A REVIEW OF MOTIVES AND TECHNIQUES AND THEIR CONSEQUENCES IN EARNINGS MANAGEMENT

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ABSTRACT

This study focuses on the concept of earnings management and its motives, techniques, and consequences. A review of literature shows that earnings management is an attempt by managers to alter financial reports either for their private benefits or for the benefit of stockholders. Companies have legitimate and illegitimate ways of engaging in earnings management. An approach is considered legitimate if it complies with Generally Accepted Accounting Principles (GAAP) and thoroughly discloses financial statements. By contrast, an approach is illegitimate if it violates GAAP. This study reviews literature on the incentives of managers and their techniques on earnings management. The types and extent of earnings management are dependent of several factors, such as personal incentives, stock market incentives, and regulatory motives. This study concludes that the consequence of earnings management is detrimental to firms when firm managers use earnings management opportunistically for their self-interests rather than for the benefit of stockholders. Earnings management is considered ethical and beneficial when managers exercise discretion over earnings within GAAP and in an attempt to safeguard shareholders’ interests. Moreover, earnings management is ethical and beneficial in communicating private information to stockholders and the public.

Keywords: earnings management, motives, techniques, consequences

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Introduction

This study is a secondary source that provides a comprehensive overview of existing literature on the motives and techniques of earnings management and their consequences. This study addresses the following questions: What is earnings management? Why is earnings management adopted? What are the techniques and consequences of earnings management?

Literature illustrates two inconsistent conceptions of earnings management. On the one hand, earnings management is defined as a purposeful intervention of managers in the financial reporting process with intent to obtain private gains; such an intent is only unethical, but is also a form of fraud in financial reporting fraud (Healy, 1999; Beneish, 2001; Nelson, Elliott & Tarpley, 2002; Rosner, 2003; Razaur, 2006; Chia, Lapsley & Lee, 2007; Fang & Huang, 2015).

On the other hand, a number of researchers defined earnings management as releasable form of decision making and reporting in legal management that intends to achieve stable and predictable financial results (Watts & Zimmerman, 1990; Holthausen & Larcker, 1995; Subramanyam, 1996; Dechow & Skinner, 2000; Davis-Friday & Frecka, 2002; Johnson & Fleischman, 2012; Tang & Elson, 2015). Existing definitions suggest that earnings management can be fraudulent or non-fraudulent.

This study suggests a new approach in determining the difference between earnings management and fraud. This new approach calls for an independent committee composed of independent directors or external auditors who determine the motives of managers. These motives are the main drivers of fraudulent acts and are the outcomes of earnings management. Earnings management is fraudulent act when it is used opportunistically by firm managers for their self-interest at the expense of stockholders. This issue is discussed in management compensation theory and is referred to as bonus plan hypothesis; this theory contends that managers are motivated to use earnings management to improve compensation (Rahman, Moniruzzaman & Sharif, 2013). Earnings management is non-fraudulent when managers exercise discretion over earnings within the Generally Accepted Accounting Principles (GAAP) to safeguard the interests of shareholders. Firms may manage earnings to smoothen out inter-temporal aspects in reported earnings.
and deliver stable and predictable earnings stream that benefits the interests of current shareholders and potential investors. According to Habib and Hossain (2011), “smoothed earnings are perceived as being less risky by investors, and earnings prediction is perceived as easier when current and immediate past reported earnings are smoothed.” This finding suggests that identifying the motives of managers for engaging in earnings management and the consequence of their engagement might help determine the difference between earnings management and fraud in financial reporting.

Managers use accrual-based techniques in earnings management to provide flexibility in accounting rules and meet earnings targets. Accruals management affects future cash flows because of its reverse effect over time. Accrual management is not the only tool available to managers. If the results of firm operations are not sufficient in meeting expectations, managers may structure actual transactions to achieve desired accounting results; such an approach is referred to as “real activities management” (Li & Rider, 2009). Real activities management can reduce future cash flows and firm value (Roychowdhury, 2006; Filip & Jeanjean, 2015; Ferentinou & Anagnostopoulou, 2016). According to Peasnell, Pope, and Young (2000), “the use of sub-optimal operating strategies is more costly than the reversals from accruals and, consequently a more aggressive form of earnings management and thus, a last resource for management.” A review of literature on earnings management reveals that managers are shifting away from accrual-based techniques earnings management to real transaction-based techniques. This shift is may be caused by the restriction of accrual manipulation in an environment with high--quality corporate regulation and national-level agency mechanisms (Cohen & Dey, 2008). Despite the increasing interest and importance of real transaction-based earnings management, evidence on the measurement of real activities management remains limited. Prior studies on real transaction-based earnings management mainly used the measures adopted by Roychowdhury (2006); however, Cohen and Pandit (2015) recently demonstrated that the measures used by Roychowdhury (2006) are severely misspecified because their Type I error rates significantly differ from nominal significance levels.

Further research should be conducted on real transaction-based techniques in earnings management. Future research can promote understanding of why managers prefer to manipulate real activities to accruals despite the cost of
manipulation. The mitigating effect of corporate governance as a control mechanism of real transaction-based techniques in earnings management should also be explored.

The rest of this study proceeds as follows. The next section discusses earnings managements and is followed by the following question: What are motives of managers for earnings management? The succeeding section briefly provides an overview and lists the most applied techniques in earnings management. The final section summarizes prior findings on the consequences of earnings management.

WHAT IS EARNINGS MANAGEMENT?

Managers issue financial statements to keep their stakeholders informed about the performance and disposition of their company. Information in financial statements helps shareholders distinguish between the best-performing firms and poor performers. Managers use managerial discretion offered by standard setters (IASB & FASB) to improving the informativeness and effectiveness of financial statements as a means of communicating with current and potential investors. According to Hazarika and Karpoff (2012), an important effect of managerial discretion is to reveal additional information. Despite this positive side of managerial discretion, discretion could lead to the manipulation of earnings by management. Managers may act with motivation for short-term self-interest and use the flexibility of accounting standards to manage earnings. Flexible accounting rules offer managers with several choices; managers may then perform actions and make decisions during the preparation of financial reports that are against the interests of shareholders (Tsitinidis & Duru 2013).

Existing literature does not offer a single definition of “earnings management.” According to Healy (1999) “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 practices.” Schipper (1989) defined earnings management as “a purposeful intervention in the external financial reporting process with the intent of obtaining some
private gain.” Earnings management is also defined as non-neutral financial reporting that is illegal and unethical (Nelson, Elliott & Tarpley, 2002). Debate continues on whether or not earnings management is illegal.

Companies have legitimate and illegitimate ways of managing earnings to achieve specific objectives. These approaches raise the following question: What is the boundary between the legitimate efforts of management to meet expectations and illegitimate activities that could be viewed as manipulative and fraudulent acts of earnings management?

Earnings management covers several legal and illegal management activities that may affect the earnings of an entity. Virtually all managerial actions have potential effects on earnings. Such an effect increases difficulty in distinguishing between legitimate and illegitimate managerial actions in earnings management. A review of literature showed mixed results on whether or not earnings management is legitimate. A number of studies argued that earnings management is acceptable because it is within the boundaries of GAAP (Watts & Zimmerman, 1990; Subramanyam, 1996; Peasnell, Pope & Young, 2000; Davis-Friday & Frecka, 2002; Barton, Kirk, Reppenhagen & Thayer, 2010). Existing studies argued that corporate managers have discretion in GAAP that allows managers to choose occasions that are part of operating a well-managed business and delivering value to shareholders. Earnings management is a legal management decision making effort made in an attempt to achieve stable financial results. Earnings management should not be confused with illegal activities performed to manipulate financial statements and report results that do not reflect economic reality. These types of activities are referred to as an act of “cooking the books” or committing financial fraud that involves misrepresentation of financial results.

Stolowy and Breton (2004) stated that earnings management differs from financial fraud if the former is covered by GAAP. Earnings management is the process of taking deliberate actions within the constraints of GAAP to achieve a desired level of reported earnings (Koumanakos & Siriopoulos, 2005; Guan & Wright, 2005). Financial fraud is defined by the National Association of Certified Fraud Examiner as “the intentional deliberate misstatement or omission of material facts, or accounting data, which is misleading and, when considered with all the information made available,
would cause the reader to change of alter his or her judgment or decision” (National Association of Certified Fraud Examiners, 1993). In line with this definition, Alan (2010) introduced three elements to recognize illegitimate managerial actions or financial fraud: “material false statement with the intent to deceive, a proof that the victim depended on the false statement, and damages occurred as a result of victim’s reliance on those false statements.”

Dechow and Skinner (2000) distinguished earnings management decisions that are fraudulent from those that comprise aggressive but acceptable ways in which managers exercise their accounting discretion. Figure 1 is an adaptation of their presentation.

Figure 1: Distinction between Fraud and Earnings Management

<table>
<thead>
<tr>
<th>CLASSIFICATION</th>
<th>ACCOUNTING CHOICES WITHIN GAAP</th>
<th>“REAL” CASH FLOW CHOICES</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Conservative”</td>
<td>Overly aggressive recognition of provisions or reserves</td>
<td>Delaying sales</td>
</tr>
<tr>
<td>Accounting</td>
<td>Overvaluation of acquired in-process R&amp;D in purchase</td>
<td>Accelerating R&amp;D or advertising expenditures</td>
</tr>
<tr>
<td></td>
<td>Acquisitions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Overstatement of restructuring charges and asset write-offs</td>
<td></td>
</tr>
<tr>
<td>“Neutral”</td>
<td>Earnings that result from a neutral operation of the process</td>
<td></td>
</tr>
<tr>
<td>Earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>“Aggressive”</td>
<td>Understatement of the provisions for bad debts</td>
<td>Postponing R&amp;D or advertising expenditures</td>
</tr>
<tr>
<td>Accounting</td>
<td>Drawing down provisions or reserves in an overly aggressive manner</td>
<td>Accelerating sales</td>
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<td></td>
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<tr>
<td>ACCOUNTING CHOICES</td>
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<tr>
<td>THAT VIOLATE GAAP</td>
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<tr>
<td>“Fraudulent”</td>
<td>Recording sales before they are realized</td>
<td></td>
</tr>
<tr>
<td>Accounting</td>
<td>Recording fictitious sales</td>
<td></td>
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<tr>
<td></td>
<td>Backdating sales invoices</td>
<td></td>
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<tr>
<td></td>
<td>Overstating inventory by recording fictitious inventory</td>
<td></td>
</tr>
</tbody>
</table>

*Source: Adapted from Dechow and Skinner (2000)*
Prior findings suggest that the deliberate actions of management to achieve a desired level of reported earnings are considered acceptable and legitimate if they are within the constraints of GAAP. The positive and negative effects of these acts on earnings should be disclosed in the notes of their financial statement. By contrast, aggressive approaches with the intent to deceive or misuse the resources or assets of an organization through deferral of expense recognition, premature revenue recognition, and recognition and measurement abuse are considered financially fraudulent and illegitimate.

This study recognizes the difficulty of distinguishing rational responses to economic circumstances by legitimately exercising accounting discretion and opportunistic earnings management without identifying managerial incentives to manage earnings. This difficulty facilitated research on managers’ incentives, which will be discussed in the following section.

WHAT ARE THE MOTIVES OF MANAGERS FOR EARNINGS MANAGEMENT?

Existing studies show that managers with different incentives engage in earnings management. Prior studies identified different categories of incentives, such as management compensation, contract motivations, income-smoothing motivation, meeting or beating the earnings expectations of analysts, avoiding debt covenant violation, regulatory incentives, and earnings management performed to avoid financial distress.

Motivations of Management–Compensation Contract

Managers with earnings-based compensation contracts tend to adopt income-increasing accounting to increase earnings (Healy, 1999). When earnings drop below the lower bound or rise above the upper bound designated by the bonus plan, managers may be inclined to select income-decreasing accounting methods. This issue is discussed in two theories. Opportunist theory assumes that managers act with short-term self-interest motivation and use loopholes such as the flexibility of accounting standards to manage earnings (Degeorge & Ding, 2013). Management compensation theory, which is also known as the bonus plan hypothesis, contends that managers are motivated to use earnings management to improve compensation...
because management bonuses are often tied to firm earnings (Rahman, Moniruzzaman & Sharif, 2013). In line with these theories, Chan and Chen (2012) stated that managers are keen on maintaining earnings growth because of their effects on stock prices and because their compensations are often tied to firm earnings. Given this findings, earnings may not fully reflect the long-term implications of recent executive decisions.

**Income-Smoothing Incentives**

Income smoothing is a technique in accounting to level out net income fluctuations from one period to the next. According to Fudenberg and Tirole (1995), “income smoothing is the process of manipulating the time profile of earnings or earnings reports to make the reported income stream less variable, while not increasing reported earnings over the long run.” Similarly, Beidleman (1973) defined income smoothing as “the intentional dampening of fluctuation about some level of earnings that is currently considered to be normal for a firm.” Investors are more willing to pay a premium for stocks with stable and predictable earnings streams than for stocks with earnings that are subject to extreme and unexpected fluctuations.

Managers make discretionary accounting choices in an attempt to smoothen reported earnings around expected targets (Smith, 1993; Ronen & Tzur, 2006). Prior studies presented several reasons for earnings smoothing. First, they assume that poor performance may result in management dismissal. Thus, in an attempt to avoid dismissal when future performance is expected to be “poor,” managers shift current earnings to the future and vice versa (Fudenberg & Tirole, 1995). Second, managers also smoothen earnings to reduce the perceived earnings volatility of a firm and to present sustainable earnings that may lead to high stock prices (Thomas & Zhang, 2002; Francis & LaFond, 2004).

**Meeting or Beating the Earnings Expectations of Analysts**

Meeting or beating the earnings expectations of analysts is a success indicator for any company. On the one hand, investors reward firms for meeting market expectations at earnings announcement. On the other hand, missed expectations may lead to significant price declines and even loss of bonuses for chief executive officers and executive jobs (Koh, Matsumoto
Given these implications, meeting the expectations of analysts may be a fundamental earnings target for firms and may provide managers with strong incentives to use their discretion over reported earnings.

Firms influenced by investor expectations may be inclined to inject pessimism or optimism into their estimates or alternatively use earnings management (Lin, 2006; Iatridis & Kadorinis 2009). Levitt (1998, September 28, speech), a former Chairman of the SEC, noted that:

“… While the problem of earnings management is not new, it has swelled in a market that is unforgiving of companies that miss their estimates…. I recently read of one major U.S. Company that failed to meet its so-called number by one penny, and lost more than six percent of its stock value in one day …”

Companies should meet or surpass the earnings forecasts of analysts to preserve and reinforce their financial status, image, and reputation. Firms may be inclined to use earnings management to achieve this objective.

Avoiding the Violation of Debt Covenant

Debt covenants are contracts between lenders and borrowers that illustrate the way a company manages its finances while being indebted to the lenders. These covenants are most often represented in terms of financial ratios, such as debt service coverage ratio (DSCR), earnings before interest, taxes, depreciation, amortization, debt-to-equity, interest coverage, debt-to-tangible, and others. These ratios are regularly tested by lenders (mainly by the banks) during the term of debt (DeFond & Jiambalvo, 1994). For example, DSCR determines the amount of income one receives to service debt. Banks typically require a ratio greater than one-to-one. This requirement means demands more than one dollar in income for every dollar of debt. Failure to meet the covenants can result in stiff penalties.

According to positive accounting theory, firms that are approaching covenant violations make income-increasing choices to loosen debt constraints and avoid violation of debt covenant (Watts & Zimmerman, 1990). Violation of debt covenants illustrates instability in accounting measures, such as
earnings and liquidity and risk of default (DeFond & Jiambalvo, 1994). Violation of debt covenant also provides a negative signal of corporate performance, creditability, and managers’ reputation (Holthausen & Larcke, 1995). To avoid these undesirable effects and to abide by their debt covenants, managers may be motivated to manage their accounting numbers. However, other studies suggested otherwise. Healy and Palepu (1990) and DeAngelo, DeAngelo, and Skinner (1994) did not find evidence that firms manipulate earnings prior to violations of debt covenant.

**Regulatory Motivations**

Regulatory incentives are used to manage earnings when reported earnings influence the actions of regulators or government officials. Earnings management may help managers influence the actions of regulators or government officials, thereby minimizing political scrutiny and the effects of regulation (Scott & Jackson, 2013). For example, some industries such as insurance, banking, and utility industries, are monitored for compliance with regulations linked to accounting figures and ratios. These industries are often subject to requirements to ensure that they have sufficient assets or capital to meet their financial obligations (Rahman, Moniruzzaman, & Sharif, 2013). These regulations may motivate managers to use earnings management to meet requirements.

**Earnings Management as a Means of Avoiding Financial Distress**

Firms may also manage accounting numbers to avoid or postpone financial distress. Financial distress is a condition where a company cannot meet or has difficulty in paying off its financial obligations to its creditors (Wruck, 1990). Financial distress is usually associated with direct and indirect costs such as expensive financing, opportunity costs of projects, and ultimately bankruptcy. Thus, when companies face financial distress, executives will intentionally package the financial statement to hide the actual financial position of their companies (Garcia, Osma & Neophytou, 2009).

Managers of distressed firms have low morale and high stress caused by increased chances of bankruptcy, which will motivate them to engage in earnings management to ensure that their reported earnings meet targets and
thereby postpone bankruptcy (Rosner, 2003). Saleh and Iskandar (2005) argued that managers of distressed firms manipulate earnings in an attempt to ride out a temporary bad period. In line with this argument, Rosner (2003) investigated accrual manipulation on a sample of 293 failed US companies; this study found that firms manipulate earnings upward through accruals in pre-bankruptcy non-going concern years. Similarly, Cabán-García (2009) stated that executives involved in distressed situations manage their earnings upward in two ways: (1) through accounting (accruals) manipulation and (2) by implementing real operating management that deviates from normal practice.

WHAT ARE THE TECHNIQUES FOR EARNINGS MANAGEMENT?

The possibility of managerial intervention in the reporting process can occur through accruals and operational decisions. Accruals are the difference between net income and cash flows. For example, selling goods to others on credit creates an accrual of revenue. Firms can increase or decrease income by creating accruals. These accruals are often referred to as non-discretionary accruals, but they are an area of concern. Discretionary accruals are manufactured to manipulate earnings. For example, discretionary accruals can be altered by increasing or decreasing the estimates of bad debt reserves, warranty costs, and inventory write-downs. Healy (1999) described accruals management as the use of managerial judgment in financial reporting.

Companies can utilize the flexibility allowed in GAAP to manage reported earnings without changing underlying (past) cash flows. For instance, managers cannot measure revenue without estimating the time of payment of customers, the number of customers who will not pay, the number of customers who will return goods for refund, and costs to the seller for the fulfillment of warranty or maintenance promises or under-provisioned bad debt expenses and delayed asset write-offs.

A firm might manage the levels of discretionary accrual accounts (such as accounts receivables, accounts payable, inventory, accrued liabilities, deferred revenue, and prepaid expenses) to reach a desired income. For example, a manager reports a cash expenditure of $10,000 on a marketing
campaign as an asset called “deferred subscriber acquisition cost” instead of an expense. This reporting will not be considered a legal violation of applicable accounting and disclosure rules. This accounting decision is made to boost the bottom line of the division by $10,000. However, this accrual item results in expenditures in future periods thereby reversing the effect of beneficial income in the current period. If an over-accrual of $10,000 of revenue existed in 2013, the revenue would have decreased by $10,000 in 2014. The reverse effect of accruals management is completely predictable over time.

Demerjian and Lewis-Western (2015) indicated several reasons for practicing accruals management despite reversal of the nature of accruals. First, accruals management is used to manage upward or downward income. Any additional effect on other financial statements, such as the effect on assets and liabilities, is viewed by the manager as secondary or irrelevant. Second, accrual-based techniques in earnings management are performed easily because managers adjust assumptions and estimates within the accounting system and do not require third parties. Third, accruals management is not costly compared with the manipulation of real activities. Engineering real transactions, such as the production of sales, is complex and require significant planning. These approaches often require raising new long-term capital in the form of loans or equity (Roychowdhury, 2006).

Recent studies (e.g., Cohen, Dey & Lys, 2008; Cupertino, Martinez, & da Costa, 2015) showed a switch from accrual to real earnings management after the introduction of the Sarbanes–Oxley Act of 2002 (SOX). SOX is a legislation passed by the U.S. Congress to protect shareholders and the general public from accounting errors and fraudulent practices and to improve the accuracy of corporate disclosures. This Acts was implemented because real earnings management does not tail the cost and risk of GAAP violation or scrutiny by auditors, especially in a heightened regulatory environment (Li, Rider & Moore, 2009). Management of real activities may be indistinguishable from optimal business decisions and therefore difficult to detect, but the costs involved in such activities can be economically significant to the firm.

In contrast to accrual manipulation techniques where managers adjust assumptions and estimates within the accounting system, real activities
management is accomplished by altering the firm’s underlying operations. Existing literature does not offer a single accepted definition of “real activities management.” Shipper (1989) was the first to argue the concept of real activities management, which is “accomplished by timing investment or financing decisions to alter reported earnings or some subset of it.” Janin (2000) described the real transaction-based earnings management as business activities with a direct influence on future operating cash flows. According to Ewert and Wagenhofer (2005), “real activities management occurs when managers changes the timing or structuring of real business transactions to alter earnings that have a direct impact on operating cash-flows.” Roychowdhury (2006) defined real activities management as “departures from normal operational practices, motivated by managers desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations.” Sellami (2015) described real activities management as “change on the timing or structuring of management decision (real business decisions related to the operating, investing or financing activities), that have a direct impact on cash flows and thus in earnings, motivated by managers’ desire to mislead stakeholders about the real performance of the company.” These definitions seem to emphasize that real activities management is a deliberate action motivated by managers that can negatively affect financial reporting either through earnings numbers or accounting items.

Cohen, Pandit, Wasley, and Zach (2015) argued that real activities management is not always opportunistic. Their study demonstrated that economic shocks affect managerial decisions about the firm’s real activities in at least two ways. First, managers may engage in real earnings management by opportunistically altering real decisions to mask the effect of shock on the firm’s reported earnings in an attempt to continue reporting of high earnings. Alternatively, managers may alter real decisions as part of their rational response to shocks in to ensure that the reported earnings of a firm best reflect the shock’s effect on firm value. Overall, this study suggests the difficulty in distinguishing rational responses to economic circumstances through the legitimate exercise of accounting discretion and opportunistic earnings management without identifying managerial incentives to manage earnings.
The successful and widely used techniques in earnings management are categorized into seven sub-categorizes. This study briefly provides an overview and lists some of the most prevalent earnings management techniques in each sub-category.

**Big Bath Techniques**

“Big bath” technique is used when managers are required to report bad news (e.g., loss from substantial restructuring), making poor results look worse is an acceptable approach of avoiding possible earnings surprise in the future (Pourciau, 1993). Tokuga and Yamashita (2011) defined “big bath” as “the attempt to increase reported earnings in subsequent periods by charging items that may have a negative future impact to expenses in the current period, further worsening current period business results in an accounting period in which results are bad.”

Sometimes a company cannot avoid major irregular expenses, such as writing down assets, discontinuance of an operating division, or closing down an operating segment, and establishing restructuring reserves (Rahman, Moniruzzaman & Sharif, 2013). Considerable expenses are generally inevitable when these situations occur. Thus, earnings and stock prices will be negatively influenced by these events. Under such circumstances, a company may decide to “take a big bath” and leave all old baggage in an attempt to avoid a possible earnings surprise in the future (Yu, 2012). For example, Company A fails to meet the analysts’ earnings forecasts by $1,000 deficit in the current year. Thus, the inventory valued on the books at $2,000 per item is written down to $1,000 per item thereby resulting in a net loss of $1,000 per item in the current year. These write-downs have no financial impact. When a similar inventory is sold in later years for $1,500 per item, the company reports an income of $500 per item in the future period. This process takes an inventory loss and turns it into a profit.

**Cookie Jar Reserve Techniques**

“Cookie jar” is slang for a reserve of cash that is not disclosed in a company’s financial statement or listed as funds earmarked for a liability that does not currently exist. The term may be derived from the practice of a company of dipping into the “cookie jar” of reserves whenever convenient. Cookie
jar accounting is used to create cash reserves in good years to ensure that the money can be used to offset poor earnings in bad years. This practice involves smoothing reported earnings by taking reserves against losses during profitable periods and using reserves during unprofitable periods.

Management must estimate and record obligations that will be paid in the future as a result of events or transactions in the current fiscal year based on accruals (Rahman, Moniruzzaman, & Sharif, 2013). Given the uncertainty of the future, unpredictability surrounds the estimation process, which can be utilized by opportunistic managers to manage current and future earnings by overestimating expenses made during the current period. If and when actual expenses turn out to be lower than the estimates, the difference can be placed into the “cookie jar” to be used later when the company needs a boost in earnings to meet predictions.

Common areas where cookie jar reserves are created include estimating sales returns and allowances, estimating bad debt write-offs, estimating inventory write-downs, estimating warranty costs, estimating pension expenses, and estimating the percentage of completion for the long-term contracts.

“Big Bet on the Future” and “Flushing” the Investment Portfolio

When a company acquires another company, the former made a “big bet on the future.” Companies believe that acquisition is a good investment and they will earn a positive return on the investment. The big bet technique basically allows a firm to purchase a guaranteed boost in current of future earnings by acquiring another firm. GAAP regulations requires an acquisition to be reported as a purchase. However, Rahman, Moniruzzaman, and Sharif (2013) suggest that approach leaves two doors open for earnings management:

“First, writing off in-process research and development costs the company acquired. This technique allows a substantial portion of purchase price to be written off against the current earnings in the acquisition year. This means that future earnings will be higher than they would have been otherwise.
Second, integrating the earnings of acquired company into corporate consolidated earnings which can provides an automatic earnings boost if the subsidiary was purchased on favorable terms.”

Investments in the securities of other companies also offer an opportunity for managers to manage earnings. This technique is called “flushing” the investment portfolio. In this technique, executives manage earnings by timing the sales of securities that have gained or lost value (Rahman, Moniruzzaman & Sharif, 2013). For example, when a firm needs additional earnings, it can sell portfolio securities with unrealized gain. By contrast, when a firm intends to report low earnings, it can sell a security with unrealized loss. The gain or loss from selling securities will be reported in operating earnings in both scenarios.

**Write-off of Long-Term Operating Assets**

A company can temporarily boost its earnings by selling long-term assets with unrealized gain or loss. When the real earnings of a company cannot meet analyst expectations, managers would likely attempt to boost reported earnings to the expected level by selling assets. Conversely, when the real earnings of a company is higher than expectations, the company would attempt to drop reported earnings to the expected level by selling loss-making assets (Tariverdi & Teimoory, 2013). For example, a building owned by a company is reflected in the balance sheet at $50 million, but it is really worth $100 million. When the building is sold, the $50 million gain will enhance the current period’s earnings.

Herrmann and Inoue (2003) studied the possibility of earnings management through selling assets in Japanese companies. The results of the study showed a negative relation between income from asset sales and the current year’s performance; by contrast, the relation between income from asset sales and expected future performance is positive. Wang (2009) examined the association between earnings management and the sale of long-lived assets for firms listed in Taiwan. The findings showed that the manipulation of earnings by selling assets to avoid reporting losses is common in Taiwan.
Sale/Lease Back

Sale–leaseback transaction is another management strategy that may lead to earnings management. In a sale-leaseback transaction, a company sells an asset to a buyer and immediately leases the asset back from the buyer. Companies often enter into sale–leaseback transactions in an attempt to obtain cash financing (Whittaker, 2008).

Many sale–leaseback transactions are essentially financing arrangements that enable the seller–lessee to borrow money without classifying it as debt on the balance sheet (Tariverdi & Teimoory, 2013). For instance, the airline and hotel industries in the UK frequently use the technique over the last 10 years (Whittaker, 2008). For example, an airline firm (seller–lessee) sells its aircraft with a book value of $200 million to another company (buyer–lessor) and immediately leases the aircraft back for six years (the aircraft has a useful life of six years). According to the lease agreement, the seller–lessee is required to pay $40 million annually for six years. Obviously, the seller–lessee still owns the aircraft and still has the right to fully use the aircraft. The only element of the seller–lessee’s financial status that changed as a result of the transaction is the $200 million cash consideration and the incurred obligation to pay $240 million in cash over the life of the aircraft. This transaction should be viewed as a financing arrangement because its true substance is the exchange of cash and not the sale of the aircraft.

Shrink the Ship

Companies sometimes decide to repurchase (or buyback) their own share. Stock buyback allows companies to invest in their own company. However, this practice is banned in some countries. Countries such as the US and the UK allow a corporation to repurchase its own stock by distributing cash to existing shareholders in exchange for a part of the company’s outstanding equity. Some researchers argued that executives use this method (stock buyback) as a tool to improve earnings per share number (Grullon & Ikenberry, 2000; Brav & Graham, 2005; Hribar, Jenkins & Johnson, 2006).

Prior studies stated that companies use this technique to meet or beat the EPS forecast of analysts (Skinner & Sloan, 2002; Farrell & Unlu, 2014), build credibility and preserve their reputation with capital markets, and maintain or
increase stock prices (Graham, Harvey, & Rajgopal, 2005). Firms buyback their own stocks to improve their financial ratios because share repurchase programs reduce the number of shares outstanding. Thus, ratios tied to this measure, such as earnings per share (EPS) and price-to-earnings ratio (P/E), can be temporarily boosted (Hribar, Jenkins & Johnson, 2006). Stock buyback also increases firms’ return on assets (ROA) and return on equity (ROE) because of less outstanding equity and assets in repurchasing.

WHAT ARE THE CONSEQUENCES OF EARNINGS MANAGEMENT?

Public perception states that earnings management is detrimental to a firm, particularly after the recent scandals at Enron and Worldcom; these events generated a public perception that firm managers opportunistically use earnings management for their own private benefits rather than for the benefits of the stockholders (Jiraporn & Miller, 2008; Liu & Sun, 2015; Zhang & Tang, 2016). Consistent with the opportunistic perspective, several studies suggested that managers may manipulate earnings when their compensation is tied to the value of stock and option holdings (Bergstresser & Philippon, 2006), to avoid reporting losses and earning declines (Dechow & Skinner, 2000; Park & Park, 2004), or to avoid violations of the debt contract (Iatridis & Kadorinis, 2009).

Regardless of the managers’ incentives for accounting misstatements, misstated financial results might be harmful to the current and potential investors of companies. Earnings management can lead to direct costs on investors in the form of inefficient investments (McNichols & Stubben, 2008). Moreover, earnings management may reduce the credibility of accounting numbers thereby damaging the reputation of firms. Other scholars (e.g., Beneish, 2001; Chia, Lapsley & Lee, 2007; Perols & Lougee, 2011) pointed out that earnings management is not only an unethical behavior, but also a form of financial fraud that can severely damage firms.

However, other studies showed that earnings management is not a fraudulent act but an ethical and beneficial practice that enhances the value of information provided to the user of financial statements (Watts & Zimmerman, 1990; Subramanyam, 1996; Arya, Glover & Sunder,
understanding earnings management (2003). Jiraporn and Kim (2008) stated that earnings management does not provide private benefits to management and is not detrimental to firm value. Furthermore, firms manage their earnings mainly to meet analysts’ earnings forecasts and to reduce financing and tax costs rather than opportunistically increasing management’s compensation or equity stakes. Moreover, earnings management through real actions instead of accounting choices increase shareholders’ wealth rather than that of managers (Barton, Kirk, Reppenhagen & Thayer 2010). Hamm, Li, and Ng (2015) argued that earnings management in a less transparent disclosure regime will improve stock price and will not harm the reputation of reporting integrity, whereas earnings management in transparent disclosure regimes will harm stock price and the reputation of reporting integrity.

Literature suggests that earnings management can be viewed as either detrimental or beneficial. Earnings management is detrimental when firm managers opportunistically use such an approach for their own private benefits rather than for the benefits of the stockholders. By contrast, earnings management is ethical and beneficial when managers exercise discretion over earnings within GAAP and in an attempt to communicate private information to stockholders and the public.

CONCLUSION

Earnings management is an attempt by managers to alter financial reports either for their own private benefits or for the benefits of the stockholders. A review of literature showed that companies have legitimate and illegitimate ways of managing earnings to achieve specific objectives. A number of researchers argued that earnings management is a legal act and is completely different from fraud as long as it follows GAAP and is disclosed thoroughly through financial statements. The debate on earnings management and fraud will continue unless a proper way of differentiation is established. Hence, the current study suggests a new approach in determining the difference between earnings management and fraud. This new approach calls for an independent committee to determine the motives of managers, which are the main driver for all fraudulent acts. This new approach also considers the consequences of earnings management. Earnings management is a fraudulent act when it is used opportunistically by firm managers for their
self-interest at the expense of the stockholders. By contrast, it is ethical and beneficial when managers exercise discretion over earnings within GAAP and in an attempt to safeguard shareholder interests.

This study offers improved comprehension of motives and techniques in earnings management and their consequences. This study also outlines the phenomenon of real activities management, which has received limited research attention. Discussions and a variety of directions for future research are proposed in this study. This review showed that the concept of earnings management, particularly real activities management, remains a fertile ground for academic research.

REFERENCES


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