to it as 'contracting theory'. This theory illustrates that working of an organization is based on contracts between a number of parties like employer and employee, management and owners, creditors and company, etc. and the main motive of firms is to reduce the contracting cost. Accounting choices (discretion) of a company should be used to reduce the contracting cost which would provide a base for efficient corporate governance. The three incentives identified during this era are compensation contracts, debt covenants and political costs that tempt managers to practice earnings management. Compensation contracts were of major focus during this period. As there was low concentration of managers in ownership of the company, the compensation of the managers

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was based on bonus and incentives. The studies conclude that managers shift the future earnings to present period to maximize their personal utility. Healy (1985), Gaver *et al*. (1995) and Holthausen and Larcker (1995) have empirically proved the role of manager's compensation contract in earnings management. Except for Healy (1985), all the studies conclude that managers decrease earnings to increase the future compensation. The difference in results existed due to the difference in Healy's experimental design (Holthausen and Larcker, 1995). Debt covenants are also an incentive for earnings management. The management is more likely to engage in earnings management when a firm is close to compromising debt contracts so as to avoid the possibility of technical default.

Managers use discretion to avoid violation of debt contracts which is also known as 'debt hypotheses'. Research in this field concentrated on the relation of earnings management with debt covenants and the impact of debt covenants on earnings management. To meet the accounting constraints mentioned in debt contract and to avoid the cost arising from violation of debt agreement are two main reasons for earnings management. Sweeney (1994) shows that income-increasing earnings management has been adopted by the first time debt violators in US during 1980-1989, whereas DeAngelo and Skinner (1994) find more firms above covenant violation threshold and managers go for earnings management to avoid default in covenants. Apart from compensation contract and debt covenants, government regulations and regulators have also attracted the attention of researchers in the form of political cost. Higher accounting figures may attract strict regulation like high taxes, and in such a situation, firms like to pursue income decreasing earnings management so as to avoid political cost (Rath and Sun, 2008). Jones (1991) in her study on import relief revealed that managers report lower earnings to become eligible for getting relief. Cahan (1992) also reported similar results in his study based on antitrust enquiry by regulators to check monopoly of a firm. Consistent with earlier studies, Han and Wang (1998) conclude that firms reduce their earnings for getting relaxation from restriction on increase in gasoline price. Watts and Zimmerman (1986) stated that owners provide managers with management compensation incentives to reduce the agency cost, thus motivating the managers to maximize shareholders' wealth. Acting conversely, managers manipulate the real performance of the firm for their personal benefits. Such similar opinion applies to debt covenants and regulations dealing with the conflict between managers, owners, creditors and regulators.

With time and better interpretation of contracting incentives, it has been inferred that earnings management is not mandatorily harmful as Scott (1997) mentioned that it may be a form of efficient contracting which refers to minimizing taxes, reducing high cost debt covenants and limiting opportunism.

Stage III: 2000 Onwards – This period is also known as contemporary capital market focus period (Sun and Rath, 2008) as the focus of earnings management research reverted to capital market incentives. Lakonishok *et al*. (1994) opined that at a given point of time, stock markets may be inefficient and investors may behave irrationally. As highlighted by Dechow and Skinner (2000), greater reliance of stock prices on accounting numbers, wider access to the capital market and existence of information asymmetry in stock markets are major reasons for

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this shift. They differentiated contractual incentives from capital market incentives. Public issues managers manage earnings before and during lock-in period. This gets reflected in the stock prices in the year following the offerings with underperformance of the stocks. Research by Rangan (1998), Teoh *et al*. (1998) (1998a) (1998b), Richardson (1998), Shette *et al*. (2016) produce evidences in support of earnings management around public issues. Teoh *et al*. (1998) (1998a) (1998b) in three different papers deeply elaborate the concept of immediate and long-term effect of earnings management during pre-issue and lock-in period in initial public offerings and seasoned public offerings. Rangan (1998) has studied it on quarterly basis and the results are consistent with Teoh. Richardson (1998), using analysts' prediction and bid and ask spread, found that increased information of asymmetry led to a corresponding increase in earnings management. All these studies exhibit the effect of earnings management on stock prices and performance of companies in the US. The results suggest that market participants are not able to see through earnings management or it may be possible that favorable role from analysts assists the companies to manage earnings. The findings of Sloan (1996) state that they exaggerate the presence of low quality earnings (attributed by accruals) and underestimate the presence of high quality earnings (composed of operating cash flows). Sloan (1996) and Xie (2001) marked that participants are misled by simple and transparent earnings management practice which a rational person can easily see through. Beneish (2001) opined that insider trading is another market incentive for earnings management. Managers act as informed traders and use insider's information to sell their holding around the period when market is bullish due to earnings management before specific events. Hence, it may be said that despite the market being efficient, managers who are in most advantageous position know the time to enter and exit the market.

Leuz *et al*. (2003) investigated over 8,616 non-financial firms across 31 countries for the period 1990 to 1999 and revealed that earnings management is high in less developed stock markets than developed ones. Research on earnings management also produces that firms opt for income increasing earnings management around mergers and acquisitions. Target companies do so for getting higher price and acquiring companies do so for showing strong financial position to maintain investors' confidence. Rahman and Abu Bakar (2003) examined the earnings of the acquirer firms for the period 1991 to 2000 and found that acquirers exercise upward earnings management prior to the acquisition year. This fact is reaffirmed by Ardekani *et al*. (2012) in Malaysian market. Rahman and Abu Bakar (2003) and Ardekani *et al*. (2012) established negative relationship between upward earnings management prior to acquisition announcement date and firms' performance subsequent to the acquisition date. While studying the impact of institutional investors on earnings management around merger, Njah and Jarboui (2013) found the presence of discretionary accruals in annual reports of absorbing firm even before merger. Iqbal and Strong (2010) investigate the impact of corporate governance on earnings management around UK rights issues using a sample of 100 rights issues over five years (1991-1995). The results depict that companies with high debt to equity ratio, lower proportion of non-executive directors and absence of large block owners are likely to manipulate earnings around rights issues. Earnings management in the context of corporate governance further adds to the existing literature. Rajpal (2012) concluded that an independent director

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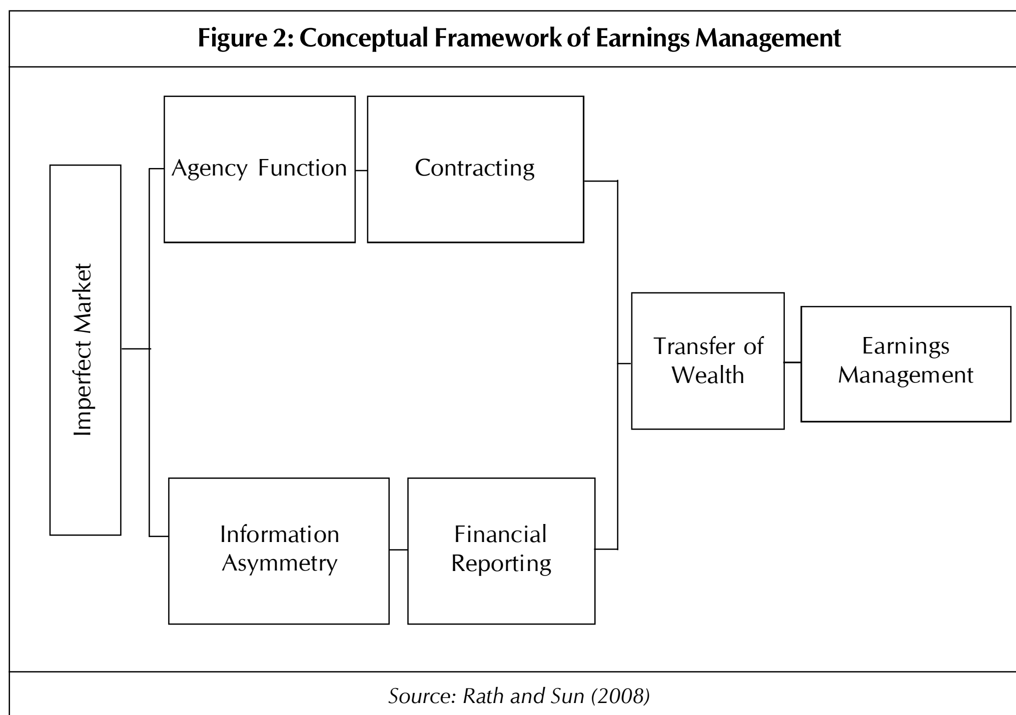
can keep a check on earnings management when he holds the position as a director in more than one company, but the same is not true in the case if he acquires the position as chairperson. He identified busyness as main reason for it. Fodio *et al*. (2013) studied the impact of audit committee characteristics on earnings management. The results conclude that the size of the audit committee is inversely related to earnings management, while independence of auditor is in direct proportion to earnings management.

Abbadi *et al*. (2016) demonstrated a negative effect on earnings management due to corporate governance variables in an examination of the effect of corporate governance quality on earnings management in Jordan. Consistent with previous studies, Mangala and Isha (2017) empirically showed the existence of earnings management in India and its relation with corporate governance variables like board characteristics and audit committee. The presence of earnings management cannot be denied in events like public issues, management buyouts, and mergers and acquisitions for meeting earnings thresholds. These events provide more opportunities to managers to indulge in earnings management.

Fundamental Conditions

Fundamental conditions are the circumstances which provide a base for the existence of earnings management. Lack of perfect or ideal market led to the persistence of such situations. Imperfect market facilitates the parties to indulge in preparation of financial reports to manage earnings. Researchers have uncovered two market imperfections that create field for earnings management, namely, agency cost and information asymmetry (Figure 2).

Figure 2: Conceptual Framework of Earnings Management



Source: Rath and Sun (2008)

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Agency Cost: This concept has been derived from agency theory developed by Jensen and Meckling (1976). It explains the relation between principal and agent, where the word principal represents owner and agent represents manager. Owners use contracting to motivate managers who otherwise have conflict of interest with them. Managers often have dual role of looking after their self-interest as well as organizational interest. Although the main purpose of contracting agreement is to give more weightage to mutual interest over self-interest, managers concentrate on maximizing their own wealth at the cost of owners (Deegan, 1996). Sun and Rath (2008) suggested that inflexibility in contract and inefficient contract binding are two main reasons for managers' earnings management behavior.

Watts and Zimmerman (1986) explain that managerial utility is in direct proportion to management compensation and stock price of a company. To increase their personal utility, managers use discretion in accounting choices that are most favorable to them. Hence, contracts which are designed to tackle agency conflicts themselves provide a gap for meeting self-interest on the part of managers and add to the cost of the owners.

Information Asymmetry: Corporate financial report aims to reduce the level of information asymmetry between managers and stakeholders. Information asymmetry is about difference in information available to the managers and parties to the financial statement. It is evident from the work of Dye (1988) and Schipper (1989) that earnings management is not possible without information asymmetry. Dye (1988) and Trueman and Titman (1988) describe that unawareness of claimholders or stakeholders regarding variance (fluctuation) in a company's economic earnings provides a reason to corporate managers to indulge in earnings management.

Richardson (1998) proves the association between earnings management and information asymmetry and opines that earnings management and information asymmetry are directly proportionate, i.e., increase in information asymmetry would directly lead to an increase in earnings management and vice versa. It is the information asymmetry that creates a base for transfer of wealth from shareholders to managers and from outside parties to shareholders. Richardson tested the theory of Dye (1988) and Trueman and Titman (1988) and found a positive association between information asymmetry and earnings management. He was of the view that internal monitoring and outside monitoring together can play a vital role in curtailing earnings management in an organization.

Forms of Earnings Management

Income Increasing Earnings Management: Management understates the cost and presents lower discretionary expenses or higher discretionary revenues so as to show growing performance of the firm. Managerial motive behind aggregate earnings management are to get benefit from contractual incentives, compensation agreements, insider trading and equity offerings (Beneish, 2001). Healy (1985) describes that managers do income increasing earnings management when they have performance binding bonus. Rangan's (1998) results are consistent with those of Healy (1985) in the context of earnings management around seasoned equity offerings. Managers practice income increasing earnings management before the public

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issue which subsequently results in poor stock performance. Teoh *et al*. (1998) also finds similar results for initial public offerings reconfirming the managerial behavior of income increasing earnings management.

Income Decreasing Earnings Management: Managers overvalue their discretionary expenses or understate incomes so as to get the benefit in future. It is done for showing growth trends in future and for avoiding regulatory actions or cost. Research literature provides evidence that managers decrease earnings in short run to get regulated outcome in future. Works by Liberty and Zimmerman (1986) and DeAngelo (1986) presents the results of decreasing earnings management in usage of contracting incentives so as to have increased compensation in future.

Jones (1991) also presents the results of negative discretionary accruals in the case of import relief investigation in the US. She is of the view that managers do so to get import relief. Consistent with earlier studies, Han and Wang (1998) conclude that companies practice income decreasing earnings management for getting relaxation from restrictions of increased oil prices. Shivkumar (2000) suggests the presence of negative discretionary accruals in his research in companies coming out with public issues in UK. But power of test in studies revealing income decreasing earnings management is considerably low because of small sample and results are not significant.

Conclusion

The basic purpose of corporate financial reports is to provide information about financial performance and position of a company to a wide array of stakeholders, namely, shareholders, creditors, investors and regulators. The matter of joint interest to all these parties is the quality of financial reports which assist users in taking rational decisions with quality characteristics like relevance, understandability, reliability, comparability and faithful representation. But the money making philosophy of the fast moving business world motivates insiders, particularly managers, to prepare and present false or misrepresented financial statements. This can be done in the form of creative accounting, fraud or earnings management. Earnings management is the initial level of manipulation. It is the presentation of dishonest and unobjective picture of a company's financials without influencing the overall value of firm for a particular period. It is not about violating the accounting standards but about violating the spirit behind the accounting standards. It is done with misinterpreting the accounting standards/rules, thus violating the spirit behind the standard. An attempt is made in this paper to differentiate earnings management from its counterparts so as to have a better understanding of the concept. It is concluded that earnings management is the very first step to manipulate the financial reports and needs to be carefully monitored. The paper further discloses the development of concept from accounting choices to earnings management. The early research in this area discussed the relation of accounting choices with stock prices. These studies failed to demonstrate any significant relation between them in an efficient capital market. Studies subsequent to the 1980s derived the incentives used by managers for practicing accounting choices in self-interest. The research unearthed contractual and capital market incentives that drive managers to falsify the reported earnings. Contractual incentives are the result of managerial or organizational

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contracts like debt covenants or management compensation. These incentives motivate managers to increase their personal compensation like bonus. Capital market incentives provide opportunity to manage earnings due to persistence of information asymmetry during capital market events like public issue, mergers and management buyouts. But tightened reporting environment due to regulatory policies and pursuance of corporate governance made it difficult for managers to have such manipulations. Corporate governance variables like board characteristics and audit committee characteristics negatively affect earnings management. But the impact level varies from country to country due to implementation issues. In a developing country like India, where legislation is more in books than a reality, it is a challenge to implement regulatory norms in a way it should be. Loopholes in the accounting system, market conditions and policy implementation issues prepare the groundwork for managers to indulge in earnings management. There is ample space for research in this field. The impact of regulatory policies on earnings management, earnings management in the context of varied accounting standards like International Financial Reporting Standards (IFRS) and insider trading as a motive for earnings management can be the potential research areas in this field so as to provide more transparent and reliable corporate financial reports to the ultimate users.■

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