Techniques of Earnings Management

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Abstract

Earnings management has become a burning issue in past decades due to its increasing practices in the corporate world The purpose of this study is to analyse the concept of earnings management and the techniques of earnings management from the perspective of Indian Financial Reporting System (IFRS). The study showcase that the space provided by various accounting standards act as motivator to the managers for discretion while decision making. These techniques highlight that there is a thin line between the limits set by IFRS and fraud. If this thin line is crossed or violated by the managers, then the earnings management practices become illegitimate and fall under fraud.

Keywords: Earnings management, Accruals, IFRS, IAS.

I Introduction

Financial statements are the key element which drives capital markets single handedly. Because all the investment decisions by the investors in capital markets are based on the quality of information presented by the financial statements. And earnings are the key element while deciding the strength of financial statement, by presenting the financial performance of the company in form of statement of profit and loss account during the year. Here, the managers take a front foot and use the accounting concepts and principles in a way to minimize expenses and losses and maximize income and gains. In other words, the managers use their discretion in decision making while preparing financial statements, thereby, determining the quantum of earnings or managing earnings. Earnings management has become a burning issue in past decades due to its increasing practices in the corporate

world. With this, it has also become a critical issue to research on. Financial reporting failures in India and all over the world are something which all of us are aware of. Satyam computers (2009), Ketan Parekh (the "Bombay Bull") case (2001), Virendra Rastogi (1995-96), C.R. Bhansali (1992-96) are some notables scandals in Indian history highlighting the poor quality of financial reporting. Satyam computers scandal was so huge in magnitude that it is known as "India's Enron". These scandals are due to the discretion of management with regard to accounting practices, corruption and negligence on the part of auditors.

Financial reporting system follows some accounting standards, such as US GAAP, IFRS or GAAP set by a particular nation. Usually, IFRS (International Financial Reporting Standards) are being adopted by most of the companies worldwide while making financial reporting. Definition given by Nash (2018, p. 41), IFRS are "a consolidated set of accounting standards, developed and maintained by the International Accounting Standards Board (IASB) which operates under IFRS foundation". Furthermore, these accounting standards are adopted worldwide and applied in more than a hundred countries. Rathke et al. (2016) stated that IFRS are principles-based financial reporting standards that facilitate management to prepare their annual reports that reflect the real picture of the company. Thus, IFRS are applied as standards by firms around the world and these standards do have a direct impact on the earnings and thereby the financial statements of the companies. Thus, the present study focuses on the techniques applied by the managers which provide them a room for earnings management practices, within the limits of IFRS. The rest of the paper has, section II with review of previous literature, Techniques are discussed in section III and section IV has the conclusion.

II Review of literature

Earnings management is a purposeful intervention in the external financial reporting process, with the intention of some private gain (Schipper, 1989). Since the definition is including only external reports, thus, the management accounting and reports does not comprise a part of it. The management is involved in taking advantage of opportunities from accounting system within the limits of IFRS. A similar point is presented by Healy and Wahlen (1999) that earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to delude some stakeholders about the underlying financial performance of the company or to influence contractual outcomes that depend on reported accounting results. Many studies are being made to examination the association between adoption of IFRS and the level of earnings management practices by assuming IFRS a regulatory tool for good quality of financial reporting.

Many previous studies claim that adoption of IFRS has resulted into less earnings management. Whether IFRS adoption is associated with an increase in accounting quality in financial statements of firms is examined by Barth et al. (2008). Among 21 selected countries, their study indicate that after adoption of IFRS, an increase in accounting quality is witnessed, since the firms recognize losses more timely, less earnings management practices and accounting figures more relevant than before. Aharony et al. (2010) also find that IFRS positively affect the information value of the financial reporting. And this effect of IFRS on information quality of financial reporting is higher in countries where the difference between domestic standards and IFRs is wide. Whereas the studies of Jeanjean and Stolowy (2008) and Rathke et al. (2016) presents the contrary results that IFRS adoption by the firms doesn't have any role in decreasing the earnings management practices. Jeanjean and Stolowy propounded that the level of earnings management does not decrease after mandatory adoption of IFRS in Australia, France and Uk, inspite, management incentives and embedded institutional factors have a significant role in IFRS adoption for these countries. And the results of Rathke et al. states that cultural and economic characteristics of the particular country have a significant influence on the way IFRS is applied in a particular country. Zhou and Habib (2013) states that adoption of IFRS provides an opportunity to manage earnings through manipulation of accruals. And a literature with academic debate on whether adoption of IFRS increases the quality of financial reports or not is under the studies of Chen et al. (2010), Christensen et al. (2015), Abdullahi and Abubakar (2017).

III Techniques of Earnings Management

The literature finds that the management of earnings by working within the limits of IFRS by management is still called valid. As there are ample accounting choices in IFRS, which provide managers a discretion to apply their judgment and adopt as per their own choice. Thus, the current study is an attempt to explain that mere adoption of IFRS does not lead to prevention of earnings management activities because the scope of IFRS is so much wide leaving methods of earnings management within the ambit of IFRS. A number of techniques are used by the managers to manipulate earnings which came within the limits of IFRS. Thus, the managers by applying these techniques aim to improve the earnings in the financial reporting. This section is about the most common techniques used by the managers for earnings management, based on the literature presented by the academicians.

3.1 Big-Bath Technique

Big-bath technique is based on the IFRS principle of "conservatism." Mulford and Comiskey (2002) has defined big-bath strategy 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". According to big-bath technique if a big loss occurs in an organization, it is better to report it at once rather than to spread it further, and clear a path for better financial statements in future. Yes, it hampers the financial performance of the current year but it benefits in future in form of better results. And big-bath is not a technique which projects the failure on the part of the firm, rather it is a positive step taken to get rid of unprofitable or idle projects/assets, so as the future earnings can be increased manifold.

3.2 Cookie-Jar Reserve

Cookie jar reserve technique is about estimation and recording of future events. According to GAPP, the company has to record the future obligations in the current year if the transaction or event was occurred in the current year i.e. on accrual basis. Under this strategy, the managers manipulate earnings by way of accrual of expenses aggressively in a year in which the firm earns good profits, so that in case of need of funds in future can be met. And if the actual expenses are turn out to be less than the estimated amount, the difference is put into a reserve called cookie jar reserve. And these reserves can be used in a year firm having insufficient profits to show consistent earnings or improved earnings. Cookie jar reserves can be created by overstating sales return, allowances, bad-debts, write-down percentages etc. in times of good profits and then these can be balanced out in bad times of the company to report consistent earnings.

3.3 Introducing New Standards

Since the business environment has a tendency to change and to cope with up this changing environment and the complex nature of capital market, need for some modifications and introduction of new standards is always exists. Now the issuance of new standards and their implementation usually takes two to three years. Not only this, but it also comes with an option of voluntary early adoption, which provides the management an advantage to manage earnings accordingly. For example, IFRS 16 i.e., Leases was issued in January 2016 and its date of annual reporting was set 1 January 2019 with voluntary early adoption. Here, the company can manage earnings by changing the time and recognizing the expenses on accrual basis rather than cash basis, while these were actually recorded on cash basis. Thus, the managers get engaged in earnings management practices by applying these standards at early voluntary stage or afterwards.

3.4 Big Bet on Future

Big bet on future technique applies in case of acquisition by the company. It is due to acquiring a new company is betting on a company whether it will give good returns in future. As per the guidelines of Generally Accepted Accounting Principles (GAAP), the acquisitions are reported as purchases are

reported in the books. Rahman et al. (2013) stated that the acquisition provides the managers to write off research and development cost against the current earnings in the year of acquisition instead of reporting it in future years and protect future earnings from these charges. It helps to manage earnings because when these costs will actually emerge in future, they need not to report these costs at that time, which in turn provides a boost to future earnings. Second advantage of big bet technique is that now the company can claim the earnings of acquired company as well. Thus, after acquisition of another company there is an ultimate boost in the current as well as future earnings of the company.

3.5 Write off (Depreciation, Amortization and Depletion)

As per IAS 16 Property, Plant and Equipments, the non-current assets should be depreciation over its useful life. While intangible assets such as copyrights, trade marks, goodwill, patents are amortized and natural resources such as natural gas, oil and coal should be depleted. These standards provide the managers discretionary power to adopt writing off method, useful life of the asset and salvage value of the asset. And managers by altering these methods, useful life of the asset may have an influence on the reported earnings, thus it may be deemed as earnings manipulation. Furthermore, IAS asks for reviewing of revision of useful life and residual value of the asset at least annually, and if there is any difference found between expected and previous estimates, then these changes are accounted for changes in estimates under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Even after following these rules, the managers still have the judgment discretion to manage the reported earnings.

3.6 Sale of long term assets and Leaseback

The increased earnings can be reported by the sales amount of the long-term asset which has unrealized gains or losses. For instance if the book value of an asset in balance sheet is recorded at INR 80K, but the market value of the asset is INR 1Lakh, then after selling the asset in market, gain of INR 20K will be reported as increase in earnings of current period. IAS 17 states that if a loss is recorded in sale of the asset or leaseback, then it must be recorded in seller’s books immediately and if there is any gain, then it will be amortized over the period of time. Thus, the earnings can be managed from gain or loss accruing from sale/ leaseback transaction.

3.7 Sale of Subsidiary/Spinning off

Another technique to earnings management is by selling a subsidiary which is not doing well for the company. It’s like “throwing a rotten apple out” to preserve the whole basket. Thus, earnings can be managed by either selling a subsidiary or spin it off or in case of equity subsidiary by exchange of stocks. In case of selling the subsidiary, the gain or loss is recorded in the current year

statement. And when the subsidiary is spinning off, then the existing shareholders will become the shareholders of the subsidiary and no gain or loss occurs in that case. Furthermore, where the entity involves in equity-based subsidiary then it's possible to swap the stock and need not to record any gain or loss.

3.8 Revenue Recognition Technique

Managers usually do the discretion while reporting the revenues. Enter a revenue before time or recognize a fictional revenue full in one go is the most popular way of entering into an earnings management practice. The new IFRS 15 i.e., Revenue from Contracts with Customers has replaced IAS 11 and IAS 18 regarding Construction Contracts and Revenue simultaneously and states that revenue is recognized only the performance obligation is being satisfied by the entity concerned. It can be done, if a company early recognize a revenue or record a revenue before competing its performance obligation, for like recording a future sale on the last day of the current year provides a boost in current year's earnings. Hurtt et al. (2000) investigated in his study that more than half of all the financial frauds are due to overstating of the revenues reporting (Toumeh, and Yahya 2019). Wasiuzzaman et al. (2015) concluded that this revenue recognition technique has a negative effect on the quality of financial reporting and also deceives the investors regarding actual performance of the entity.

IV Conclusion

To conclude, the above discussed techniques provide some ways to management to manage earnings by following the standards of IFRS itself. Thus, it is evident that IFRS gives managers an upper hand to make a decision about what method should have been selected amongst the various set in IFRS, which directly or indirectly open a door to manage the earnings for reporting accordingly. An important thing which has to be noted is that earnings management does not come under fraudulent activities unless and until it follows the criteria set by IFRS. The very moment it crosses or out bound IFRS, it does not remain earnings management, rather it becomes a fraud. But on the other hand, it is clear that earnings management does distort the quality of financial reporting because it leads to manipulations in financial statements even it it follows IFRS. And the study also highlights how managers do manipulation in earnings through different techniques to get desired results.

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