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Earnings Management and Financial Reporting Fraud: Can External Auditors Spot the Difference?

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The aim of this paper is to increase external auditors' knowledge about earnings management and help them spot the difference between earnings management and financial reporting fraud. A thorough literature review was undertaken to achieve the paper's aim. The secondary data used in this paper was obtained from different databases like Ebscohost, Business Search Premier, Academic Search Premier, Emerlad, Sciencedirect, and Jstor. The current paper suggests a new approach and way of thinking for external auditors that might help them in spotting the difference between earnings management and fraud. This new approach calls for the importance of considering management's motives which is the main driver for all fraudulent activities. A set of recommendations for external auditors, researchers, and standards' setters are provided in this paper. External auditors have to view external auditing in terms of the audit of motivations. Standards' setters should provide external auditors with more guidelines regarding the audit of management's motives. More research is still needed in management's motives and integrity.

Keywords: financial reporting fraud; earnings management; fraud detection; occupational fraud

Introduction

There is a debate in the audit literature on what should be considered as fraud or in other words, is earnings management another form of fraud. Reviewing the literature showed mixed results regarding whether earnings management is an ethical act. Some researchers (Subramanyam, 1996; Watts & Zimmerman, 1986; Holthausen, 1990; Demski, 1998; Glover & Sunder, 2003 as cited in Jiraporn, et al., 2007; Peasnell, et al., 2001, as cited in Abdul Rahman & Ali, 2006; Davis-Friday and Frecka, 2002; Diana & Madalina, 2007; Jiraporn, et al., 2007) argue that there is nothing wrong with earnings management because it is within the boundaries of GAAP, while others (Healy & Wahlen, 1999; Public Oversight Board, 2000; Rosner, 2003; Abdul Rahman & Ali, 2006; Jones, 2011; Hasnan, et al., 2008; Jiraporn, et al., 2007; Kamel & Elbanna,2010; Perols & Lougee, 2010; Beneish, 2001; Higson, 2003; Chia, et al., 2007; Jones, 2011) believe earnings management is not just an unethical act but another form of financial reporting fraud. By and large the debate on earnings management and fraud will continue unless there is a proper way to help auditors identify the difference between them.

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This paper proposes a new approach and way of thinking that might help external auditors spot the difference between earnings management and financial reporting fraud. This new approach calls for the importance of auditing management's motives and viewing auditing as the audit of motivations.

Literature Review

Defining Fraud and Earnings Management

There are various definitions of fraud in the audit literature however they all have common facts about fraud. For instance, Wells (2009) mentioned that four elements must exist in any fraud case: A material false statement, intent to deceive, reliance on the false statement by the victim, and damages as a result. Lord added that different countries define fraud by using a common set of three elements: 'Material false statement with the intent to deceive, a proof that the victim depended on the false statement, and damages occurred as a result of victim's reliance on those false statements' (2010, p.5). In fact, in each country, the definition of fraud will be slightly different; but all definitions will involve that fraud is breaking the law or violating the regulatory framework (Jones, 2011). Fraud can generally be defined as an intentional and illegal act carried out by the perpetrator to steal or misuse the victim organization's resources or assets and the perpetrator can hide his theft by concealing the true nature of the business transaction. Fraud can be undertaken for the organization (Example: Tax fraud) or against the organization (Example: Misappropriation of assets or financial reporting fraud), and can be done by people inside (Example: Management or employees) or outside the organization (Vendors or customers) (Johnson & Rudesill, 2001; Alleyne & Howard, 2005). Statement on Auditing Standards No. 99 (SAS No.99) defines fraud as "an intentional act that results in a material misstatement in financial statements that are the subject of an audit" (Auditing Standards Board, 2002). O'Gara (2004) saw fraud encompassing an array of irregularities and illegal acts characterized by intentional deception and can be perpetrated for the benefit of the organization and by persons outside as well as inside the organization. Further, Wells defined occupational fraud as "The use of one's occupation for personal enrichment through the deliberate misuse or application of the employing organization's resources or assets" (2005, p.5). Fraud can also be defined as "the intentional distortion of financial statements or other records by persons internal or external to the authority, carried out to conceal the misappropriation of assets or otherwise for gain" (Salehi & Mansoury, 2009, p.7). Jones (2011, p.7) defined fraud as 'the use of fictitious accounting transactions or those prohibited by Generally Accepted Accounting Principles (GAAP)'.

Stolowy and Breton (2003) however, stated that fraud differs from earnings management. Fraud is outside the limits of GAAP and occurs when somebody commits an illegal act. However, earnings management is within GAAP and is one form of accounts manipulation. They defined accounts manipulation as: The use of management's discretion to make accounting choices or to design transactions so as to affect the possibilities of wealth transfer between the company and society fund providers or managers (2003, p.20).Earnings management is the process of taking deliberate actions within the constraints of GAAP so as to achieve a desired level of reported earnings (Koumanakos, et al., 2005; Guan, et al., 2006). Earnings management as Jones (2011) mentioned, involves using the flexibility within accounting to manage the accounts in order to deliver a predetermined profit or achieve a specific objective.

Earnings management versus fraud: Evidence from Prior Literature

Some researchers believe that earnings management is not a fraudulent act but an ethical and legal practice that enhances the value of information provided to users of financial statements. For instance, Subramanyam (1996); Watts & Zimmerman, (1986); Holthausen, (1990); Demski, (1998); Glover & Sunder, (2003) as cited in Jiraporn et al., 2007) believe earnings management is beneficial because it potentially enhances the information value of earnings. Earnings management activity by managers was viewed as beneficial to shareholders, especially where accounting discretion is used in improving in-formativeness of reported earnings (Peasnell, et al., 2001). Earnings management is also seen as something legal and ethical as mentioned by Davis-Friday and Frecka (2002). In a research carried out by Hunton, et al., (2004) results showed that earnings management in less transparent disclosure regimes will improve stock price and not harm the reputation for reporting integrity, while in more transparent disclosure regimes, earnings management will harm both stock price and reputation for reporting integrity.

In addition, Diana and Madalina (2007) mentioned that manipulation is not fraud, it is a matter of interpretation. Jiraporn, et al., (2007) also found that earnings management does not appear to provide private benefits to management and is not detrimental to firm value. Others, however, believe that earnings management is just another form of fraud and has to be stopped. For example, Healy and Wahlen (1999) mentioned that: Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (1999, p.368).

The Public Oversight Board (2000) noted that the term earnings management covers a wide variety of legitimate and illegitimate actions by management that affect an entity's earnings. Illegitimate actions may involve intentionally recognizing or measuring transactions and other events and circumstances in the wrong accounting period or recording fictitious transactions which both constitute fraud. Rosner (2003) stated there is a fine line between earnings management and fraud. It has also been noted by Abdul Rahman and Ali (2006) and Jones (2011) that even if earnings management did not violate accounting standards, it may still lead to inaccurate information about the company, which will in turn mislead investors in judging the performance of the company. In a research carried out by Hasnan, et al. (2008) their findings revealed that earnings management has a positive and significant relationship with financial reporting fraud. Further, Jiraporn, et al., (2009) mentioned that the recent scandals at Enron, WorldCom and elsewhere have generated a public perception that earnings management is utilized opportunistically by firm managers for their own private benefits rather than for the benefits of the stockholders. In their research about the quality of reported earnings in Egypt, Kamel and Elbanna (2010) found an agreement among respondents on the importance of combating earnings management in Egypt. Besides, Perols and Lougee (2010) found that the likelihood of fraud is significantly higher for firms that have previously managed earnings even when there is no evidence of inflated revenue and when they do not meet or beat analyst forecasts. In fact the debate on earnings management and fraud will continue unless there is a proper way to help auditors identify the difference between them. There is no consensus on what is earnings management and this shows the difficulty that auditors may face in detecting earnings management or researchers may face in determining earnings management incentives (Beneish, 2001).

It is claimed that the only difference between earnings management and fraud is the compliance with standards. However, Shah (1996) believed compliance with standards is not an assurance that financial statements fairly present the financial situation of the firm. The Public Oversight Board (2000) mentioned that: “Determining whether or when the behaviour in the earnings management continuum crosses the line from legitimacy to fraud in a specific situation is not always easy and that at some point in the continuum, the motivation behind earnings management may become strong enough to result in fraud” (p. 79). Higson (2003) suggested the only way to differentiate between fraudulent and legitimate action is via understanding the motives behind each because this will help in determining whether the act was deliberate or accidental. Chia, et al., (2007, p.180) argued that “the direction of earnings management, insofar as it affects reported earnings, is dependent upon the incentives available to the managers”. In a research carried out by Kamel and Elbanna (2010) in Egypt, results showed that the engagement in earnings manipulation depends on three factors: The existence of motivations and pressures to engage in financial statement fraud, the availability of earnings management techniques, and the presence of weak corporate governance which encourages the practice of earnings manipulation.

Besides, Jones (2011) mentioned that sometimes, managers start with creative accounting but if it fails to achieve the desired accounting figures, the creative accounting can turn into fraud. Thus, it can be concluded from the above studies that by understanding managements’ motives behind fraud and earnings management, auditors can highlight the differences between them, if there is any, and can spot fraudulent acts by tracking the way managers behave to reach their goals/intentions.

Conclusion

The current paper aims to increase external auditors’ knowledge about earnings management and help them spot the difference between earnings management and financial reporting fraud. Reviewing the literature showed mixed results regarding whether earnings management is an ethical act. Some researchers believe it is a legal act and totally different from fraud because it is within the boundaries of GAAP, while others see a very tiny line between earnings management and fraud, and view it as an unethical act that needs to be fought by external auditors. The debate on earnings management and fraud will continue unless there is a proper way to help auditors identify the difference between them. There is no consensus on what is earnings management and this shows the difficulty that auditors may face in detecting earnings management or researchers may face in determining earnings management incentives. Hence, the current paper suggests a new approach and a way of thinking for external auditors that might help them in spotting the difference between earnings management and fraud. This new approach calls for the importance of considering management’s motives which is the main driver for all fraudulent acts.

Few researchers (Higson, 2003; Chia, et al., 2007; Kamel & Elbanna, 2010; Jones, 2011) supported this view. They believed the only way to differentiate between fraudulent and legitimate action is via understanding the motives behind each because this will help in determining whether the act was deliberate or accidental. Hence, by understanding managements’ motives behind fraud and earnings management, auditors can highlight the differences between them, and can spot fraudulent acts by tracking the way managers behave to reach their goals/intentions. Based on the above conclusion, the current paper recommends that external auditors should view auditing as the audit of motivation because motives can help them spot the difference between fraudulent and non-fraudulent acts. At the same time regulators should provide external auditors with more guidance to audit these motives and they should rethink about the responsibility of external auditors toward earnings management. On the other hand, more research studies on motives, management’s integrity and how to detect earnings management are still needed.

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