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Earnings Management: Legal Vs Unethical

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The obligation to perform good financial reports sometimes puts pressure on managers and/or accountants to meet the needs that leads to engage in earnings management practices, which are companies' actions in modifying their income. Earnings management could be conducted legally according to Generally Accepted Accounting Principles (GAAP), but to some extent carries out in unethical way. The objective of this article is to put forward several arguments between legal and unethical issues, therefore guide to conclusions that earnings management practices would risk the relationship between companies and stakeholders, the reputation of managers and accountants, and the credibility of the company.

Key words: earnings management, legal, unethical, fraud.

INTRODUCTION

Every company has a responsibility to prepare financial statements every period. This is because they have an obligation to inform stakeholders about the economic condition of the company. This obligation sometimes puts pressure on managers and/or accountants to meet estimated earnings. The greater the pressure, the more aggressive companies will be in achieving their targets, and one step companies can take is to engage in 'earnings management' or in the other way referred to 'creative accounting'.

Engaging in earnings management requires many considerations, because these practices are closely related to ethical vagueness (Fischer and Rosenzweig, 1995, p. 433), and this is why the issue of whether earnings management is unethical turns out to be commonly debated. It is argued that earnings management will make reporting earnings unimportant, because it cannot determine the company's economic condition objectively, which will lead to unqualified financial information, and misstated information provided deliberately in the context of earnings management may lead to fraud (Makar et al., 2000). However, this practice is still widely used in companies in order to meet market expectations. To sum up this issue, earnings management is legal, but the potential for fraud makes it unethical. This article will discuss what earnings management is, and why it is unethical, and will also put forward arguments against this issue, as well as how to cautiously avoid this practice.

Definitions. There are several definitions of earnings management. Fischer and Rosenzweig describe it as "actions of manager which serve to increase (decrease) current reported earnings of the unit for which the manager is responsible without generating a corresponding increase (decrease) in the long-term economic profitability of the unit". This statement is more appropriate in terms of managers' intention of doing earnings management practices, which not only tend to increase earnings, but also decrease them as well, in order to achieve their expectations. This also depends on the company's flexibility in performing their accounting records, whether

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they are aggressive or conservative. Aggressive accounting involves making accounting reports more favorable to stakeholders, while conservative accounting involves moderation in compiling reports.

On the one hand, Mohanram (2003, p. 2) states that one of the conditions of earnings boosting is when companies are close to achieving a target. Most companies in this situation will try to increase their earnings through earnings management practices. For instance, to meet the target at the end of the year, a company may perform operating decisions such as offering special discounts or special programs to its customers in order to increase revenue. Another way to boost income for companies is by changing the accounting methods they use such as increasing the estimated useful life of their assets, which may reduce depreciation expenses. On the other hand, companies that are below their targets will have the tendency of lowering their income. This earnings management practice is called ‘big-bath’ accounting; for example, a company that discontinues an operation or a business unit tends to over-estimate its losses, so that in the future any financial improvements will appear more respectable. Another condition of lowering income is when companies over-achieve their targets. In this case, they may prefer to lessen earnings. This is because if they perform satisfactorily, the future expectations will be hard to achieve.

Between legal and unethical. Earnings management creates another opinion regarding the relation between companies and their shareholders. The former chairman of the United States Securities and Exchange Commission (SEC), says that earnings management causes consequences, and generally it impairs the relationship between shareholders and companies, in terms of trust. It is contended that earnings management is a very essential means, which can be employed by managers to achieve the objective of maximizing shareholders’ returns and in the end increase their trust. This is because shareholders usually rely on companies’ financial reports in most of their decisions. To observe ethical judgments in relation to earnings management practices, Steven E. Kaplan (2001) conducted an experimental study involving evening MBA students, who were given different role-play scenarios as the means of observation. The results of this observation showed that when the earnings management practices brought advantages to companies, shareholders would consider them ethical. In fact, (Elias, 2002, p. 34) says that companies which are unable to achieve the estimated earnings will be stigmatized by the capital market.

However, firstly, since earnings management can harm the trust of stakeholders and the public, managers and accountants should anticipate this impact. This is because earnings management will cause stakeholders to make inappropriate decisions, as the result of misleading information that was given to them (Fischer and Rosenzweig, 1995, p. 434). Consequently, managers and accountants have to be accountable whenever they are suspected liable because of such actions. In correlation with earnings management practices, the case of Enron should be taken into consideration. Enron is a large energy trading company in the United States which previously had a significant financial performance, but was announced bankrupt in late 2001. One of the reasons is the company misstated its financial statements, causing major loss to its stakeholders. Enron’s external auditor, Arthur Andersen, has also been charged for their incapability in recognizing Enron’s fallacy, with suspicions of receiving a substantial amount of fees that caused conflicts of interest. It is highly likely that their biggest fault was to dismiss Enron’s audit documents to conceal the misconduct audit that led this company to resign their audit practice and lose many of their clients (Healy and Krishna, 2003, p. 15). Secondly, they should consider that engaging in these practices will harm their reputations as managers and accountants. Earnings management will also increase skepticism towards the integrity of managers and accountants, since they are essential people who are engaged in preparing financial statements that can depict the impartial status of companies.

It has been argued that commonly managers and accountants turn out to be losing their moral principles, and this becomes reasonable, because it is possible that some extensive pressures to take part in earnings management practices are given to managers and accountants. However, as professionals, managers and accountants should prepare themselves with understanding and moral consideration in regards to earnings management practices, in order to avoid engaging in these practices. Moreover, moral consideration will help managers and accountants to defend against the pressures (Fischer and Rosenzweig, 1995, p. 434).

Earnings management is thought to be legal and in compliance with Generally Accepted Accounting Principles (GAAP) for it provides companies with the techniques of managing earnings through adopting particular accounting methods or acquiring special operating decisions. In fact, in implementing earnings management, managers and accountants are able to use several types of legal techniques. However, according to Paul Rosenfield (2000, p. 106), former director of the American Institute of Certified Public Accountants (AICPA), these techniques are defective and may lead to management fraud if implemented aggressively, as managers and accountants may have the opportunity to create manipulative transactions. Moreover, the other reason in conducting earnings management is because managers or accountants have a specific motive to satisfy their needs, and except when this benefits the company, this motive is not acceptable (Amat et al., 1999, p. 11). Indeed, it is highly likely that in spite of everything, managers and accountants want to pursue additional benefits for themselves such as year-end bonuses or job security.

It is asserted that because earnings management is legal, many companies undoubtedly falsify their earnings. This is triggered by the intention to report as high income as possible (Rosenfield, 2000, p. 106). In fact, in order to attract stockholders or potential investors in executing investment decisions, some companies may perform high-reported income. However, according to Fischer and Rosenzweig (1995, p. 434), some managers argue that performing earnings management may cause misleading information that will affect the users of financial statements. What is more, managing earnings will not reveal the precise economic condition of the company. In fact, the intention of conducting earnings management, which results in misstatements of financial information, is intolerable. In addition, occasionally rather than to report the fundamental performance of the company, financial statements only present management needs (Grant et al., 2000, p. 41).

Makar, et al. (2000) note that it is the belief of analysts that earnings management may assist them in making earnings predictions about companies. Indeed, through earnings management practices the company can promote earnings progression evenly. However, by using distorted financial reports, the reported earnings quality will be incorrectly analyzed. This is because the manipulation by the company defectively affected the quality of financial reports.

CONCLUSION

This article has discussed the considerations of engaging in earnings management practices. There are several reasons why managers and accountants conduct these practices, for instance they receive extensive pressure to meet companies' expectations, the thoughts that these practices are legal according to GAAP, the fact that many companies manage their earnings, and the benefit for analysts, as well as their self-interest. However, there are a number of factors that particularly impair these reasons.

Earnings management practices can jeopardize the relationships between companies and stakeholders. This also can impair the profession of managers and accountants, and in the long-term these practices may damage companies' reputations because it will reduce trust in the company. Therefore, earnings management should be considered unethical, even though to some extent it is legalized by GAAP. It is to be hoped that managers and accountants will be more concerned about this issue, with the intention that stakeholders will be no longer provided with misleading financial information, since this will lead to faulty decisions. Although this article has been conducted to examine the ethical issue of earnings management, the scope is relatively general. For further research it would be interesting to observe fraud cases from 'big companies' related to earnings management practices and their impacts on business world.

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