Earnings Management and Accounting Reporting Fraud: A Theoretical Comparative Approach

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Abstract

The term of earnings management is sometimes used in literature as a synonym for accounting reporting fraud. Thereby, this paper aims to review the existing literature to offer a better clarification to the primary characteristics and differentiation between earnings management and accounting reporting fraud. The results of other previous studies have been reviewed to demonstrate the results of this study using a number of alternatives available resources to the collection of the relevant literature. The findings demonstrate that the activities of manipulating financial information continue to prevail in the business environment worldwide, despite the fact that there are strict laws and regulations to prevent earnings management and fraud behaviour. Therefore, defining the motivation of managers manipulative behaviour can enable academics and regulators to establish a framework to distance between earnings management and fraud and to recognize fraudulent actions through attempting to pursue how managers act to achieve their objectives.

Keywords: *earnings management, financial reporting fraud, financial reporting*

1. Introduction

1.1 Background

Accounting statements provide an important source for information to a variety of interested users. It is concerned with the measurement and communication of economic information to decision makers (Watts & Zimmerman, 1986). Ideally, the information provided by accounting reports should serve as a useful source for a wide range of users such as investors and creditors to enables them to predict future firm's financial performance.

The responsibility for preparing and communicating financial information lies with the business entity's managers. In order to provide a true and fair view of firm's financial performance and its real economic circumstances, the flexibility of accounting standards provides managers an ability to use their inside knowledge of the firm's current state and business position to prepare the information (Spohr, 2005). Thus, managerial flexibility allows financial reports to reflect the underlying firm's business circumstances more accurately.

Despite the essential component of accounting information is earnings which used by financial information users to make decisions regarding the company, managers have both the ability and

incentives to modify earnings. However, when the information asymmetry between managers and stakeholders exists, managers are induced to use their discretion to manage earnings (Dechow & Skinner, 2000). This managers activity is used either to “mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcome that depend on reported accounting numbers” (Healy & Wahlen, 1999: p.368).

1.2 The problem

Given the term "mislead" in the definition of Healy and Wahlen (1999: p.368), the possibility that earning management can occur in order to make financial reporting more informative for users appears to be excluded. Perols and Lougee (2011) note that fraud has the same function as earnings management; however, fraud is outside Generally Accepted Accounting Principles (GAAP), while earnings management compliance with GAAP. Despite the fact that the most commonly used term in the literature for firms’ accounts adjustment is earnings management, the terminology related to this modification is not so clear (Stolowy & Breton, 2004). For example, Dechow and Skinner (2000) indicate that there is no clearly distinguish between what is “earnings management” and what is “accounting fraud”. The authors acknowledge that there is only a fine line between the two concepts and, in the case of aggressive accounting, it is difficult to differentiate between opportunistic earnings management and financial fraud without identifying the managerial intent to manipulate earnings. Reviewing the literature reveals that there is a massive debate on whether or not earnings management is another form of fraud. While several studies argue that there is nothing wrong with earnings management since it falls within GAAP Abdul Rashidah and Ali (2006); Jacob and Jorgensen (2007); Peasnell, Pope, and Young (2000b); Rangan (1998); Subramanyam (1996); Watts and Zimmerman (1986), others Beaudoin (2008); Beneish (2001); and Sun and Rath (2010) believe that earnings management is not only an unethical act, but also another form of accounting fraud. It is obviously that there is no consensus has been reached on the relation between earnings management and fraud, even though earnings management is compliance with GAAP, whereas fraud is the form of the violation of GAAP.

1.3 Objective

The discussion on this phenomenon will therefore continue until the appropriate technique is provided to differentiate between the two terms in order to define the distinction between them. The purpose of this study is to draw the attention to the issues of both earnings management and financial fraud. In particular, this study seeks to provide an overview of the extent literature and to synthesize academic evidence relating to the main differences between earnings control and financial fraud, which can contribute to understanding what can be done to prevent these activities in the future.

1.4 Contribution

Given that there is limited research on the earnings management and accounting fraud, this study may contribute to this limitation by addressing the factors that may help to distinguish between earnings management and fraud. In particular, an overview of the literature approach is used to

discuss the main considerations of earnings management and fraud in order to distinguish between the two aspects that may help to address some of the confusion regarding the overlap between financial performance and fraud.

This paper is organized as follows: First section provides the introduction; second section presented the literature review; third section addressed the methodology; fourth section provided the findings; fifth presented the conclusion, recommendation and future research; and lastly, the sixth section provides the limitations of this paper.

2. Literature review

2.1 Earnings Management Definition and Perspective

The review of the literature reveals that the terminology of financial reports modification is not clear. For instance, there are various terms such as manipulation, aggressive accounting, creative accounting, earnings management, and so forth, which are usually used in the literature quite synonymously (Atik, 2009). Even though, Stolowy and Breton (2004) use the term of accounts manipulations for all adjustments and discretionary entries made to the financial reports, the most widely used term in the literature for firms' accounting reports modification is earnings management.

Based on agency theory, managers are responsible for making decisions on behalf of the owners and the former must practise their duties in such a way as to increase the owners' wealth and to fulfil their expectations (Jensen & Meckling, 1976). However, the separation between owners and managers in modern corporations, together with the presence of information asymmetries within a firm, spawn the possibility of opportunistic behaviour by managers from those of the owners, and hence pursue self-interning objectives (the agency problem) (Prior, Surroca, & Tribó, 2008). Given that managers practice earnings management either to gain some private benefits at the expense of other stakeholders or to mislead shareholders about the firm's underlying financial performance (Healy & Wahlen, 1999), it has been acknowledge that earnings management is considered as a type of agency cost because managers look after their own interests by releasing financial reporting that do not reflect an accurate economic picture of the company (Prior et al., 2008).

There is a growing massive debate between academics, regulator and practitioners regarding the precise definition of earnings management. However, it has been defined in many deferent ways. For example, Healy and Wahlen (1999) state earnings management occurs when managers use judgement 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 the reported accounting numbers. Likewise, Zhou and Chen (2004) define earnings management as a purposeful intervention in the financial reporting process with the intent of obtaining some private gains. These definitions are in line with the opportunistic earnings management perspective, which in turn leads to mislead firm's stakeholders. Others, on the other hand, argued that earnings management might be practiced as a means for managers to enhance the financial reporting effectiveness. For example, Fields, Lys,

and Vincent (2001) illustrate that earnings management occurs when managers practice their discretion over accounting numbers, with or without restrictions. Such discretion can be either firm value maximising or opportunistic. In line with this view, Schipper (1989: p.29) defines earnings management as "disclosure management' in the sense of a purposeful intervention in the external financial reporting process, with a view to obtaining private gain for shareholders or managers". According to this view, there are there are two types of earnings management, opportunistic and informative. With this regard, Beneish (2001) state that there are two perspectives on earnings management exercise: the opportunistic "unethical" perspective which holds that managers seek to mislead stakeholders, and informative "ethical" perspective which is a means for managers to reveal (or signal) to stakeholders their private expectations regarding the firm's future cash flows. Furthermore, Parfet (2000) states that earnings management is not entirely a bad thing if reasonable and proper practices of it are used in a well-managed business and deliver value to shareholders.

Even though the previous studies may not have reached a consensus on the definition of earnings management, they either implicitly or explicitly shed light on common main manipulate earnings aspects. The First aspect is that earnings management practice is the deliberate actions to bring about a desired level of reported earnings. This behaviour is distinct from accidental errors, such as mistakenly entering incorrect numbers by the accountant.

The second aspect is that managers can manipulate earnings by two main channels: accounting choice and discretionary accruals. Mangers can choose accounting practices from accounting choice that provided by accounting standards for adjusting accounting numbers, for example, revenue recognition methods, inventory cost calculation (Sweeney, 1994), and research and development expenditure (Dechow & Sloan, 1991). Alternatively, firms' managers might use discretionary accruals estimates, for example, provisions for dubious accounts (McNichols & Wilson, 1988), provisions for obsolete inventories (Guidry, Leone, & Rock, 1999), and deferred tax assets (Bauman, Bauman, & Halsey, 2001). This approach has been known as accrual-based earnings management. Moreover, managers can, to some extent, alter the timing of real decisions such as recognition of revenues and expenses by, for example, accelerating recognised sales revenue via credit sales or delaying recognised losses by waiting to establish loss reserves. This technique is known as real earnings management.

2.2 Financial Reporting Fraud Definition and Perspective

Fraud has become increasingly prevalent in all forms in today's world, where dishonesty has spread to every aspect of life and that illegal conduct in businesses is rising dramatically (Repousis, Lois, & Veli, 2019). Such conducts have created significant problems for communities around the world as a whole. It has been reported that fraud is not a serious problem, but is also a growing problem in most countries around the world (ACFE, 2010). The scams that have recently been exposed, especially in the financial institution, may seem to prove the common wisdom that fraud is more likely to occur when times are "tough" (Repousis et al., 2019). This indicates that when managers are under pressure from shareholders and other stakeholders, so that might motivate them to commit fraud more than any other given time frame (Hakami & Rahmat, 2019). Usually, in unusual circumstances, such as the global financial crisis,

organizations face the risk of fraud due to the increased pressure on organizations in particular and economies in general. Under such conditions, committing fraud may aim to mitigate that pressure by reporting good results and growth (Hakami & Rahmat, 2019). Along the same lines, Albrecht, Albrecht, Albrecht, and Zimbelman (2011) indicate that fraud in financial reporting occurs because of pressures to meet internal and external financial targets, opportunities and rationalization. Otherwise, the perpetrator of fraud may not be motivated through pressure from shareholders and other stakeholders but by dishonesty and personal gain (for example, to protect bonus) (Ajekwe & Ibiamke, 2017). It can be indicated that accounting fraud may be conducted due to pressure during unusual circumstances and/ or to gain personal private benefits.

Due to the financial scandals of large corporations such as Enron, Lucent, WorldCom and Satyam, the need to identify financial reporting fraud has been increased in the last few decades (Sharma & Panigrahi, 2013). Despite the fact that the term "fraud" is used frequently, it is a board term with various potential meanings. Hence, there are various definitions of fraud in the literature. One of these definitions is suggested by Phua, Lee, Smith, and Gayler (2010) who defied fraud as "leading to the abuse of a profit organization's system without necessarily leading to direct legal consequences". Wang, Liao, Tsai, Hung, and Cybernetics (2006) formulated it as "a deliberate act that is contrary to law, rule, or policy with intent to obtain unauthorized financial benefit". While, Wang (2010) defined it as "intentional misstatements or omissions of amounts by deceiving users of financial statement, especially investors and creditors". Whereas, Zhou and Kapoor (2011) defined fraud as "the intentional use of illegal methods or practices for the purpose of obtaining financial gain". According to Yue, Wu, Wang, Li, and Chu (2007), accounting fraud is conducted through making falsified financial statements where the numbers are manipulated by, overstating assets, spurious entries related to sales and profit, misappropriation in taxes, or understating liabilities, debts, expenses or losses. Nickolas (2020) defined it as "….intentional manipulation of financial statements to create a false appearance of corporate financial health. Furthermore, it involves an employee, accountant, or the organization itself misleading investors and shareholders. A firm can falsify its financial statements by overstating its revenue, not recording expenses, and misstating assets and liabilities". It is also defined as "a deliberate and improper manipulation of the recording of data in financial statements in order to achieve an operating profit of the company and appear better than it actually is" (Sharma & Panigrahi, 2013).

Given the fact that the definition of fraud would be slightly different for each country, Wells (2009) indicates that in each case of fraud, four elements would exist: A material false statement, intent to deceive, reliance on the false statement by the victim, and damages as a result. Similarly, Lord and Gestiune (2011) states that the different countries define fraud by using a common set of three elements: 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. Fraud can be generally be defined as an intentional and illegal act carried out by the perpetrator to steal or misuse the victim organization's resources or assets and the perpetrator can hide his theft by concealing the true nature of the business transaction (Kassem, 2012).

On the basis of the common elements of the above definitions, fraud is an abstract term, associated with a set of elements, events, processes, facts and actions, influenced in bad faith, once or repeatedly, such that a consequence or all of the results violate one or all of the assessment criteria, regardless of whether damages or benefits of any kind are discovered (Ciocan, 2018). Moreover, Kassem (2012) states that fraud breaches the low or violates the regulatory framework. Financial fraud can take on various forms such as tax fraud, misappropriation of assets and financial reporting fraud. It also can be undertaken by people inside such as management or employees or outside the firms, for example, vendors or customers.

2.3 Earnings Management and Financial Reporting Fraud

There are two earnings management perspectives, as stated earlier, which are informative ethical behaviour and the opportunistic unethical behaviour perspectives. From the former perspective, managers engage in earnings management to reveal to stakeholders their private expectations of the firm's future cash flows to stakeholders (Beneish, 2001). Whereas, the latter suggests that managers manipulate earnings to either mislead stakeholders about the underlying economic performance of the company or to gain some private benefit at the expense of other stakeholders (Healy & Wahlen, 1999).

In line with an ethical earnings management perspective, some researchers indicate that earnings management is not a fraudulent act, but an ethical and legal practice that aims to enhance the value of information provided to financial statements users. For example, and Subramanyam (1996); Watts and Zimmerman (1986) indicate that earnings management is beneficial behaviour as it may enhance the information value of earnings. Earnings management has been seen as beneficial to users of financial reporting, especially where financial discretion is used to improve the information efficiency of reported earnings (Peasnell, Pope, & Young, 2000a). Davis- Friday and Frecka (2002) states that earnings management is viewed as a legal and ethical activity. Moreover, the study by Hunton, Libby, and Mazza (2006) finds that earnings management can improve stock price in less transparent disclosure regimes not damage the credibility for integrity, whereas it would harm stock price and reputation for integrity reporting in more transparent disclosure regimes. Diana and Madalina (2007) suggest that manipulation of earnings is not form of fraud. Likewise, Jiraporn, Miller, Yoon, and Kim (2008) also found that earnings management does not seem to provide private benefits to management and does not detrimental to firm value.

On the other hand, some others supporting the perspective of the unethical earnings management behaviour clime that earnings management is just another form of fraud. For example, Dechow, Sloan, and Sweeney (1996) found that firms engage in earnings management prior to fraud occurrence. Likewise, Perols and Lougee (2011) found that fraud is significantly higher for firms that have previously managed their reported earnings. Powell, Jubb, Lange, and Smith (2005) argued that the motivation of both earnings management and fraud is to manipulate financial information to achieve a desired result, and in achieving these results both of them can involve the same accounting techniques. In their earnings management definition Healy and Wahlen (1999), state 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" (1999, p.368). According to this definition, earnings management exists only for the purpose of hiding deterioration, and the term "mislead" tends to exclude the probability that earning management may occur to make financial reports more informative. Furthermore, Perols and Lougee (2011) state that fraud has the same purpose as earnings management; however, fraud is outside of GAAP, although earnings management is within GAAP. Due to both fraud and earnings management are intent to be misleading, and since the term of intent is not easy to anyone to ascertain than for perpetrators, it is not possible to identify the distinction between fraud and earnings management purely through management intent.

The Public Oversight Board (2000) points out that earnings management involves a wide range of legitimate and illegitimate management acts which impact a firm's earnings. These illegitimate actions may include deliberate recognition, measuring of transactions and other events and circumstances in incorrect accounting period or recording fictitious transactions which both constitute fraud. Dechow and Skinner (2000) and Rosner (2003) suggest that there is only a fine line between fraud and earnings management. The former SEC Chairman Levitt (1998) referred to this line as "a gray area between legitimacy and outright fraud".

It has been believed that the compliance with accounting standards is the only way to distinguish between earnings management and fraud. However, Shah (1996) argued that complying with accounting standards is not a guarantee that firm's financial position is fairly present in its financial reports. Moreover, The Public Oversight Board (2000) states that "determining whether or when the behaviour in the earnings management continuum crosses the line from legitimacy to fraud in a specific situation is not always easy and that at some point in the continuum, the motivation behind earnings management may become strong enough to result in fraud" (2000, p.79). Thus, Higson (2003) has indicated that the only way to differentiate between fraudulent and legitimate acts is by understanding the motives behind them, as this will help decide whether the act was deliberate or accidental. Likewise, Kassem (2012) indicated that, unless there is a proper way to assist us distinguish the difference them, the debate on earnings management and fraud will continue.

As can be seen from the above debate, it can be suggested that, by complying with accounting regulations, the distinction between earnings management and fraud is not an appropriate approach to distinguish whether or not earnings management and fraud are related. Alternatively, it could allow researchers and regulations to explain the distinctions between them by defining the motives of management behind fraud and earnings management, if any, which can in turn help to detect fraudulent actions by pursuing how management behaves to achieve its goals and intentions.

3. Methodology

This study is a literature review research, which review the available literature on earnings management and Accounting Reporting Fraud. A variety of resources, including Google

scholars, open-access accounting and financial journal websites and other available resources, have been used for gathering relevant literature. This has been achieved by the relevant wording used for earnings management, earnings quality, accounting fraud, manipulate reported earnings, fraudulence, and a combination of these terms.

4. Findings

The findings of other studies have been reviewed to present the results of this study. These findings demonstrate that, despite the presence of stringent laws and regulations to prevent such practices, earnings management and fraud activities continue to prevail in the business environment worldwide. Although the phenomenon of earnings management and accounting reporting fraud in the literature are widely debated, it is still extremely difficult to distinguish between income management and fraud. It has been argued that understanding the motivations for earnings management and fraud might be a suitable technique to detect fraudulent activity by monitoring the achievement of managers' objectives. This can help to establish suitable models of fraud prediction and might be useful in the assessment management activities.

5. Conclusion, Recommendations and Future Research

The literature review shows that there are two perspectives of earnings management. These perspectives are ethical and unethical earnings management perspectives. In line with ethical perspective, many researchers indicate that earnings management is a legal act and entirely different from fraud due to it is in line with accounting standards boundaries, while others believe that there is a very tiny line between earnings management and fraud, and consider it as an unethical act which academics and regulations have to fight. The discussion on the relationship between earnings management and fraud will continue until an appropriate approach is available to assist in understanding the differences between the two aspects. There is no consensus on the behaviour of earnings management, which in turn illustrates how hard it is to define and assess its motives. Therefore, understanding the motivations behind earnings management and fraud may help to distinguish the differences between fraudulent and legitimate activities, that, in turn, may help to determine whether the action is intentional or accidental. It has been suggested that understanding the motivations for fraud and earnings management may provide a proper technique for detecting fraudulent actions by tracking how managers achieve their objectives / intentions. In addition, understanding the link between earnings management and fraud can help build suitable fraud prediction models, and these modules can be useful for researchers, regulators and auditors in the evaluation firms' management activities. Furthermore, researchers and accounting regulatory can use such models to improve their effectiveness and efficiency when monitoring and selecting firms to investigate for potential fraud.

The recommendation of the current study is that more future research on motives, management's integrity is still needed. At the same time, accounting regulators should provide a guidance to spot the difference between fraudulent and nonfraudulent acts.

6. Limitations

As the research is intended to review existing literature, it is important to sample the literature. Besides that, the study used only secondary resources from different written sites and publications in English, which could be regarded as study limitations.

إدارة الإرباح والإحتيال المحاسبي

مدخل نظري مقارن

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مستخلص:

يستخدم مفهوم إدارة الأرباح أحيانًا كبديل للإحتيال المحاسبي، ومن تم تهدف هذه الدراسة إلى مراجعة الدراسات المتاحة في مجال إدارة الإرباح والإحتيال المحاسبي لإيضاح الخصائص الأساسية والتي من شأنها إن تساعد على إمكانية الفصل بين إدارة الأرباح والإحتيال المحاسبي. للقيام بذلك، صممت الدراسة لمراجعة نتائج الدراسات السابقة للتوصل إلى نتائج هذه الدراسة، وذلك بالإعتماد على استخدام العديد من المصادر البديلة المتاحة والتي قد تساعد على جمع البانات ذات العلاقة بموضوع الدراسة. يتضح من النتائج أن أنشطة التلاعب بالمعلومات المالية لا تزال سائدة في بيئة الأعمال التجارية في جميع أنحاء العالم ، على الرغم من حقيقة وجود قوانين ولوائح صارمة لمنع إدارة الأرباح وسلوك الاحتيال المحاسبي. لذلك، تحديد دوافع مدراء الشركات للتلاعب بالمعلومات المحاسبية قد يساهم في مساعدة الأكاديميين والمنظمين للمهنة من توفير إطار متكامل للتمييز بين إدارة الأرباح والاحتيال المحاسبي، بالإضافة إلى إمكانية تحديد الممارسات الإحتيالية، وذلك من خلال متابعة سلوك المدراء للوصول إلى تحقيق إهدافهم وغاياتهم الشخصية.

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