

Review paper

## EARNINGS MANAGEMENT VS FINANCIAL REPORTING FRAUD – KEY FEATURES FOR DISTINGUISHING

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**Abstract.** *A major issue central to accountings research is the extent to which management is allowed to manage reported earnings, as well as the extent to which it becomes financial fraud. This paper discusses what is earnings management and financial reporting fraud, frameworks that existing literature offered to distinguish between them, how they in some cases overlap and the reasons that make the only relaying on accounting standards and management intent are not enough factors to provide clear differentiation between both.*

**Key Words:** *earnings management, financial reporting fraud.*

### 1. INTRODUCTION

The most important role of financial reports is to effectively communicate financial information to outsiders in a timely and credible manner (FASB, 1984). A major component of these annual reports is earnings numbers that are used by outsiders to make decisions in regard to the company. It has been argued that managers have both the ability and the incentive to manage reported earnings in order to increase or decrease current period earnings relative to their 'unmanaged' level. A major issue central to accountings research is the extent to which management is permitted to manage reported earnings, as well as the extent to which it becomes fraud. Although there have been some attempts made in terms of providing frameworks so as to differentiate earnings management behavior from financial reporting fraud, so far, there is no general agreement on one. Most of these frameworks have argued that management intent and compliance with accounting

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regulation can provide a clear distinction between earnings management and financial fraud. It is argued that there are some earnings management practices that overlap with financial fraud—even though they are within bounds of standards. For supporting the argument we consider the following issue:

1. Definition and features of earnings management
2. Definition and features of financial reporting fraud
3. Common frameworks for distinguishing between earnings management and financial a fraud (Literature review)
4. The overlap between earnings management and earnings management, and financial reporting fraud.

## 2. DEFINITION AND FEATURES OF EARNINGS MANAGEMENT

Earnings management has been defined in many different ways: for example, for Healy and Wahlen (1999), earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead stakeholders about the underlying economic performance of the company or otherwise to influence contractual outcomes that depend on reported accounting numbers. This definition emphasizes the opportunistic perspective of earnings management, which is to mislead the financial information users; however, some other researchers suggest the possibility that earnings management can occur for the purpose of signaling. The implication of this perspective is that reported earnings can be informative for users if the management choice of accounting policies or estimates is perceived to be credible signals of a firm's underlying economics. For example, Schipper (1989) defines earnings management by observing that 'earnings management ... mean[s] "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". Moreover, D.Fields, Z.Lys, and Vincent (2001) state that earnings management occurs when managers exercise their discretion over accounting numbers with or without restrictions. Such discretion can be either firm value maximizing or opportunistic. However, these perspectives can be differentiated through management intent, where management intent is unobservable.

Although all previous definitions could make an important difference, they highlight the common features of earnings manipulation practices. The first feature they underline the fact that earnings management behavior refers to purposeful and deliberate actions taken by management with the ultimate goal to alter reported earnings. Thus, earnings management is different from unintentional errors, such as accountant mistakenly entering incorrect numbers.

The second feature shows that earnings management can be achieved through the accounting system or business transactions of the company. The former is known as accounting-based earnings management. As a matter of fact, when managers adopt this method, the reported earning is artificially affected. This involves using estimates or judgments allowed by accounting regulation, such as expected lives and salvaging values of long-term assets, obligations for pension benefits and other post-employment benefits, deferred taxes, and losses from bad debt and asset impairments. Moreover, it can also be achieved by making changes between acceptable accounting methods, such as the opportunity to affect changes from the LIFO to FIFO, or weighted-average for inventory valua-

tion.<sup>1</sup> The latter is known as real earnings management as it attempts to manage cash flows and thus the revenues and expenses associated with operations. This involves manipulating real transactions to alter reported earnings by designing them in such way that the desired result can be obtained. Examples of this techniques include reducing prices, changing production, discretionary expenditures, including R&D and SGA (Selling, General and Administrative expenses), and debt-equity swaps.

### 3. DEFINITION AND FEATURES OF FINANCIAL REPORTING FRAUD

The US National Commission on Fraudulent Financial Reporting (1987) defines fraudulent financial reporting as an "intentional or reckless conduct, whether by act or omission, that results in materially misleading financial statements." (Rocco, 1998). According to Mulford and Comiskey (2002) for financial reporting to be considered fraudulent, there must be a preconceived intent to deceive financial statement users in a material way. Technically, accounting practices are not considered to be fraudulent until the intent to deceive has been alleged in an administrative, civil, or criminal proceeding. Prosser (1971) describes the elements of fraud as follows: false representation of a material fact; representation made with knowledge of its falsity; a person acts in the representation; and the person acting is damaged by his/her reliance (Rocco, 1998)

Although the definition of fraud could defer from country to country, fraud is seen to be violating the law or regulatory framework (Jones, 2011). Wells (2009) refers to four features that are common in any fraud case: a material false statement, intent to deceive, reliance on the false statement by the victim, and subsequent damages. Mahdi and Ali (2009) state that fraud is the intentional distortion of financial statements or other records by persons internal or external to the authority carried out to conceal the misappropriation of assets or otherwise for gain. Fraud can be undertaken for the organization (such as tax fraud) or against the organization (such as the misappropriation of assets or financial reporting fraud), and can be done by people inside (namely management or employees) or outside of the organization (vendors or customers) (Johnson & Rudesill, 2001; Alleyne & Howard, 2005, as cited in (Kassem, 2012).

### 4. COMMON FRAMEWORKS FOR DISTINGUISHING BETWEEN EARNINGS MANAGEMENT AND FRAUD

Although previous literature regarding earnings management and financial reporting fraud do not provide one general accepted framework facilitating the distinction between them to be made, they all implicitly or explicitly indicate that compliance with standards and management intent are the most important factors. Dechow and Skinner (2000) provide their view of how different types of managerial choice can be characterized, emphasizing that there is a clear conceptual distinction between fraudulent accounting practices - which clearly demonstrate intent to deceive - and those judgments and estimates that fall within Generally Accepted Accounting Principles GAAP and which may comprise earn-

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<sup>1</sup> LIFO method is acceptable accounting method for US GAAP, but not for IAS/IFRS.

ings management depending on managerial intent. However, they state that, without some objective evidence of intent, this is difficult. Based on the possibility of wealth transfer from one stakeholder to another - which notably results from the fundamental asymmetry of information between managers and other categories, Stlowy and Breton (2004) provide a framework to differentiate between the above terms, defining earnings manipulation as "the use of management's discretion to make accounting choices or to design transactions so as to affect the possibilities of wealth transfer between the company and society (political costs), funds providers (cost of capital) or managers (compensation plans). In the first two cases, the firm benefits from the wealth transfer. In the third, managers are acting against the firm." According to this framework, manipulation that falls outside the law and standards constitutes fraud, whilst activities covered by the terms 'earnings management' (income smoothing, big bath accounting) or generally 'creative accounting' normally remain within the law. Although Stlowy and Breton (2004) mention that, since the Fourth European Directive was adopted in 1978, complaints with GAAP have been made if does not provide a true and fair view of financial situation of the firm, managers must use principles taken from outside GAAP. In such a case, the violation of GAAP is no longer fraudulent. They represent earnings management and creative accounting as practices within the limits of standards.

Unlike previous studies, Yaping (2005) provides a framework for earnings manipulation in which he concedes there to be three mutually exclusive forms: earnings management, earnings fraud, and creative accounting. According to this framework, when earnings manipulation is carried out through exercising the discretion accorded by accounting standards and corporate laws and/or structuring activities in such a way that expects firm value not to be affected negatively, this is referred to as earnings management; otherwise, it is earnings fraud. Creative accounting is the earnings manipulation that does not violate accounting standards or corporate laws because of a lack of relevant standards or laws, such as when firms engage in business innovations. Accordingly, it is neither a fraudulent nor a legitimate practice. In other words, in terms of applying accounting standards and corporate laws, there is no overlap between creative accounting and earnings management or earnings fraud; however, in terms of the impact on firm value, creative accounting overlaps with earnings management if it does not decrease firm expected firm value, and overlaps with earnings fraud if it does so. Sun and Rath (2008) classifies earnings management based on the view that academic literature commonly defines management discretions that fall within Generally Accepted Accounting Principles (GAAP) as earnings management, whereas the Security Exchange Commission (SEC) extends its examining criteria of earnings management to outright fraudulent accounting. Therefore, the interpretation that earnings management can occur when the GAAP is consistent between academia and regulator, but whether fraud constitutes earnings management is ambiguous in academic definitions.

##### 5. THE OVERLAP BETWEEN EARNINGS MANAGEMENT AND FINANCIAL FRAUD

In order to alter their financial results, firms take actions that range from decisions within accounting standards to outright fraud. Decisions made within accounting regulations are often viewed as earnings management and legal practices. This view is based on the acceptability of accounting regulations so that it can draw the line on the continuum distinguishing legitimate earnings management from financial fraud. However, determin-

ing whether or when such behavior in the earnings management crosses the line of legitimacy to fraud, in some situations, is not always easy owing to a number of different reasons.

The first reason is that earnings management and financial reported fraud, in some cases, share the same elements: for example, they share the same objective, which is to deceive or mislead the users of financial information - both of which are deliberate actions taken by the management to achieve private gains, and both having the potential to cause material loss or damage for the shareholders by relying on false information. L.Perols and Lougee (2011) state that fraud has the same object as earnings management but differs in terms of earnings management in that fraud is outside of generally accepted accounting principles ,whereas earnings management is within GAAP. As both earnings management practices and fraudulent accounting can involve intent to deceive, and since the concept of intent is difficult to ascertain for other than perpetrators, the distinction between earnings management and fraud cannot be established through managerial intent alone.

The second reason is that earnings management practices via accounting accruals usually result in financial fraud. When firms inflate reported earnings by using income-increasing accruals, these accruals reverse over time (Healy, 1985); therefore, firms with income increasing accruals in prior years must either deal with the consequences of the accrual reversals or commit fraud to offset the reversals (Dechow, Sloan, and Sweeney (1996); Beneish (1997); Lee, Ingram, and Howard (1999)). Previous year income increasing discretionary accruals might also cause firms to run out of ways to manage earnings (Beneish, 1997); thus, when dealing with earnings reversals and decreased earnings management flexibility, managers might engage in fraudulent activities to achieve objectives that were previously accomplished by managing earnings. With this noted, Mulford and Comiskey (2002) states that managers may stretch the flexibility of the GAAP beyond its intended limits these actions may ultimately become financial fraud. In this same vein, Perols and Lougee (2011) have established that the possibility of committing fraud is significantly higher for firms that have previously managed earnings even when there is no evidence of inflated revenue and when they do not meet or beat analyst forecast. Lee et al. (1999) investigated fraud cases discovered by the SEC, and confirm the positive relation between the likelihood of fraud and total accruals. Moreover, document that fraudulent firms have significantly lower levels of accounting conservatism in the pre-fraud period whereas, consistent with changes in potential legal liability; such firms have an increase in accounting conservatism during the SEC investigation period.

The third is that both are driven by the same incentives. Prior research indicates that discretionary accruals components of earnings and cash flow are managed to meet or slightly beat analyst forecasts (Burgstahler & Dichev, 1997);(Burgstahler & Eames, 2006); (Amar & Abaoub, 2010); (Dechow, Richardson, & Tuna, 2000). Furthermore, firms are found to engage in earnings management practices in order to maximize management compensation or to avoid debt covenants (Balsam, 1998); (Baker, Collins, & Reitenga, 2003; Bartov & Mohanram, 2004; Shuto, 2007); (Iatridis & Kadorinis, 2009). Moreover, prior research examines whether or not the same incentives that motivate earnings management similarly motivate fraud, with focus directed towards incentives related to market expectation, debt covenants, and management compensation. In most case identified by SEC, the underlying motivation is managing earnings toward Wall Street's expectations, yet it does not rule out the other incentives (Mulford & Comiskey, 2002). For example, Erickson, Hanlon , and Maydew (2006) highlight an association be-

tween the structure of executive compensation and accounting fraud. Carrying out a study with a sample of 50 firms accused of by SEC of accounting fraud during the period 1996–2003. Dechow et al. (1996) took a sample of 92 firms subjected to accounting enforcement releases during the period 1982–1992, and subsequently found an important motivation to manipulate earnings as being the desire to attract external financing at low costs. Thus, it can be concluded that earnings management and financial reporting fraud are, in some cases, driven by the same motivations.

The fourth reason is that, with many accounting policies, when it comes to application, there is no clear limit beyond which a policy is obviously illegal. For example, expense estimation, may be illegal if the estimated amount is extreme, but legal if it is reasonable and within the spirit of the accounting standards.<sup>2</sup> GAAP does not tell managers specifically what is normal and what is extreme. Levitt's speech indicates that the SEC would target companies that engaged in 'practices that appear to manage earnings', without clearly distinguishing between earnings managed in the ordinary course of business and earnings fraudulently managed in a deliberate attempt to deceive the financial community. Therefore, in between these extremes are judgments that push the limits of accounting standards and often result in misleading financial results. In this regard, Mulford and Comiskey (2002) refer to such judgments as aggressive accounting.

As a result, there is a potential for some accounting practices to be wrongly classified according to the existing frameworks. For example, backdating of sales invoices is described as fraudulent accounting because it violates GAAP and there exists a (seemingly) clear intent to deceive. Yet there may be circumstances (however rare) where the backdating of sales invoices represents a justifiable business decision. In such cases, this action would constitute a form of justifiable accounting practice, not fraudulent accounting (i. e. accounting for construction contracts). Similarly, actions described by these frameworks as earnings management may actually represent fraudulent financial reporting. Such is the case with subjectively measured misstatements, including the estimation of provision or reserve account balances. The understating of provisions is depicted as aggressive accounting, yet could readily constitute fraudulent accounting. International Standard on Auditing (UK and Ireland) - ISA 240 explains that inappropriately adjusting assumptions and changing judgments used to estimate account balances, constitutes fraudulent financial reporting (The Auditing Practices Board - APB 2004: Para. 09) as cited by Marinakis (2011). If provision account balances are improperly estimated with purpose to mislead, then the understating of provisions would constitute fraudulent accounting, not merely aggressive accounting. The difficulty with accounting techniques involving subjectivity, however, is that intent to deceive is not easy to establish.

Another example can be found from SEC investigations in the case of Lucent Technology Company, which was accused of committing fraud in July 2001. In actuality, before this date, it was found to benefit from a £2.8 billion reserve for 'big bath' restructuring charges that were recorded as part of the process of Lucent's spin-off from AT&T. By writing off several years' worth of costs at once, Lucent reduced future costs which in turn improved future earnings (Byrnes, 1998, October 5). Although recording restructuring

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<sup>2</sup> Examples of accounting estimates are expected lives and salvaging values of long-term assets, obligations for pension benefits and other post-employment benefits, deferred taxes, and losses from bad debt and asset impairments.

costs is allowed by GAAP, some analysts believe that Lucent saves far more than was needed to cover restructuring expenses. The excess reserves helped Lucent smooth earnings by allowing it to add back £382 million to pre-tax income.

Above of all is the fact that earnings management can be achieved by real earnings management, which targets the timing of business transactions and effects cash flow component of earnings. Prior studies have shown evidence of firms altering real activities, such as price discounts to temporarily increase sales, overproduction to report lower costs of goods sold, and the reduction of discretionary expenditures to improve reported earnings (Roychowdhury (2006); Graham, Harvey, and Rajgopal (2005); Graham et al., and evidence that firms make choices between the two earnings management strategies (Badertscher (2011); Zang (2011)). In reality, most of these decisions are completely acceptable by accounting standards. Zang (2011) indicates that firms may prefer this technique because accrual-based earnings management is constrained by scrutiny from outsiders, nor is there available accounting flexibility. For example, a manager might find it harder to convince a high-quality auditor of his/her aggressive accounting estimates than a low-quality auditor. A manager might also feel that accrual-based earnings management is more likely to be detected when regulators heighten the scrutiny of firms' accounting practices. Other than scrutiny from outsiders, accrual-based earnings management is constrained by the flexibility within firms' accounting systems. Firms that are running out of such flexibility due to, for example, having made aggressive accounting assumptions in the previous periods face an increasingly high risk of being detected by auditors and violating GAAP with more accrual-based earnings management.

All above reasons make establishing a distinction between aggressive earnings management and fraud that encompasses all relevant factors is indeed challenging. As both aggressive accounting and fraudulent accounting can involve intent to deceive, and since the concept of intent is difficult to ascertain for other than perpetrators, the distinction between aggressive accounting or earnings management and financial fraud cannot be established through managerial intent alone. While in the research and professional literatures there have been some attempts to provide a distinction between earnings management and financial reporting fraud, there has been little (if any) effort to investigate how this distinction is applied in practice.

## 6. CONCLUSION

Earnings management practices and financial reporting fraud share many features, such as the aim to deceive and the motivation of gaining private gain. These common features make determining whether the management behavior is acceptable or it cross the line to become outright financial fraud is not easy task in some cases. Prior literature does not provide one acceptable framework to differentiate between them. Almost all previous attempts to do this are relaying on tow mean factors which are management intent and compliance with accounting standards. However, management intent is unobservable factor and it cannot be measured unless the management admitted that they act intentionally to deceive financial information users. Indeed, compliance with accounting regulation can provide easier distinguish between these behaviors since we have standards to compare with them. As matter of fact, these standards usually required management to use

their judgment and estimations to apply accounting policies such as estimation of obligations for pension benefits and other post-employment benefits, deferred taxes, and losses from bad debt. Nonetheless, in many cases standards do not clearly state when the applying of these estimations and judgments are within the boundaries of acceptable accounting principles or when they become aggressive and it can be considered financial fraud. Moreover, earnings management can be taken by manipulating real business transaction of the firm. This makes the distinguishing process more difficult. Therefore, this paper calls for more study to investigate the previous frameworks for differentiation between earnings management and financial fraud can be applied in practice and to consider more factors that can provide clearer distinguishing.

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## **UPRAVLJANJE ZARADAMA I PREVARA U FINANSIJSKOM IZVEŠTAVANJU – GLAVNE KARAKTERISTIKE ZA NJIHOVO RAZLIKOVANJE**

**Awidat Marai, Vladan Pavlović**

*Glavno pitanje u oblasti računovodstva jeste do koje mere je menadžmentu dozvoljeno da upravlja prijavljenim zaradama kao i stepen kada ono postaje finansijska prevara. Ovaj rad razmatra šta je upravljanje zaradama i prevara u finansijskom izveštavanju, okvire koje postojeća literatura nudi za njihovo razlikovanje, njihovo preklapanje u nekim slučajevima kao i razloge zbog kojih oslanjanje samo na računovodstvene standarde i namere menadžmenta nije dovoljno za njihovo jasno razlikovanje.*

**Ključne reči:** *upravljanje zaradama, prevara u finansijskom izveštavanju*