A Different Perspective of Earnings Management

UNE PERSPECTIVE DIFFERENTE DE LA GESTION DE REVENU

Ning Yaping[1]

Abstract: Many maintain that earnings management is harmful. Arguing that this is untrue, the paper studies the benefits of earnings management to firms' various contracting parties and investors, as well as the benefits on social resource allocation. The results of this research have important implication for regulators and lawmakers.
Key words: earnings, management, fraud, value-adding

Résumé: Beaucoup de gens insistent sur le fait que la gestion de revenu est préjudiciable. Argumentant contre cette point de vue, cet essai étude les bénéfices de la gestion de revenu pour les collaborateurs divers de l'entreprise et les investisseurs, ainsi que les bénéfices sur la distribution des ressources sociales. Le résultat de cette recherche s'avère très signifiant pour les régulateurs et les législateurs.
Mots-Clés: revenu, gestion, fraude, valeur ajoutée

1. INTRODUCTION

Earnings manipulation is management's action taken to bring reported earnings to a desired level. Earnings manipulation has three mutually exclusive forms: earnings management, earnings fraud, and creative accounting. When earnings manipulation is performed through exercising the discretion accorded by accounting standards and corporate laws, and/or structuring activities in such a way that expected firm value is not affected negatively, it is earnings management, otherwise it is earnings fraud. Creative accounting is the earnings manipulation that does not violate accounting standards or corporate laws because of the lack of relevant standards or laws, for example, when firms engage in business innovations. (Ning, 2005)

Motivated mainly by the fact that almost all academics – including those who realize that earnings management is not a fraud – condemn earnings management, this paper intends to refute the claim that earnings management is harmful, justify the wealth transfer due to earnings management, and study the value-adding functions of earnings management. The paper proceeds as follows. The next section illustrates the objections against earnings management in prior literature. Section three argues for earnings management from various perspectives, while section four recommends actions towards earnings management. The final section summarizes and explains the contributions.

2. OBJECTIONS AGAINST EARNINGS MANAGEMENT

The litigious climate in the U.S. is such that management teams tend to avoid any discussions even remotely linking the two concepts of earnings management and management fraud (Brown, 1999), while earnings manipulation is perceived by managers to be an acceptable practice (Elitzur & Yaari, 1995). In the literature there has occurred little research arguing for earnings management[2]. Instead, most academics adopt hostile attitudes towards earnings management. An explanation to this phenomenon is that earnings management is mistaken for either earnings fraud or creative accounting.

Earnings management is well-known for four accuses as follows. First, earnings management is a fraud. Second, earnings management leads to the representational unfaithfulness of financial statements. Third, earnings management implies deviousness and unethical actions (Brown, 1999) as it intends to fool or mislead users of earnings information. Fourth, earnings management has wealth redistributive effects among related parties, for example, making managers better off at the expense of shareholders.

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[1] Guanghua School of Management, Peking University.China
[2] Katherine Schipper is one of the few who acknowledge that earnings management has a positive side (see Schipper, 1989), although she did not proceed further or deeper into the subject.
*Received 12 February 2006 ; accepted 1 May 2006

3. ARGUING FOR EARNINGS MANAGEMENT

Many maintain that earnings manipulation is a harmful activity (Ziv, 1998), yet this is only partially true. Of the three forms of earnings manipulation, earnings fraud is harmful, creative accounting might be harmful, but earnings management is not harmful. This section intends to argue for earnings management from the following five aspects: representational faithfulness is only a relative concept, earnings management is not fraudulent and does not misrepresent firm's economic position or value, the wealth transfers due to earnings management are justifiable, and earnings management can be value adding.

3.1. Representational Faithfulness Is a Relative Concept

Representational faithfulness is a relative rather than absolute issue. It is impossible for financial statements to be 100 percent faithful to firm's economic or underlying value for at least two reasons. First, accounting standards involve subjective judgments. To account for the same thing, even people of the same background might arrive at different judgments. This means that even if managers have no intention to distort financial reporting, some deviations from the underlying firm value might occur. Thus, 100-percent faithfulness is only a theoretical and impractical concept just like "perfect competition". Second, when managers have private information and are allowed not to share with others, and when problems such as management compensation, tax liability and financing in capital markets draw on accounting numbers, nobody except management and/or people involved in the preparation of the financial reports will know the true earnings. This implies that outsiders have no ground to judge if financial statements represent a firm's true economic position.

Hence, faithfulness defined in terms of the representation of underlying firm value is immeasurable. However, with the definition proposed by Ning (2005), representational faithfulness can be directly measured via the compliance with accounting standards and corporate laws: a financial report is faithful if the data in the report are presented within the constraints of accounting standards and corporate laws. The only criterion to determine the quality of accounting information is how well accounting standards are followed in the preparation of financial reports.

"Information unfaithfulness" and "information distortion" are two different but related concepts. Unfaithful information is resulted from either information asymmetry or information distortion. Marin *et al.* (2002) states that earnings management has crossed the boundary between objective reporting and outright fraudulent financial reporting, namely, reporting under earnings management is neither objective nor fraudulent. Although earnings management impairs truthful reporting, financial reports with earnings management are still relevant, reliable and comparable. And this is the best we can do so far.

3.2 Earnings Management Is Not a Fraud

Earnings management is not a fraud. Fraud is an "act of criminal deception"(Hornby, 1974) or a "deceitful behavior which may be punished by law" (Procter, 1978). Namely, fraud is an unlawful or illegitimate conduct. Earnings management is within legitimate constraints, implying that the deviation of reported earnings from underlying or economic earnings due to earnings management is legitimate or authorized by accounting standards and corporate laws. Just like legitimate tax avoidance is above criticism, so should earnings management. Fraud and representational unfaithfulness are two related but different issues. Fraud is an act or behavior, while representational unfaithfulness is a feature or quality of reports. Difference between reported earnings and economic earnings could result from either illegitimate or legitimate actions. Thus, it is incorrect to say that earnings management is fraudulent because it results in such a difference.

On the other hand, earnings fraud is a cheating and immoral conduct. Examples of the cheating devices include forging documents, fictitiously recognizing revenues, bribing, and illegitimate transactions between a parent company and its subsidiary. The relationship between earnings management and earnings fraud is not like the pot calling the kettle black. It is true that both earnings management and earnings fraud lead to presentational infidelity, however, earnings fraud causes the infidelity by violating accounting standards or corporate laws while earnings management does it by making the most of the standards and laws. That is why Magrath & Weld (2002) acknowledges that some earnings management (or rather, earnings *manipulation*) techniques are not fraudulent. In opposition to what Landsittel (2000) states about the difference between earnings management and fraudulent financial reporting – the former presumes that the reporting results are not "materially misrepresented" while the latter does, it is claimed here that the difference between earnings management and earnings fraud is not the degree of presentational faithfulness but the legitimacy of the practice. That is why earnings fraud should be denounced while earnings management should not.

3.3 Earnings Management Does Not Misrepresent Firm Value

Many hold that earnings management misrepresents (i.e. overstates or understates) firm's periodic performance and economic position (e.g. Goel & Thakor, 2003). I argue that, except firm's periodic earnings performance, earnings management does not misrepresent firm value or firm's periodic economic position. Firms have incentives to manage reported earnings downward when economic earnings are above the level they desire. The part of earnings managed downward builds up an invisible reserve of earnings, and is hidden in inventory, sales returns, loan losses, warranty costs, R&D expenses, and other line items of financial statements. In the presence of this hidden earnings reserve, firms are able to manage current period's earnings upward when it is below the desired level. As a result, earnings management may result in the misrepresentation of reported earnings performance in terms of individual time periods. However, earnings management does not misrepresent firm's economic position of each individual period. The economic position of a firm in a period is represented by the total value of its assets, owner's equity and liability of that period. When earnings are managed downward, the part of earnings unreported is reserved in or transferred to some other line items, such as inventory, R&D and provisions. The managed decline of earnings is accompanied by the rise of the line items concerned at the exact amount; hence the invisible transfer does not change the underlying or economic position of the firm in that period. When earnings are managed upward, the increase of current period's reported earnings is accompanied by the decline of the line item(s) where earnings of previous period(s) has been reserved at the exact amount; namely the increase of reported earnings under earnings management is not made-up or groundless.

Earnings is a continuous variable despite that outsiders tend to regard it as a discrete variable (Patel & Zeckhauser, 1999). According to Ziv (1998), earnings management is a process of manipulating the time profile of earnings while *not* changing the reported earnings over the long run. Disregarding the benefits from earnings management such as tax savings[3] or lower-cost external financing, the aggregated firm value in the long run or the future cash flow is not misrepresented under earnings management, because the increase (or decrease) of reported earnings is accompanied by a decline (or rise) in some other line items reported at the exact amount.

Earnings management is not immoral or unethical. Although earnings management is meant to modify the behavior of earnings-information users, it is far from fooling or misleading the users of financial statements. In dictionaries[4], to fool is to deceive or to cause someone to accept as true what is false while to mislead is to guide or lead wrongly. Unlike earnings fraud, earnings management does not create fictitious amount of earnings, rather, it legitimately allocates the true amount in more than one line items besides earnings in order to "smooth" reported earnings across accounting periods. Though the amount in a certain line item may be untrue, the economic position and firm value are faithful. Managers' accrual decisions may result in earnings management (Dechow & Skinner, 2000), or earnings management incorporates accruals-based manipulation of economic earnings by managers (Evans III & Sridhar, 1996; Jaggi & Lee, 2002). In addition, accounting conservatism may result in the practice of managing earnings downward. If accrual decisions and accounting conservatism are regarded as ethical, so should other techniques of earnings management.

3.4 Wealth Transfers Due to Earnings Management Are Justifiable

Many academics posit that earnings management induces wealth transfers. Watts & Zimmerman (1986; 1990), Smith (1993) and Jiambalvo (1996) claim a wealth transfer from debtholders to shareholders when management changes accounting choices to avoid the violation of debt covenants. Watts & Zimmerman (1990) and Schipper & Vincent (2003) assume that overstated earnings result in wealth transfer to managers from other contracting parties if earnings are used as an indicator of managers' performance. Dye (1988) suggests a wealth transfer from investors (i.e. potential or future shareholders) to shareholders under earnings management. The effect of the wealth transfer from investors to shareholders is the basis of the SEC's strong opposition against earnings management.

The hostility towards earnings management for debt contracts mainly arises from the belief that firms' reported risk is higher than their real risk if earnings are managed. However this is untrue. Earnings management does not misrepresent firm's economic position or future cash flow, the increase of reported earnings for meeting debt covenants, rather than being made-up, is from the earnings reserve hidden in some other line items. When management changes accounting choices within the constraints of accounting standards to avoid the violation of debt covenants, a win-win situation occurs: shareholders are better off when the violation of debt covenants is avoided, while debtholders are better off when firms maximize their

[3] Earnings management has limited effect on tax savings. While real earnings management has an effect on both accounting income (i.e. income determined by accounting principles) and taxable income (i.e. income determined by tax laws) – hence tax expenses, paper earnings management has little effect on tax expenses mainly because income tax expenses are based on taxable income rather than accounting income.

[4] For example, Hornby, 1974; Procter, 1987

chances of meeting the covenants because the times of getting investment returns are maximised.

I find it difficult to convince myself to take the same attitude towards earnings management as SEC's due to the following facts. First, since earnings management does not misrepresent firm value or periodic economic position, it hardly distorts investors' beliefs about firms' future economic prospects. Thus the alleged wealth transfer from investors to shareholders due to earnings management, if there is any, will be insignificant. Second, rational investors attain their perceptions of a firm on the aggregate firm value rather than the single reported earnings figure alone; and they are sophistical enough, according to Ziv (1998) and Dechow & Skinner (2000), to reverse financial statements (e.g. undo or apply some discount to firms' accounting choices) and infer the information that underlined the provided disclosure. Moreover, technological advances enable them to have low-cost access to some requisite information (e.g. the information available at virtually zero cost through corporate web sites). Firms cannot be blamed for earnings management if imprudent or inexperienced investors make their decisions based on the reported earnings figure alone. The people who the SEC protects should be *rational* investors. Third, to SEC, firms have 'original sin' because they are born with the *ability* to fraud although they might choose not to do so. However, I claim that firms' right should also be protected if they walk the chalks. Fourth, accrual accounting generates more useful information for investors to assess economic performance and predict future cash flows than cash-flow accounting because it helps dampen the fluctuations in a firm's underlying cash flows (Dechow & Skinner, 2000), this means that managed earnings may sometimes be more useful to investors than unmanaged earnings. Nevertheless, generally speaking, only a small portion of the variability in stock returns is explained by accounting numbers (Fields *et al.*, 2001).

It is said that when earnings are used to measure management performance, overstated earnings cause wealth to be transferred from shareholders to managers (Watts & Zimmerman, 1990). However, because earnings overstated via earnings management is not forged but from the hidden earnings reserve, such a transfer is not immoral, especially when management performance of the year has been negatively affected by uncontrollable factors such as market. Firms with hidden earnings reserve have a comparative advantage in organizing their reported earnings information so as to avoid some temporary business risks. Earnings gained in an accounting period exceeding the upper bound of compensation scheme means that management has outperformed shareholders' expectation in the period. When management shift the surplus of current earnings via earnings management to future periods, the probability of their future earnings within the bounds is enhanced. This can be regarded as a special bonus that management deserves. Although the benefit gained is not at the expense of shareholders, shareholders may be worse off when earnings management is not practiced. Nevertheless, managers should not be blamed or punished if their hidden earnings reserves are built up via earnings management rather than earnings fraud.

There are two other undocumented types of wealth transfers due to earnings management: from financially troubled firms to healthy firms, and from firms with poorer management to firms with better management. Having a hidden earnings reserve or being able to take some of the current gains to future signals firm's financial strength. Other things being equal, firms with hidden earnings reserves are likely to have greater capability to generate profits, avoid risks and develop sustainable competitive advantages in future than firms without such reserves. This is because they have greater potential, for example, to attain the thresholds of stock offerings, to avoid the violation of debt covenants, and to satisfy regulatory requirements.[5] On the other hand, not all economically strong firms conduct earnings management. Whether to exercise the discretion permitted by accounting standards and corporate laws and how well the discretion is used reflect if management is professional. Management that conducts earnings management well is likely to be better at maximizing firm value than management that does not do it. This is because the former tends to be more skilful at financing, averting risks, minimizing tax expenses and/or losses due to reasons such as government scrutiny. Alternatively, whether to do earnings management reflects management's ability to acquire, effectively employ and create resources. In current competitive environment, the survival and sustainable development of firms largely depend on how well they acquire, employ and create resources. Therefore, economically stronger firms and firms with better management deserve higher share prices and better credit terms. From this perspective, earnings management is efficient because it helps resources to be properly allocated for economic growth, and financial statements with earnings management function as a signal, distinguishing economically stronger firms and firms with better management from others.

In contrast, earnings fraud causes inefficient resource allocation because fraudulent financial reporting diverts resources from substantive projects with actual expected payoffs to chimerical projects with fake expected payoffs (Schipper & Vincent, 2003). Fraudulently overstated earnings mask deteriorating solvency, misleading lenders to continue lending or defer foreclosure. Gains from capital market through earnings fraud resemble booty from robbery. The wealth

[5] In the United States, for example, banking regulations require that U.S. banks satisfy certain capital adequacy requirements that are written in terms of accounting numbers. Insurance regulations require that insurers meet conditions for minimum financial health. Utilities have historically been rate-regulated and permitted to earn only a normal return on their invested assets. (Healy & Wahlen, 1999)

transfer as a result of earnings fraud is illegal and immoral, hence earnings fraud deserves condemnation and punishment.

3.5 Earnings Management Is Value Adding

According to Magrath & Weld (2002), good business practice requires managers to manage earnings. Being part of risk-aversion or value-maximization scheme, earnings management helps firms reduce the risk of breaking debt covenants, stock thresholds, and regulated requirements when there is, for example, an unexpected change in input prices. When the difference between attaining and missing the threshold of stock offering, debt covenant, or regulated requirement is just a few cents, the marginal benefits of earnings management increase sharply as earnings are managed from a small shortfall to a small surplus of the threshold point. In this case, firms that do not conduct earnings management bear sharply higher costs in transactions with shareholders or debtholders. Viewing from a different perspective, earnings management helps firms to attract low-cost financing, obtain high stock prices, avoid political and labour negotiations costs, and minimize tax expenses. Accordingly, earnings management is firms' value-maximization tool. Trueman & Titman (1988) find that highly perceived earnings volatility increases the perceived bankruptcy probability of the firm and hence its borrowing costs. Firms with smooth earnings are typically rewarded in the stock market (Magrath & Weld, 2002), because they are priced at a premium to other firms (Myers & Skinner, 1999; Barth *et al.*, 1999) and discourage speculators.

Accordingly, earnings management is firms' tool to maximize shareholder value. Demski *et al.* (1984), Arya *et al.* (1998) and Dutta & Gigler (2002) provide evidence that shareholders are better off with managed earnings. No wonder why Dye (1988) claims that shareholders have a demand for earnings management. As has been explained earlier, debtholders are better off if earnings management helps their borrowers reduce the probability of covenant violation. Efficient contracting suggests that, although financial reporting discretion may allow managers to increase their compensation, such discretion also improves the alignment of their interests with those of shareholders (Watts & Zimmerman, 1986) and debtholders.

According to Black (1993), earnings are smoothed to increase the association between reported earnings and firm value, hence smoothing earnings makes the reported earnings figure more informative. Rather than misleading investors in capital markets, earnings management helps them form rational expectations about firm value because firms that are engaged in earnings management are likely to be economically stronger and/or with better management. In addition, managing earnings to reduce the perceived volatility of firms' earnings stream is beneficial to investors because it discourages welfare-reducing information acquisition by speculators. Zero earnings management, according to Dechow & Skinner (2000), is clearly not an optimal solution in capital markets.

4. SUGGESTED ACTIONS TOWARDS EARNINGS MANAGEMENT

The results of this research have important implication for regulators and lawmakers. Regulators tend to regard earnings management as harmful and in the need of immediate remedial action (Dechow & Skinner, 2000). The SEC is always against any type of earnings manipulation. This will remain to be the case, as Dechow & Skinner (2000) speculates, even if financial statements and related disclosures included sufficient detail to allow investors to adjust for earnings management. The SEC's explanation to this is its mandate to ensure that stock exchange is fair to buyers. However, it is SEC's job to work for the best interests of every lawful and rational market participant. Market participants include not only buyers but also sellers. Being within legitimate constraints, earnings management is beyond criticism, hence should not be identified as a target of regulators' enforcement actions.

Achilles cannot blame others for taking advantages of his heel because people are opportunistic. For the same reason, it gives no cause for much criticism if managers take advantages of the inadequacies of accounting standards and exploit their ability to manage reported earnings, and it is inappropriate to say that taking the advantage of the inadequacies is to subvert the intent of the standards. It is the standard makers who should hold responsible. The quality of financial statements is an indirect indicator of the quality of accounting standards (Schipper & Vincent, 2003). If the inadequacies of standards cannot be eliminated, one just has to learn to live with earnings management. Zero earnings manipulation is impossible as long as compensation scheme, tax payment, debt contracts, stock offering, labor negotiation and regulatory monitoring are not independent of accounting data; and when there are information asymmetry, accounting flexibility and management's reporting discretions.

Instead, efforts should be made to improve antifraud programs. Useful mechanisms for the purpose include internal controls, audits' check, regulatory bodies' monitoring, and financial analysts' scrutiny. In addition, accounting policymakers and standard-setters need to examine how the current standards can allow abusive manipulation of accounting numbers, and strive to reduce the subjectivity or ambiguity in accounting standards and enable the standards to cope with business innovations. The less subjectivity and ambiguity accounting standards have, the less potential of earnings manipulation. The ambiguity in accounting standards might lead to substantial disagreement as to what is within versus outside the bounds of acceptable reporting. Reporting allegations against Waste Management, Cendant, and Sunbeam, for example, are cases in point, where courts will ultimately decide whether management crossed the line. (Brown, 1999) Moreover, standard setters need to keep pace with the accelerating changes in business practices so as to prevent accounting recognition from lagging economic events and minimize the opportunities for creative accounting practices.

5. CONCLUDING REMARKS

Everything has two sides. Previous literature on earnings manipulation, however, seems one-sided because it focuses primarily, if not solely, on earnings fraud and creative accounting, though named as ‘earnings management’. Representing a significant departure from traditional researches, the paper offers a systematic study on the positive side of earnings manipulation and suggests that hostile attitudes towards earnings management are inappropriate. The disputes expected to arise from this paper are likely to improve the understanding of earnings management.

Future research opportunities include the study of the guidelines for determining the impact on expected firm value by real earnings manipulation (e.g. the impact of accelerating R&D expenses on the expected firm value), the empirical measurement of the impact, and empirical studies on the validity of the proposed definitions and the value-adding characteristics of earnings management.

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THE AUTHOR

Ning Yaping, Female. Anhuiness. Born in 1959. Obtained Ph.D degree from School of Commerce, The University of Queensland, Australia in 2001. Presently working as an Associated Professor in Guanghua School of Management, Peking University.

Contact: Guanghua School of Management, Peking University, Beijing, 100871, P.R. China.

Email: ning@gsm.pku.edu.cn