Chapter 16
Earnings Management and Fraud:
A Theoretical Background and Discussion

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ABSTRACT

The purpose of the chapter is to provide a rounded discussion of the concept of earnings management and theories underpinning this behavior. The chapter presents an overview of the concept, with a discussion of alternative definitions and the theories related to this behavior, including the commonly discussed agency theory as well as some less-researched theories such as socioemotional wealth theory and upper echelons theory. The chapter also presents incentives that can lead to this behavior and evidence in the academic literature, followed by some examples in developed and developing countries of earnings management that spilled into fraud. The chapter concludes with a summary and some potential extensions to the academic literature.

INTRODUCTION

This chapter provides a discussion of the concepts of earnings management and fraud as well as the main motivations and strategies of earnings management as found in current academic literature. Earnings management, which is sometimes also known as creative accounting, occurs when companies' managers use their judgment in either the recognition or the set-up of the transactions to influence the

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financial reports, and specifically the income statement. The end result in either case is the same. The numbers in the financial reports, which include the bottom-line earnings or losses, deviate from what would have been reported without this intervention. There are many reasons why earnings management is exercised and the motives are usually diverse but ultimately it is to either increase or decrease earnings. The benefits arising from earnings management may accrue to either individuals within a company, or to the firm as a whole and the method used can range from fairly innocuous adjustments of accounting figures to gross deception and fraud. The chapter begins with definitions followed by a discussion of the theories that underpin these concepts. Section 1.4 presents the motivations for this behavior followed by strategies used by firms. The final section discusses some international cases of earnings management that included fraudulent behavior.

Definition of Earnings Management and Fraud

Over the years, numerous researchers have attempted to define earnings management but to date there is no consensus or an accepted definition that fits all cases. Many scholars disagree on the purpose or outcome of this type of behavior, hence the multitude of definitions in the literature. In addition, there are several terms that are used interchangeably with earnings management that have slight variations in terms of their purpose or outcome. For example, aggressive accounting, cooking the books, cosmetic accounting, financial engineering, window dressing and income smoothing are sometimes used as equivalents (Akpanuko & Umoren, 2018; Gowthorpe & Amat, 2005). Earnings management (EM) is usually thought of as a means of manipulating company earnings in a way which may or may not involve fraud.

However, this is too simplistic a definition and there are many more aspects which need to be considered. Healy & Wahlen (1999) state that:

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.

Another definition given by Fields, Lys, & Vincent, (2001) states that EM arises when executives use their discretion to adjust accounting numbers. This adjustment may be either opportunistic (to further the interest of the manager), or to maximise firm value.

EM was described by Davidson, Stickney, & Weil (1987) as "the process of taking deliberate steps within the constraints of generally accepted accounting policies to bring about a desired level of reported earnings". It should be noted that the stress is on the process being *deliberate*. Schipper (1989) confirms this view by saying that EM is a *purposeful* intervention in financial reporting with the intention of increasing personal gain by meeting management objectives (opportunistic EM) or shareholder objectives (informative EM). It thus can be seen that EM is always intentional and not accidental. There is always awareness by the perpetrator of the action being taken and its intended consequence. Beneish (2001) argues that EM is detected by comparison of firm performance over successive periods, using various methods and is often found to occur when performance is unusually good or unusually bad. Table 1 below presents alternative terms and definitions for EM as well as prior literature that has used these specific definitions.

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