

*Review Article*

**Review on the Double Side of Earnings Management**

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**ABSTRACT**

This paper informs on the double side of earnings management, that is, when earnings management is considered healthy (efficient) or unhealthy (opportunistic). Earnings management is part of the contract cost that either increases or decreases agency cost. Earnings management also provides a positive or negative impact to firm value and shareholders' wealth. Efficient earnings management is said to maximise firm value and shareholders' wealth. Opportunistic earnings management is known to maximise managers' private benefits at the expense of shareholders, and this eventually affects firm value. Firm performance measurement, either accounting or market-based measurement, can be applied to determine the type of earnings management (efficient or opportunistic). This paper provides valuable information for business and academic players on insights into earnings management and the recognition of the double side of earnings management through firm performance that possibly gives impact on agency cost and continuous survival of firms.

*Keywords:* Earnings management, accrual manipulations, real activity manipulation, share buyback, firm performance

**INTRODUCTION**

Earnings management is a common word in today's business world. Earnings management is an accounting treatment

used by managers in their discretion to manage or smooth earnings in financial reports as a kind of 'language' of business reports. Generally, involvement in earnings management is done deliberately to achieve a specific objective or goal; this objective is either to maximise shareholders' wealth or managers' benefits. Prejudging earnings management as healthy or unhealthy for firms and shareholders merely considers

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one aspect of earnings management. This paper provides an outlook on earnings management, considering it is efficient or opportunistic for firms. No doubt earnings management is a 'money game' between managers and investors that does not reflect the true economic performance of the firm. The managers attempt to smooth earnings as a strategy to build market credibility and for positive growth in a firm's share price (Graham et al., 2005). This money game is used prudently to complement rewards for the firm from investors or shareholders in terms of share prices, which can provide a bright prospect for the firm for good management of shareholders' wealth. This documents that earnings management benefits the firm. However, earnings management is also reflected as a short-term strategy that benefits the managers and the not the firm in the long run. Earnings management is perceived as an opportunistic action at the expense of shareholders. This shows that earnings management can be healthy (efficient) or unhealthy (inefficient) to firms and shareholders or opportunistic to managers. Thus, the management action to engage in earnings management can be efficient or opportunistic earnings management. Some articles have consistently reported that earnings management is unhealthy to the firm while other articles have documented that earnings management is not detrimental to the firm (Roychowdhury, 2006; Rezaei & Roshani, 2012). This reflects on the existence of a double side to earnings management, that is, that it could be either healthy or unhealthy to the firm and shareholders.

The impact of earnings management on firms and shareholders is essential for the firms' going concern. The continuous survival of the firms also explains the aligned interest between the managers and the shareholders that keeps agency cost at the minimal. Healthy earnings management is classified as efficient earnings management as it benefits the firm (Jiraporn et al., 2008; Rezaei & Roshani, 2012). Earnings management that only benefits the managers or affects the firm's performance is classified as opportunistic earnings management, which increases agency cost to the firm (Jiraporn et al., 2008). Despite categorising earnings management as healthy or unhealthy in total, this paper emphasises on the classification point on earnings management, that is, whether it is efficient or opportunistic. When is earnings management said to be efficient or opportunistic? The objective of this paper is to convey a clear perspective on earnings management in determining whether it is opportunistic earnings management or efficient earnings management. The measurement metric to determine efficient earnings management or opportunistic earnings management is highlighted in this paper. As earnings management can be healthy or unhealthy for firms, it is inappropriate to define earnings management as unhealthy or healthy generally without first considering if it is efficient or opportunistic earnings management.

This paper presents background information on earnings management, the relationship of the type of earnings management to agency cost, how earnings

management can be a part of firm's business contract cost, classification of the double side of earnings management, that is, whether it is efficient earnings management or opportunistic earnings management and finally, the metrics to determine the double side of the earnings management. The significant contribution of this paper is to avoid prejudgement on whether earnings management is healthy or unhealthy without first investigating the firm's performance. The firm's performance is the indicator that determines the effect of earnings management. Generally, previous review papers on earnings management provided a general overview of earnings management and detecting the earnings management model. This paper aims to add to the existing literature, with emphasis on firm performance as the key factor in determining the double side of earnings management.

## LITERATURE REVIEW

### Earnings Management

Earnings management is the action of corporate officers that affects a firm's short-term earnings results (Sevin & Schroeder, 2005). Schipper (1989, p. 92) defined earnings management as "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to say, merely facilitating the neutral operation of the process)." In addition, Healy and Wahlen (1999, p. 368) documented that "Earnings management occurs when managers use judgement in financial reporting and in structuring transactions to

alter the financial reports to either mislead some stakeholders about the underlying economic performance of the firm or to influence contractual outcomes that depend on the reported accounting numbers." The judgement exercised by the managers through earnings management to alter the firms' financial reports mislead stakeholders on the firms' financial performance. Thus, shareholders make inaccurate judgements about the firm's performance (Gulzar & Wang, 2011). However, Arya et al. (2003) describe earnings management as a smooth car ride, in which the passengers (assumed: stakeholders) are overwhelmed with the drivers' (assumed: managers) expertise. This interprets that earnings management has the capability to deliver positive earnings results to stakeholders or investors of a firm. Most firms do not engage in managing short-term earnings (Jooste, 2013). Income-increasing earnings management is more widespread than income-decreasing earnings management (Beneish, 2001). Earnings management is a monetary gain from the managers' ability to exercise accounting manipulation for positive earnings performance results (Nan et al., 2015). This reflects that earnings management is an action that gives impact to earnings results. Earnings management is perceived as functional and rational by firm managers (Noronha et al., 2008). Thus, earnings management is one of the essential activities used by managers of firms to adjust earnings results whether for the benefit of the shareholders and firm or as opportunistic activity.

Earnings are a most important metric to internal or external parties of the firms (Degeorge et al., 1999) and earnings information reveals the position of firm values (Graham et al., 2005). This reflects that positive earnings play an important role in attaining positive firm performance that increases firm value. Essentially, the increase in firm value signals the strong business position of the firm, and this builds credibility among the stakeholders and increases the shareholders' wealth. The alteration of the earnings in the financial reports through the earnings management actions to conceal the true economic position reflects on the importance of earnings. Thus, earnings are managed or smoothed through earnings management with the intention to achieve the objectives aligning to shareholders interest or for managers' self-interest, which gives impact to the firm performance. Ebaid (2012) stated that listed firms in Egypt used earnings management to prevent earnings decreases and losses in their financial reports.

Firms use earnings management either to alter the positive (forward) or negative (back – earnings delay) direction of earnings figures (Degeorge et al., 1999). This could be the reason why it is called 'earnings management'; it adjusts earnings either upwards or downwards. Moreover, it is common to manage earnings upwards through earnings management in order to meet or beat the earnings per share forecast (Burgstahler & Eames, 2006). This is because earnings management alters the earnings per share (EPS) calculations

( $EPS = ER/OS$ ) of firms either through EPS numerator calculation by adjusting the earnings results (ER) or through EPS denominator calculation by adjusting the outstanding shares (OS). The known EPS denominator adjustment is through share buyback as the earnings management device or accretive share buyback (Hribar et al., 2006).

Habbash and Alghamdi (2015) conducted a study on motivation of earnings management in Saudi Arabia under developed-economy listed firms and identified several motivating factors for managers to engage in earnings management. Among the factors that cause managers to engage in earnings management are "to increase the amount of remuneration; to report a reasonable profit and avoid loss; to obtain a bank loan; to increase share price" (p. 137). This shows that earnings management action is for a purposeful reason, either for the benefit of the firm and shareholders or the managers.

According to Gunny (2010), earnings management is categorised into accruals manipulation and real activity manipulation. Consistently, managers exercise earnings management through accounting choices (accruals manipulation) or cash flow choices (real activity manipulation) to alter the earnings figure as part of the firms' transaction involving internal or external parties. Ebaid (2012) reported that accruals accounting creates opportunity for managers to engage in earnings management. For example, earnings management through accounting choices transaction such as

accrual manipulations is done among internal parties. Earnings management through cash flow choices such as accretive share buyback (Hribar et al., 2006) involves internal parties i.e. the managers and external parties i.e. the stock exchange when the share buyback activity is through the open-market buyback programme. Thus, earnings management is a contract that builds up the accounting numbers in the firm as it involves internal and external parties through the accounting treatments. This contract that builds up the firms accounting numbers can be either efficient or opportunistic for firms and shareholders. If the firm makes a residual profit through the earnings management contracts it is classified as being efficient for the firm and shareholders. Firms that make a residual loss through the earnings management contracts can be considered opportunistic for the managers at the expense of shareholders.

Dechow and Skinner (2000) have clearly drawn the line between earnings management and fraudulent accounting. The managers' intention of undertaking actions or choices to mask the true economic position or performance can be either accounting choices or cash flow choices. This paper classifies accounting choices mainly through accruals manipulation and cash flow through real activities manipulation as accounting treatments as these choices affect the accounting numbers, specifically the EPS. These accounting treatments are classified as earnings management if the managers' discretion is within the Generally Accepted Accounting Principles (GAAP). These

earnings management actions are considered to have a 'screw driver' effect i.e. to make the system work better; thus, these actions are not considered to be violating the GAAP but for the smooth running of the business (Graham et al., 2005). In sum, earnings management is a contract undertaken by managers at the managers' discretion through accounting treatment transactions to manage accounting numbers. Essentially, the discretion of the accounting treatment exercised by managers is an earnings management practice. According to Watts and Zimmerman (1990), the discretion of accounting exercised by managers can either benefit the firm's value or the wealth transfers to the managers. This reflects that when wealth transfers from shareholders to managers through earnings management outcomes it has a negative impact on firm value, ultimately reducing shareholders' wealth. Does alteration of accounting numbers through earnings management provide a bright prospect for the future of firms? Do these firms have a positive firm performance that increases shareholders' wealth from the managers' discretion in engaging in earnings management? Do these managers perform the right tasks to increase the firm and the shareholders' value or do their actions affect the firms and shareholders' wealth, which leads to agency problems?

**Agency problems.** According to Fama and Jensen (1983), agency problems arise from separation between decision and control between the principal (owner) and the agent (manager). This separation causes

conflicting interest between the owners and managers, which leads to agency problems. It is impossible for the agent to make an optimal decision for the benefit of the principal at zero cost. The cost that is incurred due to the existence of agency problems is known as agency cost. Jensen and Meckling (1976) defined agency cost as principal monitoring cost, bonding cost and residual loss. The bonding and principal monitoring costs are able to reduce agency problems through effective corporate governance mechanisms. The residual loss is that the cost outweighs the output value of the firm (Fama & Jensen, 1983). In sum, a residual loss where the cost outweighs the revenue leads to negative firm performance that conveys negative financial information to shareholders.

Firm performance holds a pivotal role in a firm's success and shareholders' wealth. As matter of fact, firm performance is generally measured through financial performance as accounting is the language of business. This firm performance reflects how well the resources of the firm are being used to generate profit in a specific period of time. In a nutshell, positive firm performance is from residual profit, and residual loss leads to negative firm performance. This residual loss is known as distorted earnings report; it occurs when the managers' interest fails to align with shareholders' interest, ultimately increasing agency cost. Distorted earnings reports affect the firms' value (Degeorge et al., 1999); in addition, residual loss is an expense for shareholders. However, the agency problems reduce when the firm

generates residual profits where the output value is greater than the cost of the input. This shows that the agents are making effective decisions that optimise principals' (shareholders) wealth through positive firm performance.

The common assumption regarding the reason agents are appointed is that they can act on behalf of the principal to maximise the firm value, ultimately increasing the principal's wealth. If the agents make an unimpaired decision that enhances the firm growth, naturally they are acting in line with the principal's goals and objective in having set up the firm. In sum, the wealth of the firm is the wealth of the principal through the agent's achievements. The agents' (managers) achievements are accounted to the managers' decision as to whether to work in line with the principal's (shareholders) viewpoint that maximise firm value in the short or long term or the managers' personal growth or as a gimmick in the short term to gain advantage for the firm, increasing the conflict of interest between the two parties (shareholders and managers), leading to agency issues or problems.

Does managers' (agents) involvement in earnings management benefit firms and shareholders (principals)? Will managers' decisions involving earnings management benefit the owners (shareholders) of the firm, or will it cause agency problems? According to Jiraporn et al. (2008), for firms with less agency cost, managers' involvement in earnings management is beneficial to firms and shareholders. On the other hand, for firms with severe



agency cost, managers are opportunistically involved in earnings management for their own private benefits, and this affects the firms' performance negatively. As matter of fact, efficient earnings management is practised by firms with less serious agency problems. The managers of these firms are working towards increasing the wealth of the firms and shareholders. Thus, for firms with minimal conflict of interest between shareholders and managers, the management of the respective firms are involved in healthy earnings management for positive growth of the firm and shareholders' wealth. In general, the discretion or judgement of managers in earnings management involvement determines the shareholders' value growth and the survival of the firms. The opportunistic decision making of the managers at the expense of the shareholders that increases agency cost through residual loss leads to opportunistic earnings management.

**Contracts opportunistic or efficient.**

Firms are a nexus of contracts between the internal and external parties (Fama & Jensen, 1983). These contracts are the rights of the managers (agents), and their rewards are based on the evaluation of performance of these contracts (Fama & Jensen, 1983). According to Fama and Jensen (1983), survival firms are firms that deliver the desired output to their customers at the lowest price covering the cost. Generally, the firms' accounting numbers are built up from transaction or contracting cost from these contracts.

Basically, contracts are classified healthy when firms make residual profits by selling

for a price above the cost. If the managers undertake contracts that lead to residual loss, they create agency problems that increase the agency cost. The agency cost is part of the contracting cost (Watts & Zimmerman, 1990). In sum, the contracting cost can be healthy to the firm when the agency cost is reduced or otherwise. As a matter of fact, agency cost is an expense to firms and shareholders, and leads to negative firm performance. Residual loss is the agency cost (Jensen & Meckling, 1976) from the contracts; this contract cost is unhealthy to the firms because it affects firm performance and shareholders' wealth. These contracts lead to untoward directions against the shareholders' viewpoint on maximising firms or shareholders' value. The decision making of the managers involved in these contracts is either for firm survival growth that enhances the shareholders' wealth or for managers' personal growth. The residual loss to shareholders is assumed to be residual profit to managers for their personal growth. Are these managers known as the agents of the firm making opportunistic decisions for their personal growth at the expense of shareholders?

**Efficient or opportunistic earnings management.** Firms that engage in income increasing earnings management provide opportunity for the investors to earn abnormal stock return in short position compared to long position for firms that use earnings management for income decreasing purpose (Kwag & Stephens, 2009). Is this earnings management activity efficient or opportunistic? Siregar and Utama (2008) reported that firms with a

higher proportion of family ownership and non-business groups engage more in efficient earnings management. Essentially, managers do possess a sufficient degree of freedom to operate a firm effectively and efficiently on behalf of shareholders. This degree of freedom gives rights to managers to exercise discretion over the accounting numbers through contracts. Thus, accounting numbers are the outcome of these contracts. As for the accounting treatment, the managers undertaking the contracts have an impact on shareholders' wealth. If the outcomes of these contracts redistribute the wealth to managers, the managers acted opportunistically (Watts & Zimmerman, 1976). The managers enhance their personal wealth through contracts at the expense of the shareholders. Thus, the managers' opportunistic action of engaging in these contracts at the expense of shareholders leads to residual loss as part of the agency cost, increasing the contracting cost. Arya et al. (2003) divided managers into two categories: selfless manager and managers with personal goals (e.g. compensation). Generally, selfless managers act in accordance with the agency theory to maximise the firms and shareholders' wealth through positive contracts not at the expense of the shareholders. Selfless managers' earnings management activities will not be detrimental to firm performance; this is in contrast with the actions of managers with personal goals.

If managers exercise discretion in accounting numbers through earnings management contracts that lead to residual

loss or negative firm performance, that earnings management is known as opportunistic earnings management. This opportunistic earnings management is either for the managers to achieve personal goals at the expense of shareholders or to position the firm to underperform in the short or long term. Opportunistic earnings management delivers negative information to stakeholders on the future direction of the firms. Yang, Hsu and Yang (2013) found that firms that issue seasoned equity offerings engage in aggressive earnings management to be in better condition in the short run to attain benefits such as allowing the insiders to dispose of shares at higher prices by putting the shareholders in a worse condition in the long term. The authors' finding reveals that the opportunistic action of the managers to attain benefits in the short term gives a negative impact to firm performance and shareholder wealth in the long run. In addition, He et al. (2010) studied private placement issuance firms in Japan and reported that firms involved in earnings management to manipulate earnings as a strategy to attract more investors suffered underperformance of shares in the post-issue period. The behaviour of the managers in using earnings management for short-term gain did not benefit the firm in the long run. In sum, this kind of earnings management activity is unhealthy to the firm. These opportunistic earnings management actions, which increase agency cost, bring no benefit to the firm and shareholders. This opportunistic earnings management is a discouraging signal for the firm's



future growth and decreases shareholders' wealth for managers in the short term. Thus, opportunistic earnings management decreases the firm's value and shareholders' wealth, suggesting an unhealthy future for the firm and the shareholders.

Bhojraj et al. (2009) reported that firms that engage in earnings management gained short-run stock price advantage but underperformed in the long run. In a nutshell, these firms engaged in opportunistic earnings management that affects the firms' value and shareholders' wealth. Jiraporn et al. (2008) pointed out that opportunistic earnings management is harmful to the firm and gives negative impact to firm value. Bhojraj et al. (2009) reported that managers who were involved in earnings management are classified as indulging in "myopic behaviors", or behavior that does not provide for the future. This shows that opportunistic earnings management does not benefit the firm in the long run. Opportunistic earnings management re-distributes wealth to managers at the expense of the shareholders. Opportunistic earnings management determined through negative firm performance results manifests to increase agency cost due to conflict of interest between the managers and the shareholders. Therefore, opportunistic earnings management is regarded as unhealthy to the firm and affects shareholders' wealth as a whole. Habib (2004) identified a negative relationship between the value relevance of accounting information and earnings management. The author reported that the investors

discounted the firm's accounting numbers if the firm practised opportunistic earnings management. This clearly indicates that the investors did not encourage opportunistic earnings management as it did not benefit the shareholders.

On the other hand, if the outcome of the contracts through accounting treatment enhances shareholders' wealth with residual profits or positive firm performance, these managers' accounting treatment through earnings management is known as efficient earnings management. The efficient earnings management benefits the firm and increases the firm's value. Thus, a contract that leads to residual loss is an opportunistic contract that benefits the managers, ultimately affecting the survival of the firms and shareholders' wealth. In contrast, contracts attributable to residual profit known as efficient contracts provide a foreseeable positive direction for the firms and maximise shareholders' wealth. Collectively, efficient earnings management exhibits positive firm performance, which ultimately increases firm value and shareholders' wealth. In sum, efficient earnings management reflects on the existence of aligned interest between the managers and the shareholders of the firms. An efficient earnings management delivers good news through positive firm performance to shareholders and stakeholders of the firm (Rezaei & Roshani, 2012). The efficient earnings management is informational to shareholders and the market. Essentially, efficient earnings management is associated with positive firm value.

Jiraporn et al. (2008) measured current financial performance with earnings management to determine whether earnings management is opportunistic or efficient. Bhojraj et al. (2009) and Rezaei and Roshani (2012) used earnings management to measure future financial performance. Jiraporn et al. (2008) and Rezaei and Roshani (2012) documented that earnings management that gives a positive effect to firm financial performance is classified as an efficient earnings management. On the contrary, negative firm financial performance is the effect of opportunistic earnings management. Thus, firm performance is used as a metric to gauge whether earnings management is efficient or opportunistic. This validates that firm performance is the metric to determine the type of earnings management used by managers. Earnings management is known to manage the earnings figure; the ideal measurement metric is accounting-based firm performance measurement such as Return on Asset (ROA) or Return on Equity (ROE) or market-based firm performance measurement such as TobinQ.

## **METHODOLOGY**

This study used content analysis to review articles or journals on earnings management from reputable databases such as Elsevier/ Science Direct, Emerald and Ebscohost from 1976 to 2015. However, there are limited articles on the double side of earnings management, leading to the author's decision to explore when earnings management is efficient and opportunistic.

## **DISCUSSION AND IMPLICATIONS**

In sum, healthy firms with less agency cost are involved in healthy earnings management for long-term survival of the firms. Rahman et al. (2013) reported that earnings management is informational when the relationship between earnings management and information asymmetry is negative whereas earnings management is opportunistic when the relationship between earnings management and information asymmetry is positive. Generally, the existence of information asymmetry indicates that managers have more information compared to shareholders such that shareholders are in doubt about the aligned interest between the shareholders and managers. The close link between information asymmetry and agency cost to earnings management predicts that firms with less information asymmetry between the managers and shareholders portray aligned interest between the two parties' practices, leading to healthy earnings management, which is efficient or informational for shareholders and the market.

Thus, healthy earnings management is efficient earnings management that aims for the well-being of the firm and shareholders. The management of these firms provides a bright long-term direction for the firm by gaining confidence from the stakeholders and shareholders through transparent positive firm performance. The decision to be involved in efficient or opportunistic earnings management is at management's discretion. Managers who consent to long-

term direction of the firms will take the wiser decision to be involved in efficient earnings management for a promising future for the firm and the managers. Opportunistic earnings management is narrowly focussed to managers' private benefits, delivering negative financial information to shareholders. Opportunistic earnings management benefits managers, not the firms; this is why opportunistic earnings management is branded as short-term focussed earnings management, which does not benefit the firm in the long run.

The firm's performance results are the yardstick to measure whether the earnings management is opportunistic or efficient. This clearly implies that the managers' discretion on engaging in either type of earnings management should acknowledge their concern for continuous survival of the firms with positive firm value and aligned interest with shareholders with the strategy to reduce agency cost. Even though earnings management is not a fraudulent activity, wrong earnings management increases agency cost; thus, opting for opportunistic earnings management raises issues of ethical consideration of the managers, which also reflects negatively on the firm and is subjected to penalties from the shareholders. The firms' future is the responsibility of managers today. Thus, managers have to make the right choice in selecting the type of earnings management. This discussion is important for helping the market, firm players and academics to draw a clear line between the double side of earnings management and its impact on

firms and shareholders' wealth. The firms' performance is the measurement tool to decide whether it is engaged in efficient or opportunistic earnings management.

## CONCLUSION

This review clearly explains the double side of earnings management, showing whether it is efficient or opportunistic. It adds further insight into earnings management as a business strategy. In addition, this review also elaborates on how earnings management is determined and the post effect of earnings management adds valuable information to business and academics players. The positive firm performance results reveal the engagement of efficient earnings management by the managers. The practice of opportunistic earnings management by managers results in negative firm performance results that possibly decreases the firms' value (short run or long run) and their shareholders' wealth. Essentially, earnings management is an action taken by managers to mislead shareholders; it is healthy for the firm and shareholders if the managers undertake efficient earnings management. Firms that adopt efficient earnings management as the contract or transaction to alter financial results posit minimal agency cost. Efficient earnings management clearly reflects on the aligned interest between managers and shareholders that ultimately strengthens the relationship between the two parties and the firm sustainably. Thus, it is important for managers with entrepreneur skills to profoundly nurture the needs of firms and

shareholders when engaging in earnings management practices. This study on the double side of earnings management avoids prejudgment on earnings management by business players and academics. The recognition of the double side of earnings management possibly can limit the number of managers who choose to engage in opportunistic earnings management as it depicts the disharmony in the position of managers and shareholders. Limited studies use real manipulation activities in earnings management studies besides the common accruals manipulation proxy. Thus, future research should investigate this area using real manipulation activity as the earnings management proxy to determine whether earnings management with real activity manipulation is efficient or opportunistic.

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