

A Review of Earnings Management Techniques: An IFRS Perspective

Ahmad A. Toumeh^{1, 2*}, Sofri Yahya³

¹ Graduate School of Business, Universiti Sains Malaysia, Penang, Malaysia

² School of Business, Al-Zaytoonah University of Jordan, Amman, Jordan

Email: ahmad.toumeh@gmail.com

³ Graduate School of Business, Universiti Sains Malaysia, Penang, Malaysia

** Corresponding Author*

Abstract

Purpose: The objective of this article is to review both empirical and theoretical literature that concentrates on the techniques of earnings management. IFRS perspective is employed in order to establish a novel comprehension of the earnings management phenomenon.

Design/methodology/approach: the study uses secondary sources include a rigorous review of scholars' findings from a major academic journals and publications worldwide.

Findings: This review confirms that earnings management could be deemed either legitimate if the managers are within the limits of the International Financial Reporting Standards, or illegitimate if these standards are violated. Further, the study concludes that earnings management techniques might be suspected as being fraudulent practices depending on the way which managers employ those techniques.

Originality/value: In contrast with prior literature, where many researchers focused on studying the effect of IFRS adoption on earnings management, this study deals with IFRS as a perspective not as an influencer which is the contribution of this study. Hence, the current article provides a framework to differentiate whether these techniques fall under earnings management practices or fraud from IFRS perspective, and also it calls attention to the space of discretion existed in IFRS.

Keywords: Earnings Management, IFRS, Accruals, Fraud

1. Introduction

Recent capital markets are generated via financial information, an effective investment decisions rely basically on information of high quality (Ogbonnaya et al., 2016). Earnings are the essence item in financial statements which is represented by the bottom line in the statement of Profit or Loss, and it summarizes the financial performance of an entity (Cudia et al., 2018; Dechow, 1994; Ghazalat et al., 2017; Kighir et al., 2013; Rahman et al., 2013). Nevertheless, managers can take advantage of the right and control that provided by the accounting system and then use their judgment while preparing financial statements and determining earnings (Bhundia, 2012; Franceschetti, 2018).

Earnings management phenomenon became a worldwide issue facing economies, and it is notably increasing in the last two decades (Alves, 2012; Hashim et al., 2013). Latest corporate collapses like; Enron, WorldCom, HIH Insurance, Nortel, eToys, Rite Aid, HealthSouth, Subeam, and Arthur Anderson have strongly indicated that the most managers nowadays are practicing earnings management (Rani et al., 2013, Toumeh et al., 2018). As a consequence, earnings management may not reflect the real performance of an entity, and shareholders will not be able to evaluate their economic decisions correctly (Goel, 2016, Toumeh & Yahya, 2017).

It is worthy of mention that financial reporting system governed by set of accounting standards (e.g. IFRS, US GAAP, national GAAP). In particular, International Financial Reporting Standards (from now on IFRS, which include old and revised IAS) have been adopted by most of companies around the world for the purpose of preparing their financial statements (Ismail et al., 2013). IFRS are defined by Nash (2018, p.41) as “a consolidated set of accounting standards, developed and maintained by the International Accounting Standards Board (IASB) which operates under IFRS Foundation”. He added that these accounting standards are adopted worldwide and are applied in more than a hundred countries.

IFRS Foundation is a non-profit organization founded to facilitate and promote IFRS (Ifrs.org, 2018). The main objective of this organization is “to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world’s capital markets and other users of financial information make economic decisions” (Iasplus.com, 2018b).

Based on the above discussion, it can be noticed that IFRS improve the financial statements` quality. Indeed, Rathke et al. (2016) professed that IFRS are principles-based financial reporting standards that facilitate management to prepare their annual reports that reflect the real picture of the company. Additionally, IFRS require some criteria in respect of accounting recognition and measurement which provide a faithful representation of the companies` financial position and a high quality of accounting information. They added that information asymmetry capital`s cost can be minimised by adopting IFRS.

On the other hand, the principle-based approach of IFRS allows managers to exercise their judgment freely through interpreting and applying the standards (Miková, 2014). As a matter of fact, IFRS provide management with alternative accounting procedures which are utilized in recognizing and reporting the economic events, this flexibility and discretion of the principles-based accounting standards can be used by managers to maximize their own interest by intentionally manipulate the earnings through selecting preferable accounting treatments that may not reflect the economic events correctly (Gray et al., 2015). In summary, Zhou and Habib (2013) highlighted that IFRS open the gate of earnings management through manipulation the accruals. However, there is an academic debate in literature whether IFRS adoption increases the quality of financial reports or not (see, Soderstrom & Sun, 2007; Christensen et al., 2015; Chen et al., 2010; Graham et al., 2017; Abdullahi & Abubakar, 2017; Cussatt, 2018).

To break down this debate, Chen et al. (2010) stated that there are two major groups; the first one supports the idea that IFRS boost the quality of financial statements, they claimed that the single global standards remove the differences in the national accounting standards which consequently leads to minimize the information asymmetry, reduce the capital`s cost, and raise capital flow abroad. On contrary, the second school stressed that the contents of IFRS are determined based on the business climate features and institutional setting. This means that accounting standards are not necessarily the same in two distinct countries due to the economic globalization and integrated stock markets, so financial information quality may not be improved. Accordingly, it is not necessary that IFRS enhance the quality of accounting information, because there are other factors can control the way of using IFRS positively or negatively.

IFRS are considered as an accountants` constitution, these standards govern the whole process of financial reporting from recording the economic events until preparing the financial statements. The “how to” is an important area of earnings management world which is filled with many strategies applied to manage the reported earnings even those that within

the limits of IFRS. Therefore, the purpose of the present study is to provide an overview of the extant literature, and to synthesize academic evidence about the earnings management techniques from the perspective of IFRS.

2. Earnings Management

Earnings Management was primarily known at the beginning of the commercial exchange (Ramírez-Orellana et al., 2017). Hepworth (1953) was the first researcher who began this subject-related research (Ruiz, 2016). He developed income smoothing term, and he explored some of both theoretical and practical reasons related to income smoothing, and from a practical point of view he found that economizing tax levies may be an incentive for managers to engage with such practices.

As described in IFRS, specifically in the paragraph [1.27] of the International Accounting Standard (IAS) 1 Presentation of Financial Statements; financial statements except for the cash flow statement must be prepared based on accrual basis (Iasplus.com, 2018a). However, managing earnings by using the accruals was originally argued by Healy (1985). He concluded that accruals modify the timing of reported earnings. Schemes of earnings-based bonus influence the changes in accounting procedures and accrual policies used by managers with a view to improve their remunerations. Subsequently, examining the “accruals” has been the focus of many scholars (e.g., Dechow, 1994; Dechow et al., 1995; 1996; Jones, 1991; Mendes et al., 2012; Sayari & Omri, 2017; Trejo-Pech et al., 2016), and it has notably increased over the last two decades (Ohlson, 2014).

Franceschetti (2018) pointed out that it is hard to find a clear definition of the term of earnings management in the practical literature, and he claimed that the first definition of this term in scholarship is offered by Davidson et al. (1987) who observed earnings management as “the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of published earnings” (p. 17).

Ramírez-Orellana et al. (2017) mentioned that Healy and Wahlen (1999) definition is the most vastly used in literature, Healy and Wahlen (1999, p.368) defined earnings management as “earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers”.

The word ‘Judgment’ had been clarified deeply by Healy and Wahlen (1999), which may be exercised in financial reporting by managers in many ways. The nature of the accounting requires an estimation of some future economic events such as the expected useful life of the non-current assets and its salvage values. In addition to that, IFRS provide a diverse of acceptable accounting methods for the same items like the depreciation methods and inventory valuation methods. Managers also use their judgments in working capital management, for example timing of purchasing inventory, receivable management and credit policies that impact the allocations of cost and net income. Thus, this is a challenge for standards setters to evaluate the flexibility of IFRS that provides a wide range of choices for managers to use their judgments in financial reports, because these judgments may increase or decrease the value of the provided information.

Schipper (1989) observed earnings management in less comprehensive definition, she defined it as “the purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain” (p.92). In details, Schipper (1989) explained that this definition excludes managerial accounting reports or activities, and focuses only on the external reports. As well, it has been stated that managers may take advantage of the opportunities inherent in the accounting system and offered within IFRS to manage their earnings.

Aforementioned academic definitions have been assessed by an influential work of Dechow and Skinner (2000), they claimed that these definitions concentrated mainly on the unobservable management's intent; also they professed that the definitions implied that earnings management existed within the boundary of GAAP. Further, they highlighted that based on these definitions there is a difficulty to differentiate earnings management from the financial fraud (Dechow & Skinner, 2000). The difficulty rose because earnings management and fraud are sharing similar incentives and elements, for example both of them aim to mislead and harm the shareholders through providing deceptive information (Marai & Pavlovic, 2013). However, this issue has created an academic debate in scholarship until now (see, Elias, 2002; Kassem, 2018; Perols & Lougee, 2011; Rahman et al., 2016). in this vein, the National Association of Certified Fraud Examiners (as cited in Nia et al., 2015, p.5) defined financial fraud as "the intentional deliberate misstatement or omission of material facts, or accounting data, which is misleading and, when considered with all the information made available, would cause the reader to change of alter his or her judgment or decision" (National Association of Certified Fraud Examiners, 1993).

Eventually, the dilemma is how to reveal the management intent in these practices in order to recognize if managers are legally exercising their judgments and estimates, or they are engaging in fraud. In this case, Dechow and Skinner (2000) provided a framework to distinguish earnings management from fraudulent accounting as illustrated in figure 1.

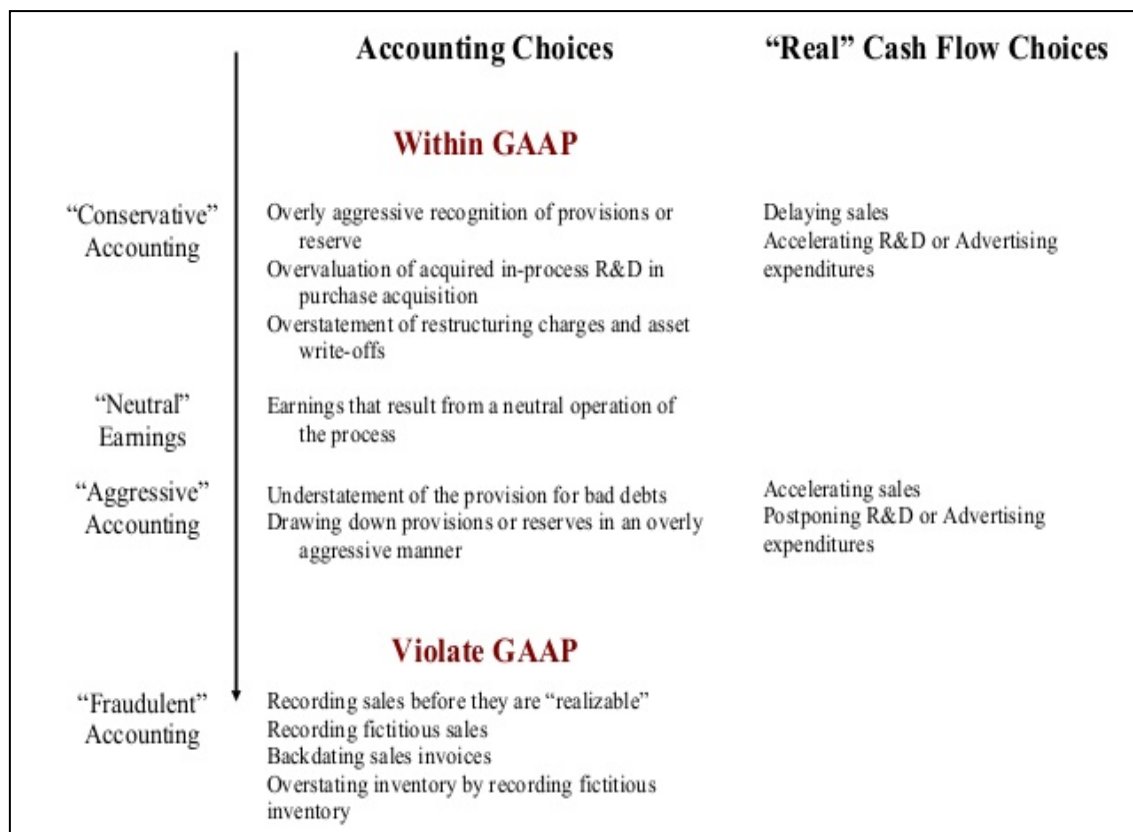


Figure 1: The conceptual distinction between earnings management and fraud
Source: Dechow and Skinner (2000)

The above figure clarifies a conceptual distinction based on whether management's accounting choices are within the limits of GAAP or violate the GAAP. When management intent is to deceive shareholders and their accounting selection violates the (GAAP/IFRS), then these practices will be considered as a fraud, and when these accounting choices are

allowed by the GAAP then they will be considered as aggressive but acceptable practices, in which accounting discretion can be exercised by managers.

In other words, prior researches argued that the deliberate actions of managers that aim to obtain desirable earnings are legitimate only if those actions within the boundary of (GAAP/IFRS) and managers should disclose the effect of their actions in the financial statements. While actions that aggressively intent to mislead shareholders or abuse the company's resources through manipulating the recognition and measurement of income and expenses are illegitimate and financial fraudulent practices (Nia et al., 2015).

3. Popular Techniques of Earnings management

Reviewing the literature in the previous section showed that when managers working within the limits of IFRS; their actions would be deemed as legitimate but also these actions are still called earnings management. Due to the diverse accounting choices in IFRS that permit managers to exercise their judgment, the current research infers that applying IFRS is not necessarily leads to prevent earnings management practices because there are many earnings management methods that are mostly existed in the boundary of IFRS.

Earnings management can be achieved through several techniques, which may affect the accounting numbers. These techniques or activities aim to boost the reported earnings in the financial statements (El Diri, 2017). Indeed, the "how to" part of earnings management contains several diversities (Ronen & Yaari, 2008). Accordingly, it is of great importance to highlight the earnings management techniques with a view to completely understand this phenomenon. Based on literature this section will flesh out briefly the most common techniques applied to manage earnings.

3.1 Improper Revenue Recognition

The early recognition of revenue or the recognition of fictional revenue in full is one of the most popular forms of earnings management (Mulford & Comiskey, 2002; Stallworth & Digregorio, 2004). With reference to the new IFRS number 15 Revenues from Contracts with Customers which replaces IAS 11 Construction Contracts and IAS 18 Revenue; revenue is recognized when (or as) the entity satisfies a performance obligation. Particularly, the standard stated that the passage of control is the central of recognizing revenue. This control is passed when the ability to direct the use of the asset and obtain substantially all of the remaining benefits from it. Schilit (2010) reported that there are some companies recognize revenue early and before completing any performance obligation under the contract; this could be achieved by recording future sales at the last day of the current period to boost their earnings. Indeed, Hurtt et al. (2000) documented that over half of all financial reporting fraud has involved with overstating revenues. As a result, Wasiuzzaman et al. (2015) addressed that this technique of earnings management reduces the quality of financial reporting and deceives investors regarding to the company's performance.

In order to differentiate earnings management from fraud under this technique, the judgment should be based on IFRS 15, so if the management departs from the recognition criteria set by IFRS 15, their practices should be probably a fraudulent accounting not earnings management.

3.2 The Big Bath

Big bath strategy is defined by Mulford and Comiskey (2002, p.51) as "a wholesale write-down of assets and accrual of liabilities in an effort to make the balance sheet conservative so that there will be fewer expenses to serve as a drag on future earnings". Nonetheless, IFRS aims to provide financial statements that include understandable, relevant, reliable and comparable information without a conservative bias (Hellman, 2008). Big bath is one of the

earnings management shenanigans that makes the corporate's earnings of the current period look worse and clean up the statement of financial position so as to show better results in the future. Moreover, big bath strategy is not an indication for corporate failure, on the contrary; it is a positive action to enhance the future earnings through getting rid of unprofitable projects or useless assets (Kent et al., 2008). However, there are number of published researches proved that managers use big baths to manage their earnings (see, Christensen et al., 2008; Jordan & Clark, 2004; Lee, 2006; Nieken & Sliwka, 2015; Omar et al., 2014; Zhou & Habib, 2013).

The benchmark of identifying whether this technique is one of the earnings management practices or not is the degree of "conservatism"; where this technique cannot be considered fraud, only if the management aimed at eliminating the negative NPV or idle assets without exaggeration that may lead to provide unreliable financial reports.

3.3 Income Smoothing

Smoothing is levelling the amplitude of periodic net income fluctuations (Hepworth, 1953, as cited in Kighir et al., 2014). In fact, income smoothing is a component of earnings management that creates growth of earnings consistently, which is generated by accrual accounting such as allocation of capitalization costs using a straight-line method over time as expenses (Giroux, 2006). Users of financial statements usually have concerns with the fluctuation level of the earnings since it indicates the degree of persistence in the company's earnings and sometimes it hints at bankruptcy risk (Safdar & Yan, 2016). Additionally, Li and Richie (2016) and Ozili (2017b) argued that management use discretionary accruals for income smoothing to minimize the variability of the published earnings over the time.

Moreover, income smoothing is divided into artificial and real. Real income smoothing is related to activities that affect cash flows such as the change in timing of investments or increasing sales by awarding promotional discounts randomly. Conversely, artificial income smoothing does not impact cash flows but involves management discretions that are available in IFRS (Lassaad & Khamoussi, 2013). However, income smoothing practices have been widely detected in different countries such as Asian countries (Rusmin et al., 2012), African countries (Ozili, 2017a), Gulf Cooperation Council countries (Shubita, 2015), Brazil (Kolozsvari & Macedo, 2016), China (Yang et al., 2012), Australia (Koh, 2005), Pakistan (Safdar & Yan, 2016), USA (Liu & Ryan, 2006), UK (Athanasakou et al., 2007), and Jordan (Obaidat, 2017).

Income smoothing intents to provide the consistency in the reported earnings which might be healthy for the company's financial image, but in all cases it should be in the limits of IFRS in order to be acceptable and considered as a legitimate earnings management.

3.4 Cookie Jar Reserves

Cookie jar reserves tactic is kind of the flip-side of improper revenue recognition. This strategy is based on future events estimations; it is a form of income smoothing and similar to big bath. Under this strategy managers manipulate earnings by aggressively accrual of expenses in which the company have good results in the current year and the results for the following year are uncertain. Managers reduce the expenses of the future year by reversing portions to inflate the next year earnings at the expense of the current year (Chhabra, 2016). For example, management may overstate sales returns or warrant costs in good times, and employing theses overstatements in the bad times to reduce similar expenses (Sevin & Schroeder, 2005). Otherwise, Caylor and Chambers (2015) addressed that deferred revenue can be deemed as another form of cookie jar reserves. Conservatively, management may build reserve by postponing their revenues in good year, and then using these deferred revenues in bad year to boost their earnings.

Commonly, managers make provisions that are permitted under IFRS. In particular, IAS 36 (Provisions, Contingent Liabilities and Contingent Assets) and its related interpretations (e.g., IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities – IFRIC 5 Rights to Interests Arising from Decommissioning, Restoration and Environmental Funds – IFRIC 6 Liabilities Arising from Participating in a Specific Market – IFRIC 17 Distributions of Non-cash Assets to Owners – IFRIC 21 Levies) require some discretionary decisions from the management to determine their provisions and their possible obligations neutrally to reflect the current best estimate. These decisions are based on some guidelines and rules that management should follow, when management violates them, fraudulent accounting might be occurred.

3.5 Big Bet on the Future

This kind of technique involves acquisition transactions. Nia et al. (2015) emphasized that companies may enter to a big bet on the future through acquire another company in order to earn a good investment from it. Further, Rahman et al. (2013) stressed that those managers may take advantage of the acquisition by writing-off the research and development costs against current earnings in the acquisition year instead of reporting those costs in the future year, thus boost their future earnings. While Omar et al. (2014) argued that managers may employ the acquisition as an earnings management strategy, where acquiring another company leads to possess a secure future earnings from that company because adding the earnings of the acquired company in the consolidated financial statements will lead to report a higher integrated earnings.

IFRS 3 Business Combinations clarified the guidance on how to cope with the acquisition. For example, the standard requires companies to use acquisition method for business combinations which is quite similar to the old purchase method. In this vein, management must apply the steps specified in IFRS 3 prior to control being obtained. While acquiring other entities in the purpose of combining their earnings cannot be one of the earnings management practices or fraud since the earnings are resulted from a neutral operation process.

3.6 Introducing New Standards

The demand for developing the existing accounting standards derived from the changing of the business environment and the increasing of the complexity in the capital markets. This leads to issuance new accounting standards with new rules and guidance. Usually it takes two to three years to apply the standard where the problem is that most of these standards came with voluntary early application which may open the gate for management to manipulate their earnings (Chhabra, 2016). An example of that is IFRS 15 Revenues from Contracts with Customers which has been issued in May 2014 and its effective date for annual reporting periods began on 1 January 2018 with earlier adoption permitted. Similarly, a recent standard IFRS 16 Leases which was issued in January 2016 applied on 1 January 2019 where it allows for earlier adoption. Furthermore, the most recent standard is IFRS 17 Insurance Contracts which was released in May 2017 and should be applied in January 2021 with also permission for early application.

Applying IFRS affect the items contained in the financial statements that in turn may change the published earnings. Therefore, managers may be engaged in legitimate earnings management practices through early or late application of these standards. While in any case this technique cannot be a fraud.

3.7 Depreciation, Amortization and Depletion (DAD):

IAS 16 Property, Plant and Equipment require that the non-current assets should be depreciated over its useful life. Intangible assets such as trademarks should be amortized while natural resources such as oil and gas are subjected to depletion process. According to Franceschetti (2018) and Omar et al. (2014) and Kighir et al. (2013), the aforementioned items require discretionary judgment by the management to choose the depreciation method (for example straight-line and balance reducing methods), to select the useful life of the assets and to estimate the salvage values. As well, Bishop and Eccher (2000) professed that the changes in the useful life of the non-current assets influence the reported earnings in the income statement which may be deemed as an earnings manipulations.

Nevertheless, under IAS 16 the residual value and the useful life of an asset should be reviewed at least annually, and in case the expectations differ from the previous estimates; any changes are accounted for prospectively as changes in estimates under IAS 8 Accounting Policies, Changes in Accounting Estimates and Error. Also, the depreciation method should reflect the pattern in which the assets' economic benefits are consumed by the entity. However, if management follows the previous rules; still this technique provides an ample space of discretionary judgment that can be exploited to manage the reported earnings. If those rules are violated, then fraudulent financial statements might be occurred

4. Conclusion

The reviewed literature indicated that the most of scholars reported that when earnings management practices disclosed and followed the accounting standards; these practices would be considered as legitimate earnings management. Otherwise, it would be illegitimate and may be considered as a fraud. This pointed out that IFRS provide a venue for managers to exercise their discretion so as to manage their earnings legally, so the application of IFRS does not certainly assure that the reported earnings are not managed. Hence, legitimate earnings management is any practice that leads to distort the process of financial reporting and these practices should be under the umbrella of the IFRS.

On the other hand, identifying earnings management techniques provides a clear picture on how managers manipulate their earnings. Unveiling this picture needs to discover the applied techniques in earnings management, particularly those that take advantage of the flexibility existed in IFRS. Thus, this study expects to advance the body of earnings management literature and to provide assistance to the reader to be more involved in the world of earnings management. In sum, the current study used secondary sources of data obtained from a wide published work throughout the academic literature to overview and inspects the techniques of earnings management from the perspective of IFRS in an attempt to close the gate of the earnings management.

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