Accruals-based Earnings Management: Concept, Origins, and Evolution

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ABSTRACT

Accruals-based earnings management is a critical and contentious topic in the field of accounting and finance. It involves the manipulation of earnings through accrual accounting methods. Despite its widespread recognition, there is a lack of consensus regarding its definition, origins, and evolution. This literature review consolidates existing knowledge on accruals-based earnings management. It seeks to clarify its concept, trace its historical origins, and understand its evolutionary path within accounting practices, emphasizing the impact of various factors on its application. Research methods - the review analyzes secondary data from 23 prominent accounting and finance journals. 41 articles and related books have been carefully selected, focusing specifically on accrual-based earnings management. This process thoroughly reviewed theoretical foundations, empirical research, and various scientific perspectives. The review identifies a diverse range of definitions and applications of accruals-based earnings management. It highlights its emergence in the 1980s, influenced significantly by agency theory. Further, it categorizes the outcomes of earnings management and explores the factors influencing its practice, including managerial intentions, international financial reporting standards (IFRS), agency conflicts, contractual obligations, and free cash flows. The evolution of accruals-based earnings management is marked by increasing sophistication and varying perceptions of its ethical implications. This comprehensive review provides a nuanced understanding of accruals-based earnings management, revealing its complex nature and the factors shaping its practice. It offers valuable insights for researchers and practitioners, enhancing the understanding of this pivotal aspect of financial reporting and guiding future research in the field.

Keywords: accruals-based earnings management, opportunistic, informational, behavioral accounting.

1. Introduction

Accounting selection practices based on accrual accounting enable management to influence its earnings, making it one of the most crucial ethical concepts in the financial reporting process. This topic has garnered significant attention from researchers, yet there is no consensus on a precise definition of earnings management. The distinction lies in the procedures and objectives behind the practice (Armstrong, 1993). According to accounting literature, earnings management can be categorized into three main types: real earnings management, earnings management through classification shifting, and accrual-based earnings management. Among these, accrual-based earnings management is the most commonly used method (Zang, 2012).

Accrual-based earnings management is defined as the manipulation of financial reporting to achieve specific benefits through significant interference in the preparation of financial statements intended for external users (Schipper, 1989). This aligns with the definition that earnings management creates a structured financial reporting process, ultimately influencing decisions, investments, or both, which impacts the final outcome (Ayres, 1994). Additionally, it is often characterized as a deliberate practice aimed at misleading certain stakeholders about the company's underlying economic performance or influencing contractual outcomes. This is achieved by management's judgment in financial reports and structuring transactions based on the figures disclosed by accountants (Healy & Wahlen, 1999).

This study emphasizes the importance of providing regulators with tools to reduce earnings management practices and to classify companies based on their use of such practices. By doing so, it benefits shareholders by protecting them from potential manipulation of earnings and ensuring more transparent financial reporting.

Earnings management, which has the potential to mislead stakeholders, is a critical issue in accounting (Flayyih et al., 2020). While the accrual approach is widely used to detect earnings management, it has limitations (Sun, 2010). The role of the audit committee in mitigating real earnings management, which involves shifting away from accrual-based practices, remains a topic of ongoing research (Ghaleb, 2018). These studies underscore the need for improved methods to detect earnings manipulation and evaluate the effectiveness of audit committees in preventing such practices.

Companies often employ earnings management tactics to mislead shareholders and financial statement users (Lee et al., 2020). While alternative methods to identify earnings management, such as evaluating earnings distribution properties and analyzing digit frequencies in accounting data, are available, these methods are still prone to model specification errors. The accrual approach remains the most widely used technique for detecting earnings manipulation. However, the lack of recent scientific reviews on earnings management practices in firms presents a gap in the current literature (Vieira et al., 2021). Accrual accounting touches on various issues, including political studies, accounting, organizational planning, and control (Bruno & Bruno, 2021). Financial statements, crucial for decision-making and financial control in local governments, can be compromised by earnings management practices, which are often difficult to detect.

2. Literature Review

Accounting research on earnings management dates back to the 1980s and has developed both theoretically and practically. Lambert (1984) and Dye (1988) made foundational theoretical contributions to the field of earnings management research. Lambert (1984) utilized agency theory to analyze how the relationship between management and shareholders influences earnings. He found that the motivation for earnings management arises from the interactions between management and shareholders, both of whom have a vested interest in the company's performance. In a similar vein, Dye (1988) argued that incentives for earnings management emerge within firms as a result of conflicts between management and shareholders, aligning with Lambert's (1984) findings.

Ronen and Yaari (2008) classify earnings management into three categories based on its potential impact: beneficial, neutral, and pernicious. Earnings management is considered beneficial when it enhances the transparency of financial reporting, helping stakeholders make better-informed decisions. It is deemed pernicious if it results in misrepresentation or fraud, misleading stakeholders and damaging trust in the financial statements. Meanwhile, earnings management is classified as neutral when the manipulation falls within the permissible flexibility allowed by accounting standards, leading to either opportunistic behavior or efficiency gains without significant harm.

Some studies suggest that earnings management can have positive effects. Scholars argue that earnings manipulation occurs by leveraging the flexibility in choosing accounting methods, while still complying with accounting standards (Yimenu & Surur, 2019).

Beneish (2001) considers Management estimates are considered as the ability of management to communicate its expectations about the company's future cash flows to investors.

Other studies have shown neutral attitudes toward earnings management (Beneish, 2001). A professional content writer will rewrite the text without changing its meaning, making sure the sentences are in active voice and easy for an 8th grader to understand (Scott, 2003).

In this context, Yaping (2006) argues that although fraud and creative accounting can be harmful, earnings management is not always detrimental. This is because the idea of representation is relative, and earnings management can actually add value to a company.

The representation of financial information is relative, not absolute. Financial data cannot fully capture the actual value of a company. This means that even if a company's management is not attempting to manipulate the financial reports, there may still be a gap between the reported and actual value of the company. Moreover, management holds private information, and factors such as managerial compensation, tax obligations, and capital market financing depend on the figures in the financial reports. Only the company's management truly understands the profits. As a result, other users of financial reports lack the means to determine if the reports accurately reflect the company's actual value. Earnings management is not fraud; fraud involves deceptive and illegal behavior that can lead to legal consequences. While earnings management is subject to legitimate constraints, it is possible for the reported earnings to differ from actual earnings within the flexibility allowed by accounting standards.

Fraud distorts financial information by violating international accounting rules, while earnings management manipulates information within the boundaries of those rules. Earnings management does not affect the long-term value of a company or its future cash flow because any increase or decrease in reported earnings is offset by corresponding changes in other reported items. Accrual accounting helps smooth out fluctuations in a company’s cash flow, providing investors with more reliable information to assess performance and predict future cash flow compared to cash flow accounting. Wealth transfers resulting from earnings management are considered acceptable because they do not impact the company's overall value or mislead investors about its future prospects. Since rational investors evaluate the entire value of a company, not just its earnings, any wealth transfer through earnings management is likely to be minimal, if it occurs at all (Yaping, 2006).

Based on findings from other experts, manipulating earnings can have a harmful effect on how financial reports are presented and how clear they are (Schipper, 1989).

Schipper (1989) defined earnings management as harmful but acknowledged its beneficial aspect as the disclosure of private information. Healy and Wahlen (1999) later supported his view on the negative aspects of earnings management. Regarding fraud, some earnings management practices are driven by management's disclosure of private information (Schipper, 1989), which can mislead stakeholders about the company's economic performance or influence contractual outcomes based on the disclosed accounting numbers (Healy & Wahlen, 1999).

Regarding transparency, Arya (2003) found that the absence of earnings management practices did not always benefit shareholders. A certain level of visibility is essential, and being transparent in financial reporting can enhance performance. However, an excessive focus on performance can be harmful by reducing transparency within the company (Arya et al., 2003).

A review of previous literature on earnings management reveals inconsistencies in its definitions. Terms like earnings management, earnings manipulation, and creative accounting have often been used interchangeably, despite their differences. To address this, Yaping (2009) provided a clear definition of results management, which is considered one aspect of the broader concept.

Earnings manipulation occurs when a company's management intentionally takes steps to boost its reported earnings to a specific level. Earnings management involves adjusting earnings through strategic decisions or activities that do not harm the company's overall value. Profit fraud involves manipulating profits by violating international accounting rules or engaging in activities that reduce the company's value. Creative accounting refers to profit manipulation that does not violate any accounting rules because there are no specific guidelines. This definition encompasses positive, neutral, and negative outcomes (Yaping, 2009) and aligns with the research of Ronen and Yaari (2008).

There are numerous empirical contributions to the study of earnings management. Healy (1985) examines the relationship between management incentives tied to corporate bonus contracts and accrual-based earnings management, using a sample of companies from the COMPUSTAT database. The study concludes that bonus contracts encourage management to select accounting practices that maximize the value of their compensation and rewards (Healy, 1985).

DeAngelo (1986) discovered that when a company manipulates its earnings in one period, it will impact the earnings in another period (DeAngelo, 1986).

McNichols and Wilson (1988) address earnings management using a measure of the allocation of bad debts, unlike previous literature dealing with various types of receivables (McNichols & Wilson, 1988).

Jones' (1991) model is compared to earlier research by Healy (1985) and DeAngelo (1986). The models by McNichols and Wilson (1988) and Jones (1991) measured the level of earnings management by examining the proportion of discretionary components in total accruals, explaining about a quarter of the variation in accrual totals (Jones, 1991). The model was later modified by Dechow, Sloan, and Sweeney (1995) to account for changes in accounts receivable, known as the modified Jones model (Jones, 1995), which has been used in several studies (Dechow et al., 1995). Dechow et al. (1995) evaluated the ability of different models to detect earnings management practices and found that the modified Jones model (1995) is the most efficient in identifying such practices (Dechow et al., 1995).

Subsequently, Ress, Gill, and Gore (1996) propose a new model based on the modified Jones (1995) that adds changes in operating cash flows as an essential determinant of accruals (Ronen & Yaari, 2008).

McNichols (2000) talks about different ways companies manage their earnings and the pros and cons of three research methods commonly used in studying earnings management.

These methods focus on total accruals, specific accruals, and how earnings are distributed after management (McNichols, 2000).

Kothari et al. (2005) studied how discretionary accruals relate to company performance and found that earnings management can vary based on a company's performance (Kothari et al., 2005).

Miller (2007) points out that the accounting accrual base enables management to manipulate short-term accruals to influence net income. Long-term accruals are expected to have less significance than short-term accruals because their impact spans multiple accounting periods, and their effect can be unilateral within the same accounting period (Miller, 2007).

The accounting earnings presented in financial reports must reflect the company's activities and the efficient allocation of resources to those activities. However, the central role of company management and its access to private information, compared to external users, means that management and certain individuals or companies have the opportunity to profit in ways that benefit them. This suggests that the concept of earnings management can be viewed as a way to take advantage of opportunities and share information (Sun & Rath, 2008).

From the opportunistic behavior perspective, management takes advantage of the situation by seizing opportunities to manipulate earnings in order to increase their own gains (Watts & Zimmerman, 1978). In this context, their personal judgments are used to enhance their benefits, thus engaging in earnings management (Subramanyam, 1996). Watts and Zimmerman (1978) were the first to introduce this opportunistic perspective, explaining managerial behavior in terms of earnings reporting that influences contractual outcomes, ultimately affecting wealth transfers (Watts & Zimmerman, 1978).

Several studies have examined whether management, motivated by incentives in their compensation contracts, actually manages earnings. Healy (1985) found that management tends to manage earnings to reduce them when their compensation is maximized (Healy, 1985).

DeAngelo and DeAngelo (1989) show that management, faced with the threat of losing its position, uses its personal provisions to present a more favorable view of the company's performance to shareholders with voting rights (DeAngelo & DeAngelo, 1989).

Dechow and Sloan (1991) also show that management at the end of its career can reduce research and development costs to increase the reported earnings (Dechow & Sloano, 1991).

Teoh et al. (1998) propose that Initial Public Offerings (IPOs) are significantly influenced by earnings management due to the information gap between investors and companies during the IPO process. They demonstrate that non-discretionary accruals used to maximize earnings can be identified prior to the IPO (Teoh et al., 1998).

Azizah (2017) confirms that many contracts, such as bonus contracts, include provisions that require earnings disclosure as part of the agreement between management and shareholders. The role of earnings in different contracts leads to variations in the behaviors of the parties involved in determining earnings. Earnings management is driven by the opportunistic behavior of contracting parties in shaping earnings. This confirms that investors should be cautious of opportunistic behavior, as earnings disclosure may reduce future earnings for various reasons. Consequently, when investors make decisions based on these earnings, two conditions can result in incorrect investment choices and enable opportunistic management actions: a weakness in the control system and a flaw in the initial contract (Azizah, 2017).

Sawicki and Shrestha (2008) point out that management adopting such behavior will choose earnings management strategies that maximize their gains. For example, they may adjust reported earnings by increasing or decreasing them when planning to sell or buy shares. The rationale is that when management intends to sell its shares, it will send a positive signal (such as an increase in earnings) to the market, encouraging external investors to purchase the company’s stock, which in turn allows these investors to maximize their benefits (Sawicki & Shrestha, 2008).

Cohen et al. (2008) state that earnings management is used to meet or exceed earnings targets, align with analysts' earnings expectations, and avoid disclosing losses. There are three reasons for practicing earnings management: first, it is essential to assess performance effectively. If the company performs well, it will maintain its position; if not, it may face removal (Cohen et al., 2008).

According to Ghazali et al. (2015), when a company's earnings are high, management may manipulate the reported earnings to capitalize on the situation. Conversely, if cash flow is low, management may manipulate earnings to help keep the company afloat (Ghazali et al., 2015).

Brio et al. (2016) note that management receives significant special advantages in capital gains based on the incorrect reflection of internal price information. As a result, external investors are unaware of the actual earnings and the price deviation from the true values (Del Brio et al., 2016). Furthermore, Suryani et al. (2018) support this finding, stating that opportunistic management behavior seeks to present good performance by demonstrating the company's ability to use its assets, often by manipulating the information in financial reports. This occurs due to the freedom management has in choosing various accounting policies (Suryani & Pirzada, 2018).

Wimelda and Chandra (2018) stated that management can make investment decisions when a company has free cash flow. If management chooses to invest in assets with low rates of return, the company may experience reduced growth prospects. This could lead management to manipulate earnings in order to boost reported profits. Free cash flows refer to the cash available to investors after the company has covered all operating expenses and paid for investments and assets. A high level of free cash flow creates greater opportunities for management to engage in earnings management, especially when the free cash flow is invested in ways that disregard the interests of shareholders. Free cash flow allows management to decide where and how to invest, and if management opts to invest in low-return assets, the resulting lower growth rate may prompt them to increase reported earnings (Wimelda & Chandra, 2018).

Susanto (2020) encourages management's opportunistic behavior by disclosing higher earnings in order to receive bonuses from earnings management (Susanto & Pradipta 2020).

From an informational perspective, management utilizes the authority granted to it to communicate internal information to external investors, helping them forecast and set expectations for future performance (Holthausen & Leftwich, 1983). Thus, earnings management aims to share crucial private information with investors, improve the quality of earnings information, and strengthen communication between management, shareholders, and the public (Jiraporn et al., 2008).

Christie and Zimmerman (1994) point out that management aims to increase the wealth of all parties involved in the contract (Christie & Zimmerman, 1994).

Subramanyam (1996) stated that discretionary provisions are useful because they are linked to future profitability. This suggests that discretionary provisions can provide valuable insights into how profitable a company will be in the future. The research investigates whether discretionary accruals from the present can help predict future cash flows, earnings, and dividends. The study suggests that if discretionary accruals enhance the information provided by current earnings in relation to future performance, then accruals can be valuable in predicting cash flows. The findings support this notion, indicating that discretionary accruals contribute essential information to earnings (Subramanyam, 1996).

Scott (1997) points out that efficient earnings management occurs when management wants to improve earnings information content by communicating private information (Subramanyam, 1996).

Louis and Robinson (2005) also confirm the hypothesis that earnings management creates informational value (Scott, 1997).

Ronen and Yaari (2008) suggest that earnings management can be advantageous because it allows management flexibility in selecting accounting methods for managing earnings.

This helps management gain insights into future cash flows. Doing so enhances the value of information provided to shareholders and the public by sharing private information (Ronen & Yaari, 2008).

In this context, it can be determined whether earnings management is opportunistic or informational based on the benefits it provides and the intentions of management. If earnings management primarily benefits a single party, it is considered opportunistic. However, if it is intended to serve the interests of various contracting parties, it is considered informational.

Iqbal et al. (2021) emphasized the need for an integrated socio-ecological approach to understanding the predictors of parental internet mediation. This approach is further supported by Hamilton (1982), who underscores the importance of analyzing existing literature to identify research gaps. Fonseca (2021) provides a practical example of a theoretical framework, discussing the EFQM 2020 Model and its alignment with management theories. However, Olechnicka et al. (2024) pointed out the lack of a solid theoretical framework in the literature on virtual academic conferences, highlighting the need for further research in this area.

3. Methodology

The evidence used in this paper is secondary data, which was obtained through a literature review of articles from academic journals.

This paper selects 23 major accounting journals. We ranked accounting and finance journals based on their focus, and from the top 10 journals in the ranking, the following were selected: Accounting Horizons (AHO), Journal of Accounting Education (JAE), Accounting Review (AR), Accounting Review (TAR), Management Accounting (MA), Journal of Accounting Research (JAR), Journal of Economics, Management and Trade (JEMT), Managerial Finance (MF), Canadian Social Science (CSS), Journal of Accounting and Economics (JAE), Journal of Accounting and Public Policy (JAPP), Englewood Cliffs (EC), Journal of Financial Economics (JFE), Journal of Finance (JF), IOSR Journal of Business and Management (JBM), Journal of Business Finance & Accounting (JBFA), Procedia Economics and Finance (PEF), Polish Journal of Management Studies (PJMS), Economia Politica (EP), Accounting and Finance Review (AFR), International Journal of Business (IJB), and International Review of Financial Analysis (IRFA).

The paper selects articles and books related to earnings management by systematically reviewing the selected journals based on the title, abstract, and keywords provided by the authors. This selection process resulted in a list of 41 articles and books from 23 journals.

This paper provides a summary of past research on accruals-based earnings management. The volume of research in this area has grown rapidly, particularly in recent years, making it difficult to review all articles. Additionally, this paper focused on the key points initially outlined. As a result, the review concentrates on the most relevant studies related to the paper's aim, specifically those that discuss the definitions of accruals-based earnings management published in reputable academic journals.

4. Research Results

This study primarily uses agency theory as its main theoretical framework. Based on the results of previous studies published in academic journals, several key points emerge. First, factors such as managerial intention, International Financial Reporting Standards (IFRS), agency conflicts, contractual terms, management continuity in position, control systems, free cash flows, discretionary accruals, and positive accounting are the primary factors influencing earnings manipulation. Next, quantitative methods are the most commonly used approaches in past studies on earnings manipulation. Furthermore, current research on earnings manipulation lacks thorough analysis, with some studies providing contradictory results. Research has focused on the beneficial effects of earnings management, while others emphasize opportunistic behavior (maximizing management benefits) or economic motives. Additionally, some research argues that earnings management distorts financial statements or reduces the transparency of financial reports. Some studies, while defining results management, have started to view it as a process, while others incorporate management objectives in their practice. Some of the findings differ in their definitions based on managerial intentions, with some treating earnings management from an opportunistic perspective and others from an informational one. Recent literature reviews highlight the evolving nature of innovative work behaviors (Wissmann, 2021), emphasizing the role of culture, social trends, and new management trends. The use of computational methods in renewable energy research has also been identified as an area for further exploration (Kolosok et al., 2021). In the field of cybersecurity, there is a need for more accurate approaches to detect attacks in the Industrial Internet of Things (Andhare, 2023). The study of virtual teams has also garnered attention, with a systematic literature review covering 2019 to 2021 (Ferreira, 2023). These reviews collectively underscore the importance and ongoing relevance of these research areas.

According to the latest research findings (2021-2024), a key issue in the field is that corporate governance mechanisms have not been thoroughly examined. Most research has focused on incentives tied to the stock market. Additionally, gaps in the existing literature include the lack of gender diversity, voluntary information disclosure, and the role of audit committees. Furthermore, studies on earnings management are scattered and need to be organized. The findings connecting earnings management, altered audit opinions, and corporate governance will be valuable for policymakers and those responsible for corporate governance, as they provide insights into how these areas can be regulated.

As a result, earnings management is part of a broader set of concepts, including financial fraud, employee incentives, and government regulations. Financial ratios are useful for auditors when analyzing financial data. However, the use of earnings management in a company can be harmful if it distorts information, making it difficult to predict future cash flows accurately. Research focuses on how earnings management is implemented, the different tools used (such as accrual EM, real EM, and classification shifting), and how corporate governance can help prevent earnings management, especially in developing markets.

Scientific studies have highlighted the importance and development of earnings management (EM) research. While earlier studies focused on factors such as demographics and socioeconomic status, more recent research has shifted toward topics like corporate governance, audit quality, and corporate social responsibility (CSR). The field has experienced significant growth, with the highest number of publications in 2020, and the majority of research conducted in the US, China, Australia, and the UK. Earnings management directly impacts the accuracy of financial reporting and the allocation of resources in economies. Research in this area is gaining momentum, particularly among scholars in North America. Recent studies have also explored the connection between CSR and EM, raising concerns about the trustworthiness of CSR efforts in light of unethical financial behavior. These findings provide valuable insights for researchers, policymakers, and professionals, identifying areas that require further exploration in EM research.

5. Conclusions

Based on management's crucial role in preparing financial reports, accrual earnings management allows management to achieve short-term goals by sacrificing all or part of its long-term objectives (such as maximizing the company's value and creating value for shareholders) by influencing accounting earnings and taking advantage of the flexibility in choosing between accounting policies. Whether earnings management is considered opportunistic or informational depends on which parties benefit from the management practice and who determines the actions. If it benefits a single party, it is considered opportunistic; if it is designed to serve the interests of various contracting parties, it is considered informational.

This paper has summarized previous research on accruals-based earnings management. The body of research on accruals-based earnings management has grown rapidly, particularly in recent years, making it challenging to review all the articles. Additionally, this paper focused on the specific points initially outlined. As a result, the review concentrated on the most relevant studies related to the purpose of this paper, particularly those discussing the definitions of accruals-based earnings management. The evidence indicating a shift in practice from accrual earnings management has prompted a review of the literature in this area. Therefore, this paper examined recent studies on accrual earnings management. The findings from this review are expected to benefit researchers and enhance financial reporting users' understanding of accrual earnings management.

Future studies may explore how institutional characteristics and government regulations impact earnings management behavior.

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