

# Earnings Management between the fact of manipulation and credibility of management procedures: a literature review

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**Abstract:-** *The result of a conflict of interests between the management, the owners, and the rest of the stakeholders in the company, and according to the principle of rational choice, which each party tries to maximize its own benefits, the earnings management has emerged, so it is known that the earnings management is performed through the practices carried out by the management, which is resultant From its selection of the company's accounting policies, influenced by management own goals. however, the study aimed to learn about the concept of earnings management, its motives, and problems by examining a set of literature review for the period from 2017 to 2019. The study concluded that there is great agreement among most researchers that earnings management methods are used to mislead shareholders and users of financial statements, Thus it can be said that it is a set of activities, means, and procedures taken by the company's management, which aims to maximize the benefits of management and achieve some benefits, regardless of their legitimacy, through the use and exploitation of flexibility in accounting standards or departure from them.*

## Introduction:

When preparing financial reports, they are subject to a large number of accounting standards and policies, and when they are published, they are subject to accounting disclosure standards, but this does not prevent corporate departments from earnings management practices (Faisal et al, 2018). however, the auditing profession has a positive role in limiting the negative effects of earnings management, as it mainly aimed at expressing a comprehensive opinion about the fairness and reliability of the financial statements, and this entails adding confidence and credibility to the data included in these statements (Coffie et al, 2018). And after completing the auditing profession for this essential role, it fulfills its social responsibility towards society as a whole efficiently and effectively, which requires setting standards and levels that guarantee the quality of performance in order for the auditing profession to

Maintain the trust of the community in auditing profession (Hundal, 2019). However, while the auditor performs his auditing work, he is responsible for increasing the effort and detailed tests while performing the auditing tasks of the financial statements of clients practicing the earnings management behavior (Barghathi, 2017). The auditor needs to make an “additional” effort and conduct broader tests for the purpose of conducting the required quality of auditing tasks, which reflects positively ”to reduce the earnings management behavior of these clients, and the additional effort increases the auditing fees (Jahn, 2017); (Nerudová et al, 2019). The process of determining the quality of auditing is difficult, due to its different nature and the multiplicity of its beneficiaries, and that the quality of auditing is a “basic” requirement for all beneficiaries of the auditing profession (Fung et al,

2019). The studies in the field of auditing quality have become one of the issues presented at the academic and applied levels due to the importance of the need to improve the quality of auditing process (Garza, 2018); ( Talab, Flayyih & Ali, 2018)..

### **The concept of earnings management goals:**

The main objective of earnings management is that the declared earnings be more stable and “steady” and give the impression of a decrease in the risks to the company, a rise in its share price, a decrease in borrowing and financing costs, in addition to an increase in investor appetite for the company's shares” (Abner & Ferrer, 2017). Earnings management goals can be determined by (Grecco et al, 2017) (Rahardjo et al, 2019):

1-Enhancing the performance of the company for the current period by increasing the number of declared earnings and by improving the image of the financial statements for the purpose of conforming to the prediction of predefined earnings.

2-Avoid declaring the company's losses because this affects the status of the company's management bonuses on its value in the market.

3-Achieving income smoothing with the aim of reducing the degree of variation in earnings figures from one period to another.

4-Reducing political costs and avoiding government interference in the company in the event of large company size.

### **Earnings management motives:**

Each practice in working life has certain motives that act as a guide to achieving some of the desired goals of that practice, and this is completely consistent with the practice of earnings management, however, the company has attributed the practice of earnings management for several reasons and motives, it may be internal or external motives. Which is as follows: (Wang & Hagigi, 2019) (Hsu et al, 2019)

### **Motives related to money market expectation and evaluation:**

1. **Earnings forecasts:** Earnings forecasts issued by financial analysts in the market or issued by

the company's management are one of the targets for earnings management (Diaz et al, 2019). (Smith & Koonce, 2019) believes that the company's management attempts to report earnings in accordance with or exceeding expectations. (Jaggi et al, 2019) asserts that the management philosophy of this behavior is a result of its concern that it will incur costs that may be prohibitive in the event that the profits that are foreseen are less than expected.

2. **Stock options:** The determination of management rewards in the form of stock options constitutes a 'strong' motivation for the company's management to choose exceptional accounting adjustments in a manner that affects the increase in the market price of shares on the date these options are granted. (Kladivko & Zervos, 2017) assumes that the value of these options depends on the share prices on the date they are granted. (Blocher & Ringgenberg, 2018) notes that the method of giving options is one of the methods that put the interests of executives and the value of the company they run in one framework.

3. **Initial equity offerings:** Initial equity offerings represent an incentive "for company management to exercise earnings management, as it aimed to influence the market price of shares when the company's shares are presented in order to raise the prices (Tee & Wiley, 2018). And when the company's shares are presented for the first time in the market and there is no previous market price for shares, there is a lack of information among investors and therefore these investors rely heavily on the financial statements, and this represents an opportunity for the company's management to practice earnings management in order to maximize returns from selling shares (Jiang et al, 2017).

### **Contractual motivations:**

Both agency theory and positive accounting theory agree that companies should use compensation and rewards contracts for managers as a way to motivate them to work as hard as possible for the good of the company (Davis et al, 2019). (Gabrielsson & Huse,

2017) believes that some company managers deliberately change the company's real results in order to obtain earnings. (Iwasaki et al, 2018) indicates that accounting data is used to help in organizing contracts between the company and multiple owners, as the administrative reward contracts for reconciliation arise between the management interests which represented by rewards or incentives and other stakeholders (Edmans et al, 2017). There are two types of contracts: lending contracts, compensation contracts, or incentives for management which is as follows (Blay et al, 2018) (Al-Najjar, 2017):

**Lending Contracts:** Positive accounting theory indicates that lending contracts significantly affect the company's accounting options (Kaya, 2017). (Vladu, 2017) believes that when the company requires loans from banks, it should provide its financial statements, in which case the company's management will seek to use the accounting methods that show earnings more than the truth, which leads to a lower probability of the company's compliance with the conditions in the lending contracts." (Breton & Breton, 2018).

**Administrative Rewards Contracts:** Management rewards contracts that belong to the administration lead to manage their earnings in order to increase the rewards and improve their career status (Ding & Wu, 2018). (Martin et al, 2019) notices that when the company's earnings are less than the required limit to obtain the bonus, the earnings are managed upward until you reach the required limit. And (Benati et al, 2018) indicate that in the case of the company's earnings is greater than the maximum that stops Granting additional bonuses. In this case, the company's management will lower earnings for future periods to obtain additional bonuses.

**Tax motives:** Earnings management methods are applied to reduce income tax payment even though most countries have taxable income that does not match accounting income (Masri et al, 2019). And that some of the tests used for accounting rules are the same for taxable income and accounting income. For example, in America, accounting methods are chosen to evaluate the stock that can affect both

taxable income and accounting income. We note that when using the LIFO method instead of from FIFO, the purchase price is increasing, the cost of sales is higher, earning is lower, and tax savings are lower (Amoh, 2017) (Hbaieb, 2019), (Amidu & Yorke, 2017) believes that the company's management can exercise earnings management by increasing the expenses due in the future period at the expense of the current period or postpone the current revenue in order to reduce Income taxable.

**Political costs:** Companies attempt to manage their earnings by changing the financial statements in order to influence investor decisions, as well as by circumventing government regulations so that the results of their business appear less profitable in order to evade government interference in them (Wuthisatian & Thanetsunthorn, 2018). (Georgiou et al, 2019) believes that economies with incompetent equity markets are vulnerable to government appointments for their chief executives. And the big companies are keen to manage their earnings and reduce them so that they are not the subject of the legislator's attention and interest. For example, in 1970 the ban on the export of oil from some countries led to a significant increase in prices, which made the oil companies achieve great profits that caught the attention of Congress, which led To the issuance of a special tax law called the law of windfall profits tax, and as a result of this law, companies started taking measures that show profits less than the truth, such as postponing the recognition of revenues or expediting the recognition of expenses (Kumar, & Nandamohan, 2018) (Maji & Goswami, 2017) .

### **Earnings management practices:**

Earnings management practices are divided into two types: real earnings management and accounting or fictitious earnings management (Widhiastuti et al, 2018) (Ranjbarian et al, 2017).

**Real earnings management:** This type of method is based on the use of management decisions related to production, investment, and sales activities, and it is called real variables or methods, and according to that the administration can do the management of real profits through three means:

**Sales and purchase management:** The administration can practice earnings management through some decisions related to sales and purchases, and this is achieved through the following: (Fantazy & Athmay, 2019)

Granting excessive discounts in the last quarter of the fiscal year with the aim of accelerating and increasing sales or leniency in terms of future sales and making them less flexible, such as increasing the credit period granted to customers.

Postponing the purchase of some assets to a later period of time, due to the effect of that decision in the volume of cash flows.

Take decisions regarding the timing of the sale of the assets.

**Optional Expense Management:** The administration can practice earnings management by increasing or decreasing some optional expenses such as research and development expenses, advertising and publicity expenses and maintenance expenses in order to achieve the target profit especially if these expenses do not contribute to achieving income in the current period (Singh et al, 2018).

**Production management:** The administration can practice earnings management by accelerating the rate of production in an excessive manner, which leads to a reduction in fixed costs and thus a reduction in the average unit cost (Ittonen et al, 2018). Likewise, an increase in production results in an increase in inventory, which leads to a decrease in the cost of sales and consequently an increase in productions (Briamonte et al, 2017).

**Managing earnings of an accounting or fictitious nature:**

Earnings management practice of an accounting or fictitious nature is based on management's use of accounting or fictitious variables as follows: (Reding & Newman, 2017) (Finkler et al, 2018).

- Practice managing earnings of an accounting or fictitious nature that depends on exploiting the available flexibility within the framework of accepted accounting principles such as managing

accounting receivables, optional accounting changes and choosing an appropriate time to implement a mandatory accounting policy.

- The practice of managing profits of an accounting or fictitious nature that is based on the use of fraudulent practices and methods that are outside the scope of generally accepted accounting principles in order to reduce the transparency of published financial reports, such as, early recognition of revenue and overstated inventory and recording fake stocks (Antonopoulos et al, 2019).

**Earnings management problems:**

Earnings management is one of the most practices that affect the quality of financial reporting in the financial statements of companies because it affects the process of showing the true performance of companies by employing the accounting policy methods, in a way that results in information that does not reflect the true performance of companies (Talab et al, 2018). Although managers realize that managing earnings, even if they achieve benefits in the short term, they may lead to problems in the long term, and among the most important of these problems: (López, 2019) (Farhan, 2018)

- **Reducing the value of the company:**

There are many decisions that companies make with the aim of affecting their profits in the short term, but they may lead to damages to economic efficiency in the long term, for example, expediting revenues or delaying expenses. (Laksmi & Kamila, 2018)

**Fading ethical standards:**

Earnings management, even though it does not clearly violate the generally accepted standards, but it is an ethically questionable practice, because the companies that manage their earnings send a message to the company's employees that concealing and misleading the truth is an acceptable practice. (Guillamón et al, 2018)

**Hide operational management problems:**

Earnings management is not practiced at the level of senior management only but is also practiced at the level of operational management, as managers in the operational management change the financial data in

order to obtain rewards, promotions and avoid criticism for poor performance, and the most important risks of earnings management at the level of lower management is Operational problems are hidden from senior management so errors remain unhandled for a long period of time (Liu et al, 2017) (Berger & Gleissner, 2018).

### **Literature review:**

Due to the misleading and concealment of earnings management practices, which led in turn to many collapses and scandals for the largest international companies, the most famous of which is (Enron & WorldCom). However, earnings management practice has received widespread attention from several organizations, such as the American Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), and the National Association of Securities Dealers (NASD) for Study and analysis, and find out the reasons and motives behind these practices and try to find some solutions or plans to reduce this phenomenon (Michalski et al, 2018). However, our research covered a review of the most important studies between 2017 and 2019.

A study (Astami et al, 2017) aimed to identify the impact of both auditing quality and culture on managers' decisions in managing earnings utilizing optional accounting accruals. however, the study sample was represented by a number of companies with high cash flows listed on the stock exchanges of nine countries in the Pacific and Asia, The researchers relied in their study on the modified Johns model, and the study reached several conclusions, the most important of which are that managers of companies with high cash flows practicing earnings management in their companies, however, the role of the auditor and culture contributes to reducing the practice of earnings management by managers of companies with high cash flows.

(Cuong & Ha, 2018) has provided evidence that estimating and pricing discretionary accruals according to the modified Jones model is performed by the market and that the Non-Discretionary

accruals coefficient is greater than the value of the discretionary accruals coefficient, meaning that market dealers view the discretionary accruals as less reliable and that this means that discretionary accruals are more likely to be manipulated by managers, and in turn is a good measure of earnings management.

The study (2018 Brahman et al.) Aimed to identify the extent of a correlation between earnings management and environmental disclosure for industrial companies operating in Malaysia, and the study sample included 248 industrial companies registered in the Malaysian Stock Exchange for the period from 2008-2015, however, the study concluded that the environmental disclosure of Malaysian industrial companies has a positive impact on the earnings management through environmental policymakers by comparing the behavior of industrial companies with their environmental responsibility towards society and their confrontation with environmental management practice by Malaysian industrial companies. As for the study (Kolsi & Attayah, 2018), it aimed to identify the extent to which companies with social responsibility deal with accounting numbers and data in an opportunistic manner, or adopt a financial reporting strategy in a transparent manner, and the extent of the relationship between companies with social responsibility, operating cash flows and abnormal discretionary accruals. however, the study sample was represented by a group of 34 Emirati companies listed on the Abu Dhabi Stock Exchange for the period 2009-2014, and the study reached several conclusions, the most important of which is a positive correlation between the disclosure of UAE companies to their social responsibilities and abnormal discretionary accruals, and there is no correlation between operating cash flows and the disclosure of UAE companies and social responsibilities.

The study (Alareeni, 2018) examined the effect of some of the properties of companies on earnings management, and the researcher used the multiple regression method to prove the research hypothesis, however, the study concluded that most companies

in the Gulf Cooperation Council countries practice earnings management except for the companies of Oman, however, earnings management is practiced by reducing earnings, as well as some variables such as company size and leverage, have no significant impact on earnings management practices in GCC companies. As for the study (Idris & eta, 2018) aimed to identify the correlation between the efficiency of the auditing committee and earnings management in Jordanian energy companies, and how can the intensity of the external auditing act as a mediator in this relationship, therefore, this study concluded that the efficiency of the auditing committee has a significant and negative impact in the same time on earnings management, and there is a positive interactive effect of the intensity of the external auditing and the efficiency of the auditing committee on the earnings management, which supports the correlation between the intensity of the external auditing and the efficiency of the auditing committee in limiting earnings management.

The study (Yasser & Soliman, 2018) examined the impact of auditing quality on the earnings management practiced by some companies in Egypt where the researchers used a regression method to clarify the relationship between the quality of the auditing and the size of the auditing company, specialization in auditing and the auditing period. The study found that the auditing period has a significantly positive correlation with earnings management, while other variables such as the quality of the auditing, the size of the auditing, and the specialization in auditing have maintained a weak correlation with earnings management. As for the study (binti & Khomsathn, 2018), it focused on the correlation between the transparency of disclosure of reserves and the management of accrued earnings, and the study concluded that the transparency of the disclosure of the reserve account has a negative and significant impact on the management of accrued earnings, and the quality of the auditing as an intermediate variable has a negative impact on the relationship between transparent account disclosure and managing accrued earnings.

(Al-Sraheen, 2019) the study aimed to identify the role of auditing committees by limiting earnings management, and to recognize the impact of cash flows in Jordanian companies on earnings management, and what is the effect of providing non-auditing services by the company auditor to the company (study sample) on the quality of the auditing, however, the sample was represented by a number of industrial companies which listed in the Jordanian stock market for the period from 2014 to 2016, which totaled (336) companies. The study reached several conclusions, the most important of which is that, there is a positive correlation between earnings management and cash flow surplus, and that the auditor providing his non-auditing services to his clients will effect on his independence, this, in turn, will affect the quality of the auditing and will be reflected in the earnings management.

As for the study (Barghathi, 2019), it aimed to identify the extent of earnings management practice and what are its causes, in addition to, the extent of the financial report's contribution to the disclosure of earnings management in Libyan banks. However, the sample of the study consisted of a number of Libyan banks. The researcher relied on his study on the questionnaire form and analyzed these forms using the SPSS statistical program, The study concluded that the management of Libyan banks practices earnings management, due to the misuse by the administration of the authorities granted to them in these banks, and thus mislead users of financial statements regarding the nature of the normal activity thereof, as well as the weakness of the external auditor's work, which leads to financial reports containing earnings management practices, and thus affects investor decisions as well as the quality of financial statements.

The study (Baatour et al, 2019) showed the impact of multiple departments on managing earnings based on the accrual basis and also provided an analysis of whether the earnings management methods in Saudi companies increase or decrease with the average number of multiple departments, where the study concluded that the management of real earnings It occurs a lot in companies whose board of directors

includes members practicing multiple departments works, and that the independent variable which is (the number of appointments or external positions held by managers) is the most important factor that has been ignored by corporate departments and earnings management literature, and among the recommendations of this study, it calls for restrictions on the number of companies Circuits filled by board members.

### **Recommendations and future research:**

Through the conclusions reached by some of the most important literature review related to the subject of earnings management and from the viewpoint of these literature reviewers, for the period from 2017 to 2019, researchers recommend some recommendations; Among them is the establishment of a controlling committee that works to provide a high-quality auditing environment that works to limiting undesired practices such as the practice of earnings management, the controlling committee also must controlling auditing offices to ensure their commitment to performing the required quality of auditing tasks. Also, a law should be issued to allow continuous inspection of auditing firms to verify their compliance with professional laws and standards when performing auditing tasks. As well as working to educate investors and corporate departments of the negative effects of earnings management practices on their investment decisions.

The auditing companies should pay attention to the good training of the auditors that working in their offices for the purpose of increasing their qualification and technical skills, in addition, to focusing on practical training in the fields of specialization in order to form experts who are able to build distinguished provisions in the field of auditing, which reflects its positive impact on the quality of the auditing process.

Future research can examine the quality of financial reports and their impact on earnings management practice in sectors other than industry, Future research can examine the quality of financial reports and their impact on earnings management practice in sectors other than industry, and study the impact of

the auditor's issue legally, socially and professionally on the quality of the auditing process, in addition to examining of the extent of Iraqi auditing firms 'interest in qualifying and training their auditors and the impact of this on the quality of the auditing process, And examine the impact of the use of decision support the quality of the auditing in light of budget constraints and time pressure.

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