Techniques, Motives and Controls of Earnings Management

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Abstract

Earnings are the powerful indicators of the firms’ business activities. Since a company’s stock is measured by the present value of its future earnings, investors and analysts look to earnings to determine the attractiveness of a particular stock. Companies with poor earnings prospects will typically have lower share prices than those with good prospects. So, earnings management plays a key role to determine the share price of a company as well as direct resource allocation in capital market. This paper specially focuses on earnings management, quality of earnings and various techniques (like cookie jar reserve, big bath, and big bet) that are used to manage earnings in the business entity. Extent and type of earnings management depends on several factors like stock market incentives, personal incentives, political & regulatory motives. Finally, this paper concludes that rigorous accounting standard, awareness of audit committee, corporate governance and consciousness and the morality of the stake holders play a vital role to control earnings management.

Key words: Earnings management, Cookie jar reserve, big bath, big bet

1. Introduction

Earnings mean the profits of a company which is represented by the bottom line of the income statement and a summary item in financial statements. Earnings are the vital item in financial statement because it represents to what extent the company engaged in value added activities. Earnings also indicate the signal of direct resource allocation in capital market. Investors and analysts look to earnings to determine the attractiveness of a particular stock. The company’s stock is measured by the present value of its future earnings. Companies with poor earnings prospects will typically have lower share prices than those with good prospects. A company’s ability to generate profit in the future plays a very important role in determining its stock’s price. Since company’s value is directly related with future earnings, all the

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Stakeholders are interested whether earnings management is being practiced or not by the business organization. Management has also a key interest in how earnings are reported and every
executive needs to understand the effect of their accounting choices or learn to manage earnings so that they can make the best possible decisions for the company.

2. Objective of the Study:

The main objective of this study is to focus on techniques, motives and control of earnings management. In the light of this main objective, the specific objectives of the study are as follows:

i. To know about earnings management;
ii. What are the techniques are applied to manage the earnings;
iii. To know the factors that motivate the manager to manage the earnings and
iv. How we can control the earnings management.

3. Methodology:

This research is based on secondary sources. Secondary sources of information include academic journals, books and websites. In this paper we have given an idea about earnings management. After that, we have analyzed the techniques that are used to manage the earnings to maximize the personal benefit. We have found out to manipulate earnings what are the factors act as incentive to the management. We have recommended some mechanism to prevent and control of misuse of earnings.

4. What is Earnings Management?

Earnings management may be defined as reasonable and legal management decision making and reporting intended to achieve stable and predictable financial results. A large number of companies are using earnings management either to maintain steady earnings growth or to avoid reporting red link. In other words, earnings management is a strategy used by the management of a company to deliberately manipulate the company’s earnings so that the figures match a predetermined target. This practice is carried out for the purpose of income smoothing. An accounting expert can manipulate earnings in several ways within the boundaries of accounting standards. It can be said unethical but not always illegal. Earnings management is firms’ strategic tool for maximizing firm value and reducing risks.

The accounting literature defines earnings management as “distorting the application of generally accepted accounting principles.” Many in the financial community assume that GAAP deters earnings management. Earnings management results less from distortion of the application of GAAP than from the application of inherently faulty GAAP.

Earnings management is recognized as 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 earnings.

So, Earnings management can be defined as the accounting policies or the accruals control, chosen
by the management of enterprises to make the earnings reach the expected level under the pressure from the relevant stakeholders and the constraints of generally accepted accounting principles (GAAP). In addition to the choice of accounting policy and the control of accruals, the means of earnings management have also included lobbying for the regulatory organization to modify the accounting principles and the manipulation of profit figures in the fiscal report.

5. Literature Review

“Earnings management occurs when managers use judgment in financial reporting and structuring transactions to alter financial report to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.” Healy and Wahlen (1998). There are two methods that could be used for earnings management. First, one could use the flexibility allowed in generally accepted accounting principles (GAAP) to change reported earnings—without changing the underlying (past) cash flows, which Healy and Wahlen describe as usage of managerial judgment in financial reporting. This is called accounting earnings management. Second, a manager may change operating decisions, such as delivery schedule or maintenance, in order to manage the underlying cash flows that will affect the reported income reports, which is being described as structuring of transactions by Healy and Wahlen. This kind of management is usually referred to as economic earnings management.

According to Roman (2009), “Earnings management occurs when firm management has the opportunity to make accounting decisions that change reported income and exploit those opportunities”. He also stated that accounting for business operations requires judgment and estimates. For example, one can’t measure revenue without estimating when customers will pay, how many will not pay, how many will return goods for refund and costs to the seller for fulfillment of warranty or maintenance promises.

Many writers restrict the term “earnings management” to the selection of estimates that achieve an earnings target and would not use the term to refer to timing of transactions. According to Roman (2009), earnings can be also be managed by timing of transaction. For example, management can decide to paint the office in December. All other things being equal, management will report lower earnings in that office painting period than in other periods. Management can choose when to paint and thereby, manage the earnings. In addition, management of a company that uses a LIFO cost flow assumption for inventories has an opportunity to manage earnings by timing end of year purchases. In times of rising prices, management can buy during this period which will increase the cost of goods sold and reducing income or delay purchases until the next period that will decrease this period’s cost of goods sold and increasing income. Management can choose when to buy and manage earnings. Management has the ability to choose a number from a reasonable price range and be confident no one can say some other number is better gives them the opportunity to manage earnings. When management’s number choice is made with an eye to its effect on net or comprehensive income, it is engaging in “earnings management”.

Several researches found different managerial incentives for earnings management. DeFond and Jiambalvo (1994) find that sample firms accelerate earnings prior to lending covenants, and Holthausen, Larcker and Sloan (1995) observed that managers manipulate earnings downwards when their bonus are at their maximum. Healy (1985) also documented similar evidence. Another set of studies focus on top managers’ job security and their incentives to manipulate earnings when the managers are faced with a possibility of losing their respective jobs. Watts and Zimmerman (1986)
suggest that certain factors such as debt covenant constraints, compensation plan provisions, political costs, the need to issue equity capital, insider trading, etc. provide managers with incentives to manage earnings.

Earnings management literature finds that motivations and opportunities for income manipulation vary with circumstances like CEO changes. Dechow and Sloan (1995) found that CEOs tend to reduce spending on research and development in their final employment years, possibly to increase reported earnings.

Several recent studies investigate the capital market incentives for earnings management. These studies emphasize on discretionary accruals during the periods when capital market incentives are believed to be high. Several studies investigate the relationship between earnings management and security offerings. Teoh, Welch and Wong (1998a), and Kabir (2002) observed earnings management of initial public offerings (IPO), and Rangan (1998) and Teoh, Welch and Wong (1998b) investigated earnings management of seasoned equity offerings. These studies found evidence that at issue year firms, on average, have high positive earnings and abnormal accruals, followed by poor long-run earnings and negative abnormal accruals. Stock-for-stock mergers are another area where potential earnings management is examined. Erikson and Wang (1999) report that, in the quarters leading up to the merger, acquiring firms manage earnings upward apparently in an attempt to increase their stock prices. This is generally believed by the regulators and the public that managers manipulate reported earnings (Levitt, 1998). Perry and Williams (1994) provide evidence of managers’ manipulation of earnings in the predicted direction in the year preceding the public announcement of management’s buyout intention.

Prior research by Burgstahler and Dichev (1997), and Degeorge, Patel, and Zeckhauser (1999) found cross-sectional evidence that: (1) small reported losses are unusually rare while small reported profits are unusually common, and (2) small declines in reported earnings are unusually rare while small increases in reported earnings, suggesting that managers use their accounting discretion to avoid reporting losses and earnings declines. Managers exercise discretion over earnings to enhance earnings information by allowing communication of private information. It is most important to avoid losses, but once profitability is achieved it is then important to report increases in quarterly earnings and once increases have been achieved the goal becomes meeting analysts’ earnings forecasts. (Watt and Zimmerman (1986); Holtahusen (1995); Degeorge, Patel, and Zeckhauser (1999)). Managers of firms that achieve long string of consecutive increases in quarterly earnings per share (EPS), have stronger incentives than managers of other forms to practice earnings management. Balsam (1998) examines the manner in which earnings components, including discretionary accruals, affect CEO cash compensation and shows that discretionary accruals are associated with CEO cash compensation. Discretionary accruals are positively and significantly associated with executive compensation, which suggests that firm managers use discretionary accruals to increase their compensation (Shuto, 2007). Nondiscretionary earnings components are more value relevant than discretionary earnings components (Subramanyan, 1996). Gaver and Gaver (1998) find that extraordinary losses are unrelated to CEO cash compensation. Baber, Kang and Kumar (1998) also find that the effect of earnings changes on compensation increases with persistence of those earnings changes.

Xie et al (2003) argue that the nature of accrual accounting gives managers considerable discretion in determining the earnings in any given period. According to Teoh et al (1998a), within the boundary of GAAP, managers have several sources to manipulate earnings. They can choose an accounting method to advance or delay the recognition of revenues and expenses, use discretionary aspects of the application of the chosen accounting method, or
adjust the timing of asset acquisitions and dispositions to alter reported earnings.

There is a large literature examining the relationship between board monitoring and firm performance on various aspects such as CEO turnover, stock return, operating performance and financial reporting quality (Weisbach (1988); Brickley (1994); Vafeas (1999); Dechow et al (1995); Beasley (1996)). These previous papers not only confirm that the board of directors does affect firm performance, but also find some characteristics of the board are related to the effectiveness of the board, especially in monitoring top managers. These characteristics are the independence of the board, the competence of outside directors, outside directors’ ownership, and the activity of the board.

6. Techniques of Earnings Management

Earnings management is a very popular term used by management to manage earnings. But it does not mean any illegal activities by management to manage earnings. Managers can achieve earnings from accounting choices or by operating decisions. Managers can manage earnings because they have flexibility in making accounting or operating choices. The most successful and widely used earnings management techniques can be classified into twelve categories. Here some of the most common categories are described below:

i. “Cookie jar reserve” technique:

The cookie-jar technique deals with estimations of future events. According to GAAP, management has to estimate and record obligations that will be paid in the future as a result of events or transactions in the current fiscal year based on accrual basis. But there is always uncertainty surrounding the estimation process because future is not always certain. There is no correct answer; there may be reasonably possible answers. Management has to select a single amount according to GAAP so there is a chance of taking the advantage of earnings management. Under the cookie-jar technique, the corporation will try to overestimate expenses during the current period to manage earnings. If and when actual expenses turn out lower than estimates, the difference can be put into the “cookie jar” to be used later when the company needs a boost in earnings to meet predictions. Some examples of estimation to manage earnings are: sales returns and allowances, estimates of bad debt and write-downs; estimating inventory write downs; estimating warranty costs; estimating pension expense; terminating pension plans and estimating percentage of completion for long term contracts etc.

ii. “Big Bath” Techniques:

Although a rare occurrence, sometimes corporations may restructure debt, write-down assets or change and even close down an operating segment. In these instances, expenses are generally unavoidable. If the management record estimated charge (a loss) against earnings for the cost of implementing the change then it will negatively affect the cost of the share price. But the share price may go up rapidly if the charge for restructuring and related operational changes is viewed as positively. According to Big
bath technique, if the manager have to report bad news i.e., a loss from substantial restructuring, it is better to report it all at once and get it out of the way.

iii. “Big Bet on the Future” technique:

When an acquisition occurs, the corporation acquiring the other is said to have made a big bet on the future. Under Generally Accepted Accounting Principles (GAAP) regulations, an acquisition must be reported as a purchase. This leaves two doors open for earnings management. In the first instance, a company can write off continuing R&D costs against current earnings in the acquisition year, protecting future earnings from these charges. This means that when the costs are actually incurred in the future, they will not have to be reported and thus future earnings will receive a boost. The second method is to claim the earnings of the recently acquired corporation. When the acquired corporation consolidated with parent company earnings, then immediately receive a boost in the current year’s earnings. By acquiring another company, the parent company buys a guaranteed boost in current or future earnings through big bet technique.

iv. “Flushing” the investment portfolio:

To achieve strategic alliance and invest their excess funds, a company buys the shares of another company. Two forms of investment are trading securities and available for sale securities. Actual gains or losses from sales or any changes in the market value of trading securities are reported as operating income where as any change in market value of available for sale securities during a fiscal period is reported in “other comprehensive income components” at the bottom of the income statement, not in operating income. When available for sale securities are sold, any loss or gain is reported in operating income. A manager can manage its earnings through various techniques which are:

i. Timing sales of securities that have gained value: The company can sell a portfolio security that has an unrealized gain and report the gain as operating earnings if it is required

ii. Timing sales of securities that have lost value: If the manager wants to show lower earnings then he can sell the security that has an unrealized loss and report the loss in operating earnings.

iii. Change of holding intent, write-down “impaired securities: Management can manage earnings through change of its holdings from available to sale securities to trading securities and vice versa. This would have the effect of moving any unrealized gain or loss on the security to or from the income statement

iv. Write-down “impaired securities: Securities that have an apparent long term decline in fair market value can be written down to the reduced value regardless of their portfolio classification.

v. “Throw out” a problem child:

To increase the earnings of future period, the company can sell the subsidiary which is not performed well i.e. “the problem child” subsidiary may be “thrown out”. Earnings can be managed through sell the subsidiary, exchange the stock in an equity method subsidiary and spin off the subsidiary.

A gain or loss is reported in the current period statement when a subsidiary is sold. The existing shareholders become the owner of the problem child by distributing or exchanging the shares of a subsidiary with the current shareholders. As a result, no gain or loss is normally reported on a spin off.
Moreover, it is possible to “swap” the stock in an equity method subsidiary without having any recordable gain or loss.

vi. Introducing new standard
New rules and regulations are introduced in GAAP due to changing demand of business environment. Accounting principles can be modified in a way that will not change the earnings. When a new accounting standard is adopted it takes two to three years to adopt the standard. Voluntary early adoption may provide an opportunity to manage the earnings. A company can take the advantage of manage earnings by changing the time an accrual basis rather than cash basis those are recorded as expense on a cash basis. Moreover, timely adoption of a better revenue recognition rule will provide a new window to manage the earnings.

vii. Write off of long term operating Assets:
The cost of long term operating assets used or consumed is recorded as an amortization (intangible assets- goodwill, patents, copyrights, and trademark), depreciation (tangible assets- buildings, machinery, equipment) and depletion expense (natural resources-timber, coal, oil, natural gas) over the periods expected to be benefited. Management has the discretionary power when selecting the write off method; write off period; estimating salvage value. It is not necessary to record depreciation or amortization expense if the long term operating asset changed to non operating asset.

viii. Sale/leaseback:
A company can enhance the earnings of the financial statement by selling a long term asset that has unrealized gain or losses. For instance, the cost of a machine showed in the balance sheet at Tk 20 lac, but its market value is now Tk. 30 lac. If the machine is sold then Tk. 10 lac gain will enhance the current period earnings. In addition, by recording a gain or loss a company can manage its earnings. According to IAS 17, losses occurring in a sale/leaseback transactions are recognized on the seller’s book immediately and gain are amortized over the period if it is capital lease or proportion of the payment is operating lease.

ix. Operating versus non operating Income:
Earnings are two types: operating and non-operating. Non operating earnings will not affect future earnings where as operating earnings are expected to continue in the near future. Non operating income includes: discontinued operations, extraordinary gains or losses, cumulative effect of change in accounting principles. The manager can manage its earnings when making decisions about items which falling into those areas. To illustrate, a disposition of a major manufacturing plant could possibly be classified as either a special or unusual charges or as discontinued operations. What classification is more accurate may depend on management judgment regarding this factor.

x. Early Retirement of Debt:
Management can manage the earnings by selecting the fiscal period of early retirement of debt. A gain or loss is occurred when the company makes the early payment of cash which is different from the book value of long term debt such as bonds. This gain or loss is recorded as an extraordinary item at the bottom of the income statement which boost the earnings of that period.

xi. Use of Derivatives:
Derivatives offer a lot of opportunities for manager to manage earnings. Derivatives can be used to protect against some types of business risk, such as: interest rate changes; commodity price change; the weather; oil price changes; changes in foreign currency exchange rates. Derivatives should be
reported as assets and liabilities in the balance sheet and measured at fair value. Gains and losses from derivate transactions are generally recognized immediately in regular income. For example, suppose a company had a large issue of bonds outstanding at a fixed interest rate. The company could enter into an interest rate swap that would effectively convert the fixed rate bonds into variable rate bonds. When the interest rate increases, the company would then record an increase in interest expense for the bonds and a decrease if the rate has decreased. Since, when the company enters into the swap is up to the company, the timing option provides an opportunity to manage the earnings.

xii. **Shrink the ship:**
Companies do not have to report any gain or loss for repurchase of their own shares on the income statement because no income is recognized on the transaction. Income is only earned through equity transactions outside the firm, not with those involving the firm’s owners. A stock buy does not affect earnings but it is used to affect earnings per share.

So, these are the common & popular earnings management techniques. Management uses these techniques as & when required to manage earnings. Management uses cookie jar reserve technique to show boom earnings in the future period. Big Bath technique are used in the belief that if a manager have to report bad news i.e., a loss from substantial restructuring, it is better to report it all at once and get it out of the way. Sometimes a subsidiary may underperformed & the earnings of this type of security are managed by throw out a problem child method. Companies that changes GAAP have to take care that stock market does not view the change as lowering the quality of earnings. Timely disposition of long term productive assets (Sale/leaseback and asset exchange technique) can result in the recording of unrealized gains or losses. Under the amortization, depreciation and depletion method, management manages earnings by selecting the write off method & period & estimating salvage value.

7. **Motives behind 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. Legal earnings management means financial reports are adjusted in line with financial reporting standards. Earnings management becomes fraudulent financial reporting when it falls outside the bounds of acceptable accounting practice. Therefore, companies will only engage in earnings management when the benefits of this behavior are higher than the risks and costs involved. Stable dividend and stable business act as motivational tools to the manager to manage earnings (Suda and Shuto, 2006). Matsumoto (2002) argues that firms with high growth prospects have greater incentives to manipulate earnings to avoid unfavorable market reaction to negative earnings news. Matsumoto also stated that the earnings of loss firms are less value relevant and thus managers are less likely to adjust earnings to meet targets.

Prior researches identified different categories of incentives: stock market incentives; signaling / concealing private information; political costs; personal interest; internal motives; management compensation contract motivations; lending contracts motivations and regulatory motivations

i. **Stock market incentives.**
The interaction between accounting numbers and stock markets reaction can indeed push management towards earnings management. Investors often rely on the views and forecasts of stock market analysts to put together a portfolio of potentially successful firms. Meeting or beating the analysts’ forecasts seems to be of enough importance for companies to engage in earnings management. Meeting the analysts’ expectations is important because firms that meet or beat expectations enjoy higher returns, even when it is likely that this is achieved through earnings management or expectations management. Missing an earnings benchmark has negative implications for stock returns as well as CEO compensation. To be able to meet or beat the forecasts, managers turn to
earnings management. If pre-managed earnings are below the forecast, managers use income-increasing earnings management. If pre-managed earnings are higher than the forecast, managers can choose between income-decreasing earnings management (saving it for a rainy day) or not managing the earnings (hoping for an increase in stock return).

Companies that show an increase in earnings as well as in revenues are less susceptible to earnings management. To align shareholders’ goals with managers’ objectives and give less room to agency conflicts, CEO’s and senior management are often compensated by equity incentives. This kind of opportunistic behavior might even increase when there is a direct link to these two incentives and the financial benefit of the firm’s management. Recent research also considered earnings management in specific stock market situations, such as an initial public offering and seasoned equity offerings.

i. **Signaling or concealing private information**
Earnings management is, by definition, a process of altering financial information in order to achieve certain goals. Failing firms engage in earnings management and alter their annual accounts to conceal their financial struggle without immediately measuring the consequences on stock price or CEO compensation. The growth signal combined with another signal such as a stock split might be an effective way of communicating private information.

ii. **Political costs**
Firms can also manage reported earnings by changing financial statements in order to influence shareholders’ opinions and decisions. Governmental regulations and tax laws, when company make use of financial reports, are obvious candidates to be analyzed as possible sources of earnings management motives. It can be valuable to companies to seem more/less profitable to escape from governmental interference. When accounting numbers are the basis for tax calculation, there might be large tax avoidance incentives for earnings management. In summary, political costs seem to be a strong incentive for firms to manage their earnings. This is even proven in economies where there exist no efficient stock markets and CEO’s are appointed by the government.

iii. **Personal incentives**
There might be other than financial motives for the CEO to manage earnings. A new CEO can be tending to downwards earnings management in the year of change and upwards earnings management in the following years. Retiring CEO’s use upwards earnings management to leave in style and keep a seat on the board.

iv. **Internal motives**
Finally, there are motives for earnings management that are not linked to external stakeholders (such as shareholders, government or unions) but are intra-company. Within a company, it might also be useful to alter financial reports or to structure transactions in such a way that budget ratcheting is avoided or performance standards are met. Managers will choose to use income-decreasing unexpected accruals when the earnings innovations are transitory. Companies using externally determined standards (i.e. relatively unaffected by participants such as peer group standards, fixed standards or cost of capital) are less likely to smooth earnings than those companies that use internal standards (budget goals, prior year, subjective standards).

v. **Management compensation contract motivations**
The management compensation theory, also known as the bonus plan hypothesis contends that managers are motivated to use earnings management to improve their compensation, as management bonuses are often tied to the firm’s earnings. It is thus expected that earnings management is used to increase income. Managers are more likely to choose to report accruals that defer income when the cap on bonus awards were reached, as they had no more to gain from extra earnings and would be better off increasing income for the following year at that point. These ties in with the ‘big bath’ hypothesis, which suggests that if managers are unable to manipulate earnings to
reach a particular target, they will have the incentive to use earnings management to decrease current earnings in favor of future earnings and, therefore, future bonuses. Dechow & Sloan (1995) found that managers decrease research and development expenditure in the final year of their terms in order to increase earnings and thus their payout upon leaving the company.

vi. Lending contracts motivations
Another major hypothesis is the debt covenant hypothesis. This theory is based on the fact that creditors often impose restrictions on the payment of dividends, share buybacks and the issuing of additional debt in terms of reported accounting figures and ratios, in order to ensure the repayment of the firm’s borrowings. Hence, the hypothesis is that firms who have a lot of debt have an incentive to manage earnings so that they do not breach their debt covenants. Banks used loan loss provisions to manage earnings (Sumit, 2006).

Studies have produced mixed results in this area. Healy, DeAngelo, and Skipper investigated whether firms close to breaching their lending covenants changed accounting methods, such as the accounting of depreciation, accounting estimates, or made other transactions in order to avoid breaching their covenant. They concluded, however, that there was little evidence of earnings management by these firms; rather, they were more likely to reduce dividend payments or restructure their operations and contractual obligations. On the other hand, DeFond & Jiambalvo (1994) found that firms who violated their debt covenants used accruals to increase income the year before the violation.

vii. Regulatory motivations
Some industries, in particular the banking, insurance and utility industries are monitored for compliance with regulations linked to accounting figures and ratios. Banks and insurance firms especially are often subject to requirements that they have enough capital or assets to meet their liabilities. Such regulations may give managers incentives to use earnings management.

Research has shown that banks which are close to minimum capital requirements use earnings management techniques such as overstating loan loss provisions, understating loan write–offs and recognizing abnormal realized gains on their investment portfolios, presumably so as not to breach the regulatory requirements.

8. How to control Earning Management:
One way to control earnings management (by accounting techniques) is setting more rigorous Accounting standards. However, this may have the unwanted effect that manager’s turn to ‘real earnings management’, which consists of abnormal, suboptimal, business practices in order to change reported earnings. Given the weak legal system and the lack of accounting and capital market infrastructure in transitional economies, emerging economies are particularly likely to face severe problems in monitoring managers’ accounting decisions. The introduction of international accounting standard and practices in the market has been shown to increase market liquidity; reduced transaction cost, and improved pricing efficiency. It is still an open question as to whether the adoption of international accounting standards improves the quality of accounting information, thereby reducing the level of earnings management. Firms adopting IAS are less likely to smooth earnings, less likely to manage earnings upwards to avoid reporting a loss, and more likely to recognize loss timely than non-adopting firms.

As the world’s economies have become increasingly interlinked, many countries are trying to harmonize their accounting standards, and even to adopt a common set of reporting standards. Under the lead of the International Accounting Standards Board (IASB), more than 100 countries have either implemented International Financial Reporting Standards (IFRS) or plan to do so. The US Securities and Exchange Commission (SEC) announced that it would promote international compatibility by allowing foreign companies to access US capital
markets while reporting under IFRS (SEC, 2007). In the European Union, companies were obliged to prepare their consolidated accounts in conformity with IFRS if, at their balance sheet date for financial years starting on or after 1 January 2005, their securities were admitted to trading on a regulated market of any EU Member State (European Union, 2002). A similar rule applies in Australia.

In addition, corporate governance practices signal the potential for earnings management. Permissive structures indicate that manipulation is more likely. The board of directors sets overall policy & provided oversight for operating activities. Historically, boards were composed mainly of owners, managers & other insiders. It is now clear that a majority of independent board member is essential for effective oversight.

Moreover, if accounting standards as well as governmental scrutiny do not completely eliminate earnings management then auditors should be confronted with attempts to alter financial reports. Increased audit quality could or should lead to increased quality of reported earnings. Audit committee members must be aware of the ways in which management’s accounting-related choices provide opportunities to manage earnings — through timing of transactions and making estimates.

Roman (2009) suggested that Audit committee members can use the summary of critical accounting policies as follows:

1) Understand the transactions that require management to make the judgment or estimate. (For example, a company that mentions its accounting for inventory as significant is telling us it has more goods for sale during a period than it in fact sells.)

2) Understand the choices available to management in U.S. GAAP or, now, under IFRS, to account for the transactions in item 1. (In the U.S., the company can use FIFO or LIFO or weighted-average cost flow assumptions or specific identification. The company reporting under IFRS cannot use LIFO.)

3) Understand what management chose and why. (A company choosing LIFO likely does it to defer income tax payments in times of rising prices and increasing inventories.)

4) Most important, understand the potential a given choice provides for earnings management. (If the auditor doesn’t know how a company using LIFO can manage earnings by delaying year-end purchases, he won’t know to ask whether there have been unusual year-end accelerated or deferred purchases.) When auditors understand how a company’s transactions intertwine with its accounting principles, they will be able to determine whether a company engages in earnings management or not.

**Conclusion:**

Earnings management is a tool for satisfying self interest of the managers. But, it can be used for the welfare of the stake holders, if it is ethically used. So, to get the optimum benefit of earnings management, steps should be taken to improve corporate governance. Accounting standards should be revised and set in such ways, that there remain no loopholes for manipulate earnings. Auditors should be more careful in detecting earnings manipulation and their independence should be ensured. Finally, the consciousness and the morality of the stake holders can turn this malpractice into a good one if the motivations behind the earnings management are free from evil intensions.

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