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A Conceptual Overview of Earnings Management

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Abstract
The main aim of this study is to provide an overview of earnings management. Earnings Management practices are prevalent in organizations recently and this is attributed to bad corporate governance. Accountants and Managers apply strategies that heighten earnings management in the financial reporting process by using profit eroding mechanisms which lead to drastic consequences (corporate collapse both internationally and locally as in the cases of WorldCom and Enron as well as African Petroleum Plc and Cadbury Nigeria Plc). Thus, corroding public (investors) confidence and reducing the quality of the financial reports which eventually brings adverse effects on resource allocation in the economy. Hence, investors, regulators, and academics are concerned about the continuous financial reporting abuses. This paper explored literatures on earnings management and showed the techniques used by managers to manipulate earnings in various organizations. This study suggests that a supervisory authorities be put in place by appropriately enforcing framework needed to exert compliance by firms in the preparation and presentation of financial statements. Also, the accounting profession should strengthen its ethical code so that the individual accountants and auditors will be less willing to connive and engage in the practice of earnings management.

Key Words: Earnings, Financial, Income, Manipulation, Reports.

Introduction

Financial statements and reports are used by the prospective investors and general public at large as a yardstick for measuring businesses and their performances. This valuation is based on the expectation of future performance, which is usually derived from past performance. Ou and Sepe, 2002 asserted that the reported earnings and book value of a firm are commonly used as the basis for valuation. However, the relevance of accounting information in determining the value of the firm may be influenced by the market's perception of the reliability of that information (Whelan & McNamara, 2004).

Earning is an interesting single item in financial reporting and managers are interested in the way they report it in the financial statements. For this reason they have to learn how to manage their earnings. Thus, they will be able to enhance both the form and the content of financial reporting by adjusting the accounting income in order to maximize its utility (Daghsni, Zouhayer & Mbarek, 2016).

Existing accounting practices permits a degree of choice of policies and professional judgment in determining the method of measurement, criteria for recognition and even the definition of the accounting entity. The exercise of this choice could involve a deliberate non-disclosure of information and manipulation of accounting figures, thereby making the business appear more profitable than it really is (Ijeoma, 2014). Hence, users of financial statements are many times misled and this constitutes a threat to corporate investment and growth.

Nevertheless, financial reports became doubtful after a series of firm bankruptcies and frauds cases of Enron, Tyco, Xerox, WorldCom, and HealthSouth in the United States; Ahold, Vivendi, Lernout and Hauspie in the Europe; African Petroleum Plc and Cadbury Nigeria Plc in Nigeria, These catastrophes on one hand caused lack of confidence in the credibility of published financial statements and, on the other hand, a loss of investor's confidence in the management of companies. Consequently, this doubt takes the form of a repeated issue which poses a fear in the minds of shareholders, investors and other users of financial information in believing the financial reports presented by companies, hence, earnings management.

Earnings Management recently attracted serious attention from academia, regulators and financial analysts. The term is not new in accounting phrasing, as it has been variously described sometimes as 'aggressive accounting' or 'innovative accounting or 'cosmetic accounting' or 'creative accounting' or 'window dressing accounting' or 'deceptive accounting' or rather 'game of number'. A number of companies engage in earnings management because of the accounting discretion window provided by flexible accounting rules. Naser (1993) sees earnings management as the transformation of financial accounting figures from what they actually are to what preparers' desire, by taking advantage of existing rules and/or ignoring some or all of them.

Akers, Giacomino and Bellovary (2007) defined Earnings management as an attempts by management to influence or manipulate reported earnings by using specific accounting methods (or changing methods), recognizing one-time non-recurring items, deferring or accelerating expense or revenue transactions, or using other methods designed to influence short-term earning.

Furthermore, while describing earnings management; Ningi (2006) opined that creative accounting is one aspect of earnings manipulation which does not violate accounting standards or corporate laws because of the lack of relevant standards or laws, for example, when firms engage in business innovation. Also, Idris, Kehinde, Ajemunigbohun and Gabriel (2012) outlined that creative accounting refers to accounting techniques in which financial information is distorted and manipulated in order to present a better financial picture by either increasing or decreasing the profit as the case may be, by giving a misleading appearance of the capital size or structure and by concealing relevant information from existing and potential investors. Therefore, it can be deduced that earnings management/Creative accounting is the practice of recognizing revenue in a way that makes a company look better than it is, cover financial risk, reduce reported losses and enhance reported profits as well as escape shareholders' control while still conforming to the Generally Accepted Accounting Principles (GAAP).

Earnings management can be used as an indicator of earnings reliability. The perceived lack of earnings reliability may result in the market placing less reliance on earnings in the valuation process. The focus may then shift to book value as a source of information for valuation purposes. Security Exchange Commissions (SEC) held that earnings management dwindle the quality of financial reporting and could be undesirable to shareholders. When the interests of the shareholders and mangers diverge, the mangers can manipulate earnings for their own benefit In fact, enhancing the reliability and integrity of financial reporting is a capital research topic. Therefore, the control and the preparation of financial reporting have become more essential. In order to guarantee the quality of financial reporting, a corporate governance process is needed as a major device. This has led regulators to realize the importance of corporate governance.

Rationale for Earnings Management

The reasons for Earnings management are diverse and range from the intention to satisfy analysts' expectations to incentives to realize bonuses or to maintain a competitive position within the financial market. Earnings management becomes fraudulent financial reporting when it falls outside the bounds of acceptable accounting practice. Thus, firms will only engage in earnings management when the benefits of this behavior are higher than the risks and costs involved (Rahman, Moniruzzaman & Sharif, 2013). Ijeoma and Aronu (2013) posited that most managers who practice earnings management look for loopholes in financial reporting standards which they can exploit to adjust the numbers as much as is practicable to achieve their desired aim or satisfy their financial projections.

Furthermore, Matsumoto (2002) stated that firms with high growth prospects have greater incentives to manipulate earnings to avoid unfavorable market reaction to negative earnings news, whereas earnings of loss firms are less value relevant and thus managers are less likely to adjust earnings to meet targets. Reacting to why managers of firms engage in earnings management and become successful in the presence of stern guidelines and procedures; Ali, Butt and Tariq (2011) stated that creative accounting practice is sometimes good and sometimes it brings crisis in the companies by violating the corporate governance principles.

Earnings management has focused largely on the effect on decision of investors in the stock market. Studies by Grover, 1991a; Schroeder and Spiro, 1992; Sweeny, 1994; DeFond and Jimbalvo, 1994; Dechow, Sloan and Sweeney, 1995; Dahi, 1996; Amat, Blake and Dowds, 1999; Leuz, Nanda and Wysocki, 2003; Desai and Dharmapala, 2006; Ningi, 2006; Chen, 2007; Akenbor and Ibanichuka, 2012; Ibanichuka and Ihendinihu, 2012 have explored and put forth reasons why directors of listed companies (entities) manipulate their financial reports and accounts:

i. Income smoothing: this occurs when firms desire to report a steady trend of growth in profit, rather than to show volatile profits with a series of dramatic rise and falls.
ii. Manipulate profit to tie into forecasts, another modified way of income smoothing.
iii. Income boosting: accounting Policy change often made to distract attention from unwelcome news of the company's actual performance and ranking among its peers.

iv. Boost/Maintain share price with the effect of reducing the apparent level of borrowing and creating the appearance of a good profit trend and thus position the company at a vantage position for new share issues and takeover bids.
v. Directors insider dealings involving delay in release of information for the market to enhance their opportunity to benefit from their inside knowledge.
vi. Circumvent contractual rights, obligations and constraints; prevalent where companies are subject to various forms of contractual rights, obligations and constraints based on the amount reported on the accounts.
vii. Avoid Government Regulations by choosing accounting methods that tend to reduce their reported profits.
viii. Enhance Directors Bonus Scheme where the scheme is linked to profit or the company share price.
ix. Profit sharing arrangement may induce choice of accounting methods to minimize declared profit to depress claim on the firm.
x. Tax saving purposes where taxable income is measured in relation to the accounting figures.
xi. Change in management with a motivation to shift responsibility for losses and poor performance to previous management.

However, conflicts of interest among various interest groups (managers, investors, employees, tax authority) in companies lead to the earnings management. Ijeoma (2013) opined that managing shareholder interest is to pay less tax and dividends; Investor shareholders are interested in getting more dividends and capital gains; Country tax authorities would like to collect more and more taxes; Employees are interested in getting better salaries and higher profit shares. Hence, earnings management puts one or two to benefit at the expense of others.

Evidences of Earnings Management in Nigeria and around the Globe

Earnings management practices have been on the increase in both financial and non-financial industries in Nigeria as some firms present grossly exaggerated, misleading and deceptive state of financial affairs so as to attract unsuspecting investors or obtain undeserved accounting based rewards. It is evident that the extent of window dressing of financial statements in Nigeria has greatly violated all known ethical standards of the accounting and auditing profession (Ijeoma, 2014).

Earnings management in Nigeria was evidenced in African Petroleum Plc when it was planned for privatization in 2001, the financial position of the firm showed that its financial statements were not fairly presented. A number of transactions, including substantial loans, were omitted from the financial statements. This fact was discovered when a due diligence audit was done in preparation for privatizing the company (Oyejide & Soyibo, 2001).

Again in 2006 another earnings management scandal was reported in Cadbury Nigeria Plc when the board members doctored the accounts to cover up certain inadequacies and unscrupulous deals perpetuated by the management of the firm. An independent investigation of the firm's financial statements confirmed a significant and deliberate overstatement of the firm's financial position through inflated stock figures over a number of years, and this compelled the company to diminish its reserve by making a one-time exceptional charge in 2006 of between N13 billion and N15billion (Itsueli, 2006).

In the financial industry, the corporate failures of most Nigerian banks and investigations into the activities of their Chief Executive Officers by the Anti- graft agency, Economic and Financial Crimes Commission (EFCC) are largely due to fraudulent financial reporting. In 2009, the Central bank of Nigeria (CBN) sacked five (5) Bank managing directors and Executive Directors for mismanagement and alleged fraud. This has affected the stability and growth of the Nigerian financial system since some of the said banks are no longer operational; Intercontinental bank, Oceanic Bank, and Fin Bank. It is therefore arguable that the practice of creative accounting is hostile to the continual growth of the Nigerian financial system.

In 2013, the House of Representatives Committee on Finance accused deposit money banks in Nigeria of sundry sharp practices, including tax evasion, non-remittance of government revenue and outright falsification of their accounts. In a report released on the 25th of August 2013, the committee said it had uncovered a lot of discrepancies in the data submitted to it by the banks including the outright refusal to present documentary evidence of revenue remittances, blank violations of existing laws, self-exemption from existing rules, false declaration and manipulation of financial information (Ijeoma, 2014). Preliminary findings showed that the published audited accounts of some banks were at variance with the figures the banks submitted to the committee during investigation. It was then revealed that many banks deliberately engaged in the earnings management practice of inflating their operating costs to reduce exposure to taxes. Similarly, over the years, the Nigerian government lost billions of naira in fraudulent and cunning and shady dealings corruptly designed by some banks to evade taxes. The effect of this large scale corruption on the nation's economy is unquantifiable. Further, some banks also created exemption rules for themselves in total disregard for the provisions of existing tax laws, particular violations of the stamp duty, withholding tax and value added tax (VAT) laws. There are also many cases of late remittances or outright failure to remit money collected on behalf of government (Ijeoma, 2014).

Further, in the United States of America precisely in March 2010, Alloway reported the findings of a bankruptcy examiner on the collapse of Lehman Brothers, an American Investment Bank that used earnings management techniques marked "Repo 105" and "Repo 108" generally called "Repo 105" to manipulate its leverage ratios. The bank used 'repo' transactions to temporarily remove securities inventory from its balance sheet and created a materially misleading picture of the firm's financial condition in 2007 and 2008. Over $50 billion of liabilities were thus removed from the balance sheet effectively reducing its leverage ratios.

However, Ibanichuka and Ihendinihu, (2012) stressed that the collapse of a firm has always inflicted its stakeholders and society with negative marks resulting in varying degrees of negative growths in major indices of organizational performance; and that corporate distress/failure do not only inflicts damage to the value of the firm (by extension, reducing stakeholders wealth), but the other interest groups (employees, creditors, customers, management) too do have their dose of the bitter pill. It is spiral and infectious, and may have a crippling effect on other economic entities and the economy as a whole. Creative accounting thus, offers a formidable challenge to the accounting profession, the regulatory authorities and the entire business.

The Good Side of Earning Management

Earnings Management is seen differently by numerous authors depending on the viewpoint from which they are appraising the performance of an organization. There is certainly a good side of earnings management when properly practiced for the benefits of the organization prior to accomplishing the strategic performance objective of the organization. A good earnings management as perceived by Parfet (2000) in the context of decision making is where subtle effects from human perceptions and peer pressures, the complexity of combined factors, and a high-stakes business environment impact good people who are trying to do their jobs with integrity. A good side of earnings management sometimes takes a form of contracting perspective earnings management which is usually anticipated by the principal when the bonus contract was being negotiated so that it allowed for in-setting bonus rate through lowering contracting costs in the face of rigid and incomplete contracts; and, it can reveal inside information to investors. Lipe (2001) argued the following points on the good side of earnings management:

a. **Incentives given on contracts:** Bonuses given on net income of contracts usually caused volatility of the new accounting standards which may lead to lower net income and negatively affect managers' efforts. Secondly, debt covenant contracts, this means that the new accounting standards may increase probability of debt covenant violation and as contract violation is costly, earnings management may be low-cost way to work around.

b. **Investor-based arguments:** This implies that the discretionary accrual management as a way to credibly reveal management's inside information about earnings expectations, for instance some managers foolishly report more earnings than can be maintained, also some managers report earnings to the extent that management expects it will continue. Secondly, credibility of the management communicates inside information to investors and as such, blocked communication may inhibit direct disclosure of earnings expectations.

Limitation of Earning Management

As discussed earlier, earnings management if properly used may result to the upliftment of an organization; and bad earnings management could fall the organization. Thus, earning management means interference with the standards to hide real operating performance. However, some of the techniques used that may influence bad earnings management as pointed out by previous studies are discussed below:

a. **Financial Reporting Perspective**

In discussing financial reporting perspective in relation to bad earnings management, Hanna (1999) opined that management of an organization is tempted to provide excessive, unusual, non-recurring and extraordinary charges to put future earnings in the bank and these future earnings are buried in operations. This makes it difficult for investors to diagnose the reasons for subsequent earnings increases. Also, investors and analysts look to core earnings, ignoring extraordinary and non-recurring items, this Implies that manager are not penalized for non-core charges, such as write-downs and provisions for restructuring. But current non-core charges increase core earnings in future years, through lower amortization and absorption of future costs. Consequently, managers are tempted to overindulge on non-core charges, thereby putting earnings in the bank, such action is referred to as 'cookie jar accounting'. Also, in discussing securities market reaction, Hanna found evidence that market uses frequency of such charges as proxy for their misuse.

b. Contracting Perspective

From a contracting perspective, it is believed that managers manage earnings to cunningly maximize their benefits. Healy (1985) observed that managers act on their self-interest when their bonus schemes are tied to the reported net incomes. However, managers not only manage earnings for self-interests but also manage earnings for an efficient contracting. Healy (1985) found that managers utilize such information superiority to maximize their wealth on their bonus scheme which suggests that managers might possibly manage earnings to protect their bonuses. Dechow, Sloan and Sweeney (1996) concluded that accrual information is a key determinant of the earnings manipulation; therefore, it is reasonable to assume that earnings restatement firms can be characterized as firms who knowingly and intentionally engaged in earnings manipulation.

Conclusion

The collapse of a firm has always inflicted its stakeholders and society with negative marks resulting in varying degrees of negative growth in major indices of organizational performance. This is spiral and risky, and may have an adverse effect on other economic entities and the economy as a whole. Earnings management thus, offers a formidable challenge to the accounting profession, the regulatory authorities and the entire business community.

Suggestions

The study put forth the following suggestions:

Firstly, earnings management should be regulated by the supervisory authorities by appropriately enforcing framework needed to exert compliance by firms in the preparation and presentation of financial statements. Secondly, the accounting profession should strengthen its ethical codes so that the individual accountants and auditors will be less willing to connive and engage in the practice of earnings management, this has become imperative in view of the ethical challenges to the accounting profession posed by creative accounting resulting from the vast range for abuse of accounting policy choice, judgement and assumptions about the future and reclassification and presentation of financial numbers in financial statements.

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