Meanings, Motivations and Techniques of Earnings Management

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ABSTRACT
Earnings management has been a crucial enterprise behavior that would influence the figures on financial statements and the decision of report users. Because of transactions in capital market, some contract items and relevant government laws, managers are motivated to manipulate earnings. By manipulating accruals and real transaction activities and some methods, such as taking big bath and cookie jar reserves, the accounting figures reported on financial statements can be managed and changed. Besides, different kinds of firms may take different methods to manipulate earnings, but there are several ways that are very common that stakeholders should take into consideration.

Keywords: Earnings Management, Motivations, Techniques

1. Introduction
It is widely believed that companies, especially companies that are listed and are going to be listed engage in earnings management very often, taking actions to change the data reported on financial statements. While there are plenty of theoretical researches trying to document what earnings management exactly is, there has been no agreement about the explicit definition of earnings management. Some scholars think earnings management is in accordance with accounting principles, standard and the laws, while others hold the view that the manipulation of earnings is to realize private interests rather than maximize the firm’s value and they think the manipulation is aggressive or fraudulent for the accounting standard. As Healy and Wahlen’s research in 1999 regarding earnings management is typical and representative, this paper takes their points as the base to summarize the literatures concerning motivations for earnings management. There are in total three incentives according to Healy and Wahlen (1999), which are to meet capital markets expectations, to meet contract items that are related to accounting figures and to meet government laws and regulations. This paper does literature review about taxation regulation briefly, which Healy and Wahlen (1999) did not, because the author thinks taxation is so important that for most of regions when there are earnings, there is taxation, and although regulations would be variable in different areas, the main content and purposes would not differ significantly. This paper also summaries some literatures about techniques of earnings management. The difference between reported earnings and cash flows is accruals, so manipulating accruals is a way of earnings management. Besides, manage real transaction activities is one of the techniques as well. What is more, there are also some common techniques, such as taking big bath and cookie jar reserves. In addition, although different types of firms may have different techniques to manipulate reported profits, several commonly used techniques should attract stakeholders’ attention when analyzing financial statements.

2. Definition of Earnings Management
There are many researches concerning earnings management interiorly and abroad, but scholars have not reached an agreement on the definition of earnings management. However, many scholars have made different theoretical explanations of earnings management at different aspects and in different degrees. Scott (1997) described in his famous book Financial Accounting Theory that "earnings management is the behavior of managers to maximize their own utility or company value through the choice of Accounting policies within the permissible scope of GAAP (Generally Accepted Accounting Principle). This definition puts forward the purpose of earnings management from the perspective of managers and companies, namely, self-utility maximization and corporate benefits maximization. It also involves the relationship between GAAP and earnings management and points out that earnings management does not violate GAAP. Healy and Wahlen (1999) thinks: "earnings management occurs when managers use judgement in financial reporting and in constructing transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence the contractual outcomes that depend on reported accounting numbers.” The definition proposes two approaches to earnings management and argues that the purpose of management to manage earnings is to mislead reporting users and thus influence their decisions. Schipper (1989), moreover, argues that earnings management is the enterprise management personnel purposefully controlling external financial reports disclosure management in order to obtain some private interests (not neutrally processing
3. Motivations for Earnings Management

Concerning the motivations of earnings management, many different scholars have conducted relevant studies. Healy and Wahlen (1999) summarized the motivations for earnings management arise from: (i) capital market expectations and valuation; (ii) contracts that are written in terms of accounting numbers; and (iii) anti-trust or other government regulation. Most of the studies can be classified as one of the three points, so this paper reviews some literatures based on these points about earnings management reasons.

3.1. Capital Market Expectations and Valuation

The first is about the motivation of Capital Market. According to Healy and Wahlen (1999), motivations related to capital market transactions can be divided into two categories: capital market transactions and meeting expectations of financial analysts, some investors and other shareholders.

3.1.1. Capital Market Transactions

According to Dye (1988), one reason for managers to manipulate earnings is that investors and financial analysts would use accounting figures to do valuation of stocks. Besides, one reason for income smoothing is that managers believe that most investors would rather invest more in companies with smoother income stream (Ronen & Sadan, 1981). Income smoothing is a technique for earnings management. Many researchers find that management buyouts would lead to some earnings management, and the manager of buyout firms tends to show lower earnings before buyouts. DeAngelo (1988) points out that the earnings figures are critical for the valuations in management buyouts and she assumes that the manager of buyout firms has a motivation to “understate” earnings. Also, controlling unexpected accruals belongs to earnings management as well. The research carried by Perry and Williams (1994) report that some companies control unexpected accruals changes for revenue and depreciable capital and find that unexpected accruals are negative before management buyout.

However, managers do not always “understate” earnings. Sometimes they would “overstate” earnings as well, such as during the period of offering equity. Teoh, Welch and Wong (1998) indicate that firms tend to report positive unexpected accruals before initial public offerings and seasoned equity offerings.

3.1.2. Meet Expectations

In order to meet the expectation of financial analysts and some investors, managers have incentives to manipulate earnings. As Lees (1981) states that managers think that
forecasts inaccuracies lead to instability and make investors have the concern that the company is highly risky, and the share price would go down. Burgstahler and Eames (1998) reports that companies do earnings management to meet analysts’ forecasts. What is more, Kasznik (1999) finds evidence which is consistent with firms, having the possibility of failing to reach earnings forecast, to manage earnings upward by controlling unexpected forecasts.

3.2. Contracting Motivations

Secondly, it is about contracting motivations. Generally, when two parties sign a contract, it is for the purpose of fulfilling the terms and contents of the contract, and it is also judged by the terms and contents of the contract whether they have completed the contract as signed and negotiated. In this way, when the terms of the contract are related to the company’s earnings, the management will have the motivation to carry out earnings management, so as to ensure that the contract terms of earnings have been completed. Healy and Wahlen (1999) classify contracts into two categories: Management Compensation Contracts and Lending Contracts.

3.2.1. Management Compensation Contracts

In many enterprises, executive compensation is linked to the company's earnings. Typically, managers take Big Bath or Cookie Jar Reserve to delay or report accruals, especially if some companies have bonus caps. Guidry, Leone and Rock (1998) finds that how managers’ report income depends on their bonus plan. They state that it is possible for managers to defer income when the target earnings in the bonus plan is not going to be met or when they are eligible for the maximum award under the bonus plan. Besides, the reported accruals are less likely to defer income in companies without bonus award limit than those with bonus award when the award cap is reached (Healy, 1985 and Holthausen & Larcker & Sloan, 1995).

Other studies have shown that there are other factors in addition to an explicit bonus plan that influence management’s decisions about the company's earnings. Dechow and Sloan (1999) states that CEOs in their final years have incentives to reduce R & D expense in order to increase reported earnings. Also, incumbent managers intend to use their discretion to increase reported earnings when there is a proxy competition for the company’s management power (DeAngelo, 1988).

Under the Management Compensation Contracts, managers exercising their discretion for the company to manage earnings is mainly due to their private benefits, such as higher bonus award and the continuance of their job in the firm. However, in terms of Healy and Wahlen (1999)' research, there is no evidence to tell whether this behavior is widespread, or it has influence on stock prices.

3.2.2. Lending Contract

When a company wants to borrow money from a commercial bank, the commercial bank will generally analyze its solvency by reading some data listed by the company. Sweeney (1994) selects a company that really violated the debt repayment contract for analysis. She finds that the party who broke the contract did earnings management to increase income figures after the breach of the contract. This indicates that the sample company did not deliberately avoid the breach of the contract, which may be to prepare in advance for the future non-breach of the contract. Moreover, Sweeney (1994) also finds that firms at risk of default seem more willing than others to adopt new accounting rules that boost earnings sooner rather than later. Conversely, DeFond and Jiambalvo (1994) find that the sample companies were in charge of changing income-increasing accounting figures in the year preceding the breach of the contract.

3.3. Regulatory Motivations

The third one is about regulatory motivations. In many countries and regions, policies, laws and regulations promulgated are related to the earnings of a company, and some industries and companies carry out earnings management due to the laws, regulations and policies promulgated by the government. Healy and Wahlen (1999) concluded that there are three types regulatory motivations for manipulating earnings: earnings management to avoid industry regulations, to reduce the risk of investigation and intervention by anti-trust regulators, and for tax planning purposes.

3.3.1. Industry Regulations

According to Healy and Wahlen (1999), some industries (banking, insuring and utility industries) have to satisfy corresponding regulations which are directly connected with accounting figures. As for banks, banking regulations ask for capital adequacy requirements that is shown by accounting figures. With regard to insurers, they are asked by the insurance industry regulations to reach minimum financial health. As the regulations and rules are explicit and specific for these industries, it is not surprising that in order to meet or not violate the regulations, managers in these industries are likely to exercise earnings management. Banks that are very close to the prescribed minimum capital adequacy requirements overestimate loan loss provisions, underrate loan write-offs and recognize abnormal realized gains on securities portfolios (Beatty & Chamberlain & Magliolo, 1995). In addition, Petroni (1992) provides evidence that insurance firm with financial weakness of property-casualty, which is very close to violate the insurance industry regulations, tend to underestimate loss reserves reported.
3.3.2. Anti-Trust Regulations

In spite of some industry regulations, other regulations and rules may also prompt firms to manage earnings. For instance, firms that are sensitive to anti-trust laws always have incentives to report lower profits and earnings than they ought to be. Cahan (1992) provide evidence that firms claimed income-decreasing abnormal accruals in investigation years for anti-trust violations. Obviously, when the investigated firms are discovered to break anti-trust regulations, there might be corresponding punishment. Thus, firms in the investigation years have incentives to manage earnings in order to meet the regulations.

3.3.3. Tax Planning Purpose

Earnings have strong relationships with taxations all the time. For most of the firms, when there are profits, there is the issue of taxation. As a result, earnings have great effect on taxation and vice versa. Despite in different regions tax regulation may be variable, the main purposes would not differ significantly. As Tian (2020) stated, many firms may properly adjust the recent profits of enterprises so as to reduce the recent tax payment amount. For instance, in Portuguese, Marques, Rodrigues and Craig (2011) find that under the government’s tax regulation, firms with higher income tax rates are discovered to reduce earnings and profits to almost zero and it is more likely for them to manipulate and manage their earnings than other companies. Thus, in order to make the rate payment more economical and properize, many companies manipulate earnings for tax planning purpose.

4. Techniques of Earnings Management

As managers have incentives to manipulate earnings of the firm, it is not surprising that managers would use their discretion exercise earnings management. Teoh, Wong and Rao (1998) consider estimates of depreciation and bad debt provision near initial public offerings and they find that firms surrounding IPO are more inclined to make use of or change depreciation policies and bad debt provisions. The variation between the reported profits and cash flow is due to accruals. Thus, accruals accounts (such as accounts payable, accounts receivable, inventory, prepaid expense, accrued expense, accrued liabilities, deferred revenue) can help the firm to reach target profit without changing underlying cash flows. For instance, a manager reports a revenue of $50,000 on selling of goods on credit, and profit for the year increases by $50,000 while no more cash inflows.

Unlike accrual manipulation methods to manage within accounting system of the firm, real activities management require changing and altering the firm’s real activities (Nia & Huang & Abidin, 2015). Schipper (1989) defines real activities management as using timing investment and decisions of financing to manipulate the reported profits or some subset of it. However, some hold the view that operating real activities aims to manage reported profits, while others think managing real activities is to change timing and structuring of real business transactions to manipulate earnings that have effect on operating cash flows (Ewert & Wagenhofer, 2005). Thus, there is evidence to prove that earnings management can be exercised to alter many items reported in the financial statement, not just profits or earnings. Different kinds of earnings management carried by the managers have different objectives to reach, then different techniques. For instance, if it is hard for a firm to meet the expected earnings by financial analysts, the firm may produce large amounts of sales on credit at end of this year. Then the firm may record revenue which has not been realized. In addition, if managers want to exercise earnings management to change cash flows, they may change relative items in the contract. For example, if the manager wants to increase cash inflow for the current year, they would require in the contract that the customer to pay in advance, before the end of this year, rather than at the beginning of next year. Besides, Levitt (1998) discussed five popular “illusions” that are taken advantage of by managers to “obscure actual financial volatility” in the SEC speech. They are: “big bath” restructuring charges, creative acquisition accounting, “cookie jar reserves,” “immaterial” misapplications of accounting principles, and the premature recognition of revenue. There are some details about different categories of earnings management techniques. First, it is “Big Bath” restructuring charges. If drawing a picture illustrating a firm’s earnings successively for several years, the year with “big bath” would be represented as a huge drop compared with the prior and the following year. The reason why there is a “big bath” mainly because the firm gather expenses and costs that might occur in following years into current year, whose results may already be not good. 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.” “Big Bath” technique can help to gather following years’ costs and make following years’ reported earnings to be higher and steadier. Actually, there is a similarity between “big bath” and creative acquisition accounting: allocating a large amount of costs and expenses to one year and letting the following years nearly unaffected. A crucial accounting task after merger is to distribute the acquisition cost to assets of the required company. However, according to Levitt (1998), many acquirers record the large amount of purchase price as an “one-time’ charge-to record as ongoing research & development expenses and leaving future earnings unaffected. Besides, it is “Cookie Jar Reserves”. As Levitt (1998) stated that many companies estimate some items unrealistically, such as warranty costs, loan losses and sales returns. In that instance, they can squirel away accruals as “cookie jar reserves” during periods when earnings are good and take advantage of them in bad times. Moreover, materiality is always a word that can attract accountants’ attention. However, it is very difficult to distinguish material and immaterial. Thus, many
firms abuse this concept and to use the flexibility to manipulate the figures in financial reports. As Levitt (1998) points out that firms deliberately wrongly record the figures, but the errors are within a defined percentage ceiling. However, it has to be noted that in accounting filed, sometimes a very slightly difference of the numbers would lead to greatly variable outcomes. Examples of such standards are 1% of sales, 5% of operating profits or 10% of stockholders’ equity. Moreover, even just one penny falling short the expectations may lead to large amounts of loss for of the company. So, managers may change some accounting figures “slightly” to exercise earnings management without severe deviation. As a result, auditors are supposed to think twice whether their behavior have violated GAAP. Lastly, Premature Recognition of Revenue is a technique frequently being used to manipulate earnings as well. Levitt (1998) describes that “companies try to boost earnings by manipulating the recognition of revenue”. This happens when firms recognize revenue when sales are not confirmed by the customer, that is when the customer still have time and opportunities to terminate, end and invalidate the sale. This action would lead to the increase of the firm’s reported earnings, but the earnings are not controlled by the firm and it should not be recorded.

5. Conclusion

This paper has provided some literature review about meanings, motivations and techniques of earnings management. Different researches document earnings management differently. As stated by Healy and Wahlen (1999), managers have incentives, including capital market expectations, contract items and some regulations of industry or government, to manipulate reported earnings. This paper also summarizes some literatures researching on techniques of earnings management, including manage accruals and real transaction activities What is more there are also some common techniques, such as taking big bath and cookie jar reserves. Importantly, report users and stakeholders should know how a firm might manage its affairs, namely, to reduce the influence of earnings management on decision making. Though different types of firms may have different techniques to manipulate reported profits, several commonly used techniques should attract stakeholders’ attention. For instance, many firms increase expense through using the method that would lead to more asset depreciation, and vice versa. So, stakeholders should calculate depreciation that would reflect the most real situation of the firm by themselves. The same is true for recording the cost of inventories. Sometimes the firm might use FIFO (first in first out) while use LIFO (last in first out) at other times. Actually, FIFO can best reflect the actual situation of the firm’s inventory. Thus, stakeholders should also pay attention to this category when inventory is important for the firm.

Reference


