EARNINGS MANAGEMENT AND THE OPTION OF REGULATION OF FINANCIAL REPORTING

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Abstract

The accounting world in the contemporary times has faced the challenge of earnings management, which is being carried out to extreme negativity has made for casting aspersions on the credibility of accounting principles and financial reporting. There are various authorities, individuals, institutions and bodies that are involved in one way or the other in examining and regulating companies' financial book. Despite the existence of these bodies, our country and other nations in the world are still experiencing corporate failures through the activities of earnings management. This study will through the review of extant literature, offers interesting insight into a strong connection between earnings management and regulation of financial reporting. The paper recommends that, regulation of financial reporting should be carried out to its details and that the regulatory bodies should harmonize the existing regulations and put in more efforts to ensure that financial statements conform to them, amongst others.

Keywords*:* earnings management, regulation, financial reports, standards

The term earnings management also known as creative accounting has many definitions depending on the author's point of view. Wikipedia (2005) said it is an accounting practice that deviates from standard accounting practices. Vladu and Matis (2010) view it from positive and negative perspectives. Positively, they said earnings management connotes invention of accounting principles and techniques to recognize changes in economic, social, political and business environments. It also connotes genuine changes in accounting practice. From a negative viewpoint, they said earnings management means undesirable practices which assimilate unethical elements for attracting providers of capital by presenting a misleading and deceptive state of a certain firm's affairs.

According to Domash, (2002) the term referred to a systematic misrepresentation of the true income and assets of corporations or other organizations. It is a euphemism used in accounting practices that do follow the letter of the rules of standard accounting practices, but deviate from the spirit of those rules. They are characterized by excessive complications and the use of novel ways of characterizing income, assets or liabilities with the intent to influence readers towards the interpretations desired by the authors. The terms "innovative" or aggressive are also sometimes used. Other synonyms commonly include: Cooking the books, Enronomics, cosmetic accounting or roasting of the books, window dressing, deceptive accounting, etc.

Earnings management practices are actually used to manage earnings; in most cases to make them look deceptively attractive. According to Grossman (2002) it occurs when managers use judgement in financial reporting and structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of a company or to influence

contractual outcomes that depend on reported accounting numbers. The purpose of earnings management, according to the author, is to enhance earnings status or to improve company's Debt-Equity ratio, all in the bid to reflect positive and impressiveness on companies' share valuation and pricing. It is used also in off-balance sheet financing. Other uses are: in income recognition, impairment of purchased goodwill, manipulation of reserves, revaluations and depreciation, window dressing, e.g. loans repaid just before the year end and then reversed in the following period, sales and repurchase transactions, changes in accounting policy, stock valuation policies, amongst others.

Creativity in company accounting, according to Naser (1993) may arise under at least three different financial market conditions. The first is when a company floats its shares to attract investors to subscribe to such shares either at par or at a premium. The second is when the company whose shares are already listed in a stock exchange, wants to paint an attractive picture of its financial conditions so that the shares may be quoted at a premium. Furthermore, a company having its shares listed in the stock exchange may declare and pay high dividends based on inflated profits through overvaluation of assets. Finally, undervaluation of liabilities and change in systems of stock valuation and other policies may also be used to boost the image of the company.

Other motivations of earnings management according to Walton (1996) include: personal incentives, bonus-related pay, benefits from shares and share options, job security, personal satisfaction, cover-up of fraud, tax management, management buyouts, meeting internal targets, meeting external expectations, provide income smoothing, window dressing for an initial purchase order (IPO) or a loan, change in management, etc. One another commonly accepted incentive for the systematic over-reporting of corporate income which came to light in 2002, as reported in Wikipedia (2015), was the granting of stock options as part of executive compensation packages. Since stock prices reflect earnings reports, stock options could be most profitably exercised when income is exaggerated, and the stock can be sold at inflated profit.

With the above in mind, the motivation for this study was to critically review the existing financial reporting regulations or whether the standards guiding financial reporting accord with International Financial Reporting Standards (IFRS) and to ascertain the adequacy of these regulations to the extent of curbing the menace of earnings management in corporate organizations. The result of this research may be useful to regulators, auditors and directors in Nigeria and other parts of the world, as they continue to deliberate upon appropriate ways to stop or at least reduce earnings management practices in corporate organizations.

The questions which this study sets out to answer therefore are: is the Nigerian financial reporting regulatory system such that can brace up to the challenge of monitoring companies to actually report their financial state of affairs? Can it ensure greater accountability and transparency in financial reporting? How can financial reporting be made more reliable to eliminate or reduce earnings management practices?

Theoretical Framework and Literature Review

The accounting world in contemporary times has faced the challenge of earnings management which has been carried to extreme negativity, thereby casting aspersions on the credibility of accounting principles and financial reporting. This has affected the general public, accounting information users, stock market regulatory bodies, etc, in fact earnings management has been said to have constituted a threat of our time. According to Richardson (2000), earnings management could be a blessing or a curse. It is a blessing where it introduces something new to refine the accounting

system and therefore become an addition to the existing stock of accounting knowledge. It becomes a curse when it brings in unethical elements into financial books. But a real world situation tends to show that earnings management practices are, in most cases a curse rather than blessing and therefore become undesirable. Its main purpose is to attract unsuspecting investors, or obtain undeserved accounting based rewards, by presenting an exaggerated, sometimes misleading or deceptive state of a company's financial affairs. .

According to Vladu and Matis (2010), management discretion in the application of accounting methods used to report firm performance is not considered to be manipulative, until this particular discretion is used with the intent to manipulate reported results. This is also related to the fact that, managers may focus on short-term personal incentives such as maximizing salaries, bonuses and other short-term compensations, rather than focus on the long-term economic success of the firm. All these doubts appear according to the authors, where a separation of ownership from the control of a corporation exists and in this respect the conflict that arises is described by the Agency theory; which formed the theoretical frame work of this study.

In the context of Agency theory, as contained in Jensen (1986), the firm is considered to be a legal fiction that serves as a focus for complex process that is characterized by conflictual features of individuals' objectives. According to Christensen and Feltham (2005), the conflicts are related to sharing economic resources; and the lack of confidence between shareholders and managers which emanates from the contracting values of earnings management in this principal-agent relationships, deepens the conflict. According to Gowthorpe and Amat, (2005), some of these conflicts of interests inherent in agency relationship, are in some cases self afflicted and this is for the fact that, shareholders sometimes overlooked and accept some deliberate manipulations of accounts; becoming in this way unwittingly accessories to manipulation, as they believed that, the manipulations are advantageous to them; but in the real sense, they are the losers as a result of information asymmetry.

In carrying out earnings management, an expense may be treated as an asset to improve book profits or alternatively, an asset may be expensed to show lower profits. Similarly, revenue may be transferred to a liability (through provisioning) to reduce book profits, or a liability may be dressed up as revenue or even omitted to show higher book profits virtually at the whims of the accountant, managers or the directors, without the knowledge of the shareholders.

The practice of earnings management has the power to distort recorded financial performance of a firm, making it difficult and even more difficult for an investor or financial analyst to assess the performance of the firm and to compare between different companies. For this reason, earnings management as a deceptive practice, conflicts with the basic tenets of accounting regulation transforming the exercise of standard setting in a redundant feature on one hand and on the other hand providing an unfair advantage to companies that are able to successfully practice this falsehood system.

Jim Kenan, the Attorney General of Victoria (Sen and Inanga, 2005) in a speech before members of the Australian Society of Accountants, stressed that *financial statements which inflate the performances of companies by manipulating figures should be stamped out as it puts the investors to great difficulties to distinguish between the paper entrepreneur and the truly successful entrepreneur.* The message from his statement means that:

- There are companies listed on the stock exchange, which show inflated profit and better financial position in their creative accounting statements to attract investors. These creations of accounts misguide and create confusion.

- Some company prospectus may not always depict the reality of the financial positions of the listed companies.
- Processes adopted for created accounting statements may hold out untrue hopes to investors for a shorter period but cannot continue to succeed for a longer period.
- Ultimately, the concerned companies listed in the stock exchange collapse and the investors lose their investments, confidence in them and the stock market.

Earnings Management Techniques

All earnings management techniques revolve around the basic process of debiting and/or crediting an inappropriate account when recording a transaction or an event. By implication, the process also covers not debiting and/or crediting the correct account with the correct amount. Some of these techniques include:

Big Bath Charges: In this technique, instead of showing losses for a couple of years, a big loss is shown for a single year by charging all expenses in that year. This may be done if there are apparent reasons for poor profitability in that year and the management feels that by lumping all expenses in one bad year, they can start showing better profits in following years.

Creative Acquisition Accounting: Despite all the guidelines and provisions put in place by IFRS 3 and Security Exchange Commission (SEC) on how the purchase price of business acquisition should be allocated, there are still rooms for manipulations of amortizing levels to create goodwill or capital reserve at will.

Cookie Jar Reserves: This involves over provisioning for accrued expenses when revenues are high to help bring down profits to a level that is safe to maintain in the future. Similarly, failure to provide for all the accrued expenses can help to show larger profits during tougher times when such is the need of the hour.

Materiality: A change in an immaterial item can help a firm a million of naira. For example, some companies do not recognize an expenditure under say N10,000 as an asset, even if its benefits is likely to be spread over several years. Varying this limit to say N5,000 can easily increase profits while hiking up this limit may lead to lower profits.

Revenue Recognition: Firms virtually have a free hand in timing the booking of their revenues at any stage starting from the moment sales contracts are signed till the promised product or service has been fully delivered to and accepted by the clients.

Wrong capitalization or expensed: This is the process of capitalizing an expense item with the aim to improve profit or expensing an asset with the purpose of reducing profit.

Indiscriminate change of accounting policies: Due to the latitude available in accounting policies, companies can alter their profit figures by changing the accounting policies and deliberately omit to mention the change of policy, the reason(s) for the change in the notes or omit to give correct impact of the change. E.g. change in stock valuation method, change in rate of depreciation or method of depreciation or materiality levels or even revenue recognition policy.

Earnings Management Saga World Wide

Earnings management incidents are widespread globally. The difference is the degree and technique applied. It has lead to the collapse of companies that have reported substantial profits in the immediate previous years. Some of these companies include:

- Brentford Nylon collapse in 1976 after declaring a profit of £130,000 sterling in the previous year.
- Polly Peck a UK textile company which announced a fantastic interim result to June 30th, in September 1990, only for it to collapse October 1990 the same year.
- The Enron saga of 2001, which was able to conceal a net loss of $600 million for a period of three years through creative accounting; on revelation it finally went down.
- Africa Petroleum of Nigeria being package for privatization, a debt of N10.6 million was treated as off-balance item and were undisclosed. A further debt of N22.5 million owed by it, was not also disclosed. It finally collapsed in 2002.
- In 1986, Midland Banks (UK) wrote off its low developing countries (LDC) lending as below-the-line extraordinary item; contrary to UK accounting standards – SSAP 6.
- Also in 1986, West minister bank treated this equivalent item as above-the –line exceptional item to arrive at its operating results. This is also contrary to UK accounting standards.
- Other cases are: Deutsche telecom, Qwest and Waste management in the US, Vivendi in France, Centrica and Royal Dutch/Shell in the UK, amongst others. All these tales of woes left investors lamenting.

The Concept of Regulation of Financial Reporting

Regulation of financial reporting according to Okoye and Ofoegbu (2006), involves setting standards for disclosure in the financial report as well as ensuring that non-compliance is punished. According to the authors, it involves providing adequate mechanism to monitor adherence to the standards of disclosure required in financial reporting. In Nigeria and other developing and developed countries, financial reporting is regulated. That is why Wolk and Tearney (1997) stated that, financial reporting is a regulated activity.

Standards according to Anao and Obazee (2002), are guiding rules and principles to be followed in financial reporting without which the objectives of financial reporting will not be achieved. The particular objectives of financial statements according to Accounting Principles Board (APB) are to present fairly and in conformity with generally accepted accounting principles, financial position, results of operations and other changes in financial position. These were further broken into general and qualitative objectives.

Regulation of financial reporting according to Adebayo (2005) is necessary in order to ensure that there is uniformity in the form and content of disclosures in the financial report, and moreover that certain level of standard is met in financial reporting. There are various financial reporting regulations and regulators in Nigeria, these include: Corporate Affairs Commission (CAC); the Financial Reporting Council of Nigeria (FRCN), the National Insurance Commission (NAICOM), Insurance Act 2007; the Central Bank of Nigeria (CBN); the Securities and Exchange Commission (SEC); and the Nigeria Stock Exchange (NSE). However, Obazee (2005) identified the regulatory documents to include: the Companies and Allied Matters Act, (2004) as amended; the Banks and Other Financial Institution Act (BOFIA, 1991) as amended, The Insurance Act of 2004, Investment and Securities Act 1999 as amended and the Financial Reporting Council of Nigeria Act. 2011.

In the immediate past years, there has been a surge in corporate reforms around the world. These reforms were galvanized by the financial scandals anchored by earnings management practices that resulted in the collapse of big companies in the United States of America, Asia, Africa and the United Kingdom in the 1980's, 1990's and even in this present 2000's. This has brought about greater

demand for transparency, requiring more reliable, accurate and accountable financial reporting that would ensure adequate protection of corporate stakeholders. According to Wikipedia Free Encyclopedia, 2015, the primary vehicle for disclosure of all relevant information about an entity, stewardship and accountability is the financial report. With this, financial reporting therefore becomes a crucial element necessary to expose earnings management practices in organizations.

To be useful, financial information must possess the fundamental qualitative characteristics of relevance and faithful representation. Financial information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decision of users by helping them evaluate past, present and future events, confirming, or even correcting their past evaluations. Faithful representation connotes that the financial information must faithfully represent the phenomena that it purports to represent. It must be complete and free from errors. Others are; it must be understandable. This implies that the information must not only be intelligible, but also that the users can understand it. Verifiability; this implies that the accounting results can be corroborated by independent measures, using the same measurement methods. Neutrality; this implies that the accounting information is directed towards the common needs of users, rather than the particular needs of specific users. Timeliness; this involves an early communication of information to avoid delays in economic decision-making. Comparability; this implies that differences should not be the result of different financial accounting treatments and it should be comparable between periods and between related companies. Completeness; this implies that all information that reasonably fulfills the requirements of other qualitative objectives should be reported (Statement of Financial Accounting Concepts (SFAC, NO.2)). In a situation a financial statement do not possessed these or some of these characteristics, then there are earnings management's elements therein. It is now left to the various regulatory bodies to ensure that such financial statement is not published. Or if already published, it should be withdrawn.

The Option of Regulation of Financial Reporting and Earnings Management

The dare need of objective financial reporting has come to the fore in these days of need to assure accuracy in reporting, objectivity and credibility in the accounting profession. The US Securities and Exchange Commission have never before now stated its concern for the public it has the mandate to protect in respect of objective reporting. The same goes for the Nigeria Stock exchange Market and particularly the SEC. The U.S SEC has under the aegis of the International Organization of Securities Commission (IOSCO) formulated and adopted the international Disclosure Standards based on their conclusion that the standards were of high quality and that their adoption by organizations will bring a lot of credibility to financial reporting.

Regulation of financial reporting will reduce the incident of earnings management to the minimum if regulators carry out their duties and responsibilities in accordance with the various regulatory documents. This they can achieve, according to Dulacha, Phil and Izan (2006) and Musa AL-Faki (2006) by:

- Proper supervision of company's financial books. By this any sharp practice(s) by the firm concerned can be detected.
- Ensuring complete independence of the auditor
- Ensuring all the time that, financial statements are prepared in all material respects, in accordance with the necessary identified financial reporting frame work and regulatory documents.

With this, if any creative tendencies are observed in the process of their examination it will be quickly identified, notified and corrected.

- Ensuring that the financial statement present a true and fair view of the firm's position.
- Ensuring that the financial statements are not only free of material misstatements, but also conform to statutory regulations. This exercise will give credibility to the financial statements prepared by the directors and presented to the shareholders as evidence of their stewardship.

The Companies and Allied Matters Act (2004) sets the general framework for financial accounting and reporting by all registered companies in Nigeria, and stipulates the basic minimum requirements with regards to financial reporting. The Banks and Other Financial Institutions Act (BOFIA) 1991, as amended empowers the Central Bank of Nigeria (CBN) to register and regulate Banks and other Financial Institutions (Musa Al-Faki, 2006). The Insurance Act of 2004 regulates the financial activities of insurance companies in Nigeria. The Investment Act (ISA) 1991 requires the Securities and Exchange Commission (SEC) to regulate and develop the capital, maintain orderly conduct, transparency and sanity in the market in order to protect investors. The Nigerian Accounting Standard Board (now Financial Reporting Council Board), is charged with the responsibility of issuing statement of Accounting standards for application in the preparation and presentation of financial reports. They also provide strategic and thought leadership both in the field of accounting and financial reporting. The standards issued by the Board, according to the Financial Reporting Council of Nigeria Act, 2011, are models containing set of rules, parameters and requirements of financial reporting. They describe what information to be presented in financial statements, how to present the information, and the form to use in presentation. They give guidance on the type of notes required to explain what has been reported. The Financial Reporting Council assumes responsibility for the 23 standards previously issued by the NASB on 2nd July 2012 where, 16 of the standards have been translated from SAS to IFRSs. In spite of all these provisions, standards and bodies, Nigerian companies still experience earnings management occurrences leading to failures in the banking sector and other sectors of the economy.

Why Earnings Management still exist amongst Nigerian Companies

From the works of Okoye and Ofoegbu (2006), Dallas (2005) and Rossouw (2005) the following were identified:

1. Existence of inconsistencies in the regulations guiding financial reporting.
2. Lack of uniformity in the time allowed for annual returns of financial statements by companies regulatory bodies.
3. No adequate mechanism for the enforcement of regulations.
4. Companies and Allied Matters Act (2004) yet to adopt IFRSs nor be updated to reflect modern issues.
5. No provision was made for the observance of Insurance Act 2007.
6. In Investment and Securities Act 1999, no provision was made for returns to appropriate body.
7. International Financial Reporting Standards (IFRSs) are limited in number.
8. Non-review of existing standards, amongst others

Conclusion

There is no doubt that regulation of financial reporting can help to reduce the practice of earnings management to the barest minimum, the above short comings notwithstanding. This is because, if the practitioners are aware that their acts will be detected and exposed by the various supervisory bodies, they will learn to curb their excesses. However, to achieve this goal, the regulatory authorities should harmonize the existing regulations to avoid inconsistencies in preparation and presentation of financial statements. Also, the companies and Allied Matters Act (CAMA), 2004, should be further reviewed and the financial reporting provisions must be made to accord with the International Financial Reporting Standards (IFRS). Finally, there should be adequate monitoring and supervising mechanism for compliance with standards and other financial reporting regulations by all regulatory authorities. This will help to reduce earnings management tendencies that may arise from unethical, hazard and adverse selection of disclosure requirements. With this, information provided by management to investors and other stakeholders is checked for accuracy, adequacy and reliability.

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