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## **EARNINGS MANAGEMENT AND THE QUALITY OF THE FINANCIAL REPORTING**

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**Key words:** Earnings quality, reporting quality, earnings management, earnings smoothing, accounting quality.

**Abstract:** During the last time in the development of the financial reporting and frauds there have emerged several problems related to the quality of several indicators on the financial statements and especially the quality of the earnings indicator.

According to the literature on the financial reporting it results that companies have the possibility to smooth earnings or manage earnings as a tool to avoid reporting a loss. While the economic entities are using the national and international accounting standards, the working practice of accountants/auditors shows episodes of the management of the earnings. One of the conclusions of this paper is that there is not enough information among accounting professionals regarding the practices of the earnings management. One of the recommendations is to include issues of fair and ethical reporting in the modules of the faculty of economics especially on the master level.

Based on the many studies of this issue in other countries, this paper will show if this phenomenon is known in Albania and furthermore how important it is for the quality of the financial reporting in Albania. In order to achieve this objective it has been done a review of related studies. Because of the new legislation on the financial reporting being implemented in our country the recommendations of this paper may be valuable to the enforcement of the accounting standards mechanisms.

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### **Methodology**

This paper provides general information on the earnings management, the ability of the economic entities to report real earnings and the correlations between this indicator and the estimation of future earnings. The primary research was focused on the review of the literature available for the topic. The approach used during the secondary research was the survey approach.

The survey was conducted using three categories of population: Albanian accountants and large accounting companies operating in Albania (including branches of foreign and Albanian companies), auditors and auditing companies operating in Albania (including their branches). As regarding the type of the survey, there were used the interviews as a more flexible forms of research comparing to questionnaires.

### **Literature review**

One of the first questions of this research is: What is the earnings management? This is a question asked by other researchers also. Then another question would be: Does the earning management exists in Albania?

The earnings management is a strategy used by the management of the company to deliberately manipulate the earnings of the company, in order to meet the pre-established targets of the management. In the literature this practice is known as "earnings smoothing". So, instead of reporting extraordinary good profit for a year and bad profits for another year companies try to keep relatively stable profits.

According to the Security and Exchange Commission (SEC) the abusive management of the earnings is "a material and intentional misrepresentation of results". When the earnings smoothing is exaggerated the SEC has the authority to apply penalties.

The methods used by managers to smooth earnings may be complex; they may be related to accounting choices or operating decisions (also called economic management of earnings).

The management of the company uses the economic management to achieve pre-specified targets on the profit. As the great investor Warren Buffett (2009) once said, "Managers that always promise to "make the numbers" will at some point be tempted to make up the numbers". In the Buffet's perspective the earnings management is intentional. Based on the global practice the earnings management may be legal or illegal.

Each executive manager must understand the effect of the accounting choices in order to take the best decisions for his company. The earnings management has been paraphrased by Giacomin, Bellovary, and Akers (2006) as "a reasonable and legal management of the decision-making and reporting with the intention to achieve predicted and stable financial results". The earnings management must not be confused with illegal activities that aim to manipulate financial statements and report results that do not reflect the economic reality. These kinds of activities which are known as the "books cooking" include also manipulation of financial results.

From the review of the literature it results that many managers face the pressure to cross the line between the earnings management to "cooking the books". The great pressure to report high profits is

confirmed by a survey made in the Business WeekCFO conference held in 2001; according to it 55% of CFOs interviewed were asked to misrepresent the financial results and 17% of them have agreed to do this (Burgstahler and Dichev, 1997).

There are several points of view regarding the earnings management, but many researchers agree that "it is a widespread phenomenon". Burgstahler and Dichev (1997) noted that 8-12% of firms with small pre-managed profits decreases manipulate earning to achieve earning increases, while 30-44% of the firms with small pre-managed losses manage earnings to create positive earnings. This means that a large number of companies are using the earnings management either to keep a steadily earnings growth or to avoid the "red ink" reporting.

Another study evaluates that operating earnings for Standard & Poor's 500 stocks "have been inflated at least 10% per year for the past two decades, thanks to the one time inclusion of some expenses that could have been capitalized and other accounting tricks (The Economist, 2001). It is widely accepted that operating earnings are closely correlated to the stock's price over the long terms, which means that the prices of the "S&P 500" stocks are affected from the continuous efforts to use techniques of the earnings management.

General Electric (GE) is one of the best stocks companies from the shareholders point of view. This company achieved \$10.7 billion profit for the fiscal year 2000. It had a return on investment of approximately 48% during the previous five years (1995-2000). The earnings of General Electric seemed quite predictable, a straight upward line. How can it be? An explanation may be the increase of the eight industrial businesses and of 24 financial-services units of this company.

Another explanation may be the earnings management, "the orchestrated" timing of gains and losses in order to smooth up bumps and especially avoid a decline. Among big companies, GE has long been known as "a relatively aggressive practitioner of earnings management". Birger (2001) emphasizes that: "this type of long-run earnings increase does not happen without a reason. GE has used a number of legal "gimmicks" to achieve its vaunted consistency.

Professor Laurence Revsine (1991) thinks that the word "misrepresentation" is not appropriate to describe the legal management of the earnings. She shows that managers know what the "real profit" is but they deliberately try to show different amounts of earnings. In many cases it comes out that managers decide to increase the profit, because accounting standards permit them to do so.

As above mentioned, the earnings management may happen because the managers have several opportunities while making: (1) accounting choices or (2) operating decisions. For the users of the financial statements it is important to define which earnings management type has been practiced.

When the managers make several accounting choices, there is not a clear line between legal and illegal reporting choices. In this context, an

accounting decision such as the estimation of an expense maybe considered illegal if the amount estimated is exaggerated, but it is considered completely legal if it is a reasonable amount. The accounting standards do not show which one is an exaggerated action and which one is a normal one.

The case of cost estimation for the warranty products is an example of an accounting decision taken by the managers of a company. The accounting standards require the cost of the warranty to be considered as an expense at the same year that the incomes from the sale of the product are recognised. This entry is done based on the accounting principle of matching expenses and respective incomes. This cost is subject to the decision of the financial manager of the company. While the guarantee cost depends from the experience of previous years, it may be settled at minimal or maximal levels of the cost in the years. If the financial manager would like to report the highest possible profit for the period he would use for the guarantee expense the lowest level of the guarantee cost historically reached by the company. The same manager maybe justified to use a lower (compared to the minimal level) guarantee cost by confirming for example that the quality audit has improved during the actual year, reducing the cost per guaranty unit. But what will happen if the manager uses a cost which is much lower than the minimal level, let's say half of the minimal level, only because of this will help to achieve the desired target for the net income of this year? While the use of this cost for the guarantee unit has not a reasonable support, the border line between the legal and the illegal has been crossed passing into the financial fraud side.

As it may be understood from this example, it may be concluded that there is not a bright line between the earnings management and the financial fraud in the accounting standards.

In this context, it is up to auditors and financial analysts to give their opinion. As it results from this paper, it is quite possible to make the difference. The auditors can audit the materiality of transactions as an option.

Managers make operating decisions like: doing or not a special discount to clients who pay within 10 days, implement or not an incentive program to increase sales at the end of the quarter, invest or not for a new machine, hire additional employees or not, etc. The earnings management via the operating decisions is known as the "economic earnings management", because it attempts to manage the cash flows and thus the respective incomes and expenses of the period.

In the existing literature is emphasised that the key element of the accounting fraud is the intent to deceive. In many fraud situations it is hard to observe the intention of the management as regards the accounting decisions. Fraud generally happens for personal gains and maybe direct, as a higher bonus for the year, or indirect, such as the job security, or the maintaining a carrier path. The financial fraud has been defined by the National Association of Certified Fraud Examiners as "the

deliberate misstatement or omission of material facts or accounting data which is misleading and when considered with all the information made available would cause the reader to change or alter his judgment or decision" (ACFE, 1993).

Regarding the fact that if the earnings management is an ethical or a legal issue, it is worth citing Burns and Merchant (1990), who interviewed the readers of Harvard Business Review (HBR) (Giacomino, Bellovary, and Akers, 2006). They ask them to list the acceptability of the practices of the earnings management. Prior to this study, researchers and accounting professionals were not really attentive to the moral of the management of the short terms earnings. After the latest financial frauds events and the failure of some big companies that alarmed the financial world, the profession and the academic reviews reconsidered the concept of the earnings quality and earnings management

According to Burns and Merchant it results that when the practice of the earnings management is not clearly prohibited from the accounting legislation in vigour or when we are dealing with a slight deviation from the rules, then it is considered as an ethical practice in spite of who will be effected from this practice or from the information that comes out of it. This means that whoever using the information on the short term earnings is sensitive to misinterpretation, manipulation or cautious deceive. From the study it comes out that the short terms earnings are managed by most part of the companies.

In other further studies, some men and women have been selected in order to study their perception on earnings management. It results that women are more strict on their perception to the above mentioned phenomena then men are.

A key factor for the earnings management is materiality. When the amount included on the earnings management is a small amount then this practice may be listed as a slight deviation from the law, while if the amount is a large one then this practice is considered as a serious violation of the law.

### **Situation in Albania**

As above mentioned, for the study of the situation in Albania it has been used the survey approach. The categories of the population used were: Albanian accountants and large accounting companies operating in Albania (including branches of foreign and Albanian companies), auditors and auditing companies operating in Albania (including their branches).

From the interviews with Albanian professionals of accounting/auditing it results that the earnings management is known as working practice of managers of the companies. In their activity they have had the opportunity to misrepresent figures mainly at the end of the year with the intention of improving the financial reporting and especially the earnings indicator.

On the other side Albanian accountants and auditors agree that during their activity they have been asked by managers to paint a rosy picture of the economic reality of the company. They also agree that these practices affect the earning indicator and the earnings quality regardless of the earnings management being legal or illegal. If the earning indicator is not correct, then the quality of the financial reporting of the company is questioned. In this context, the quality of the financial reporting will affect also the decisions of the shareholders, banks, creditors and mainly the credibility of the company. In other words the accountants and auditors agree that the earnings management is a responsibility of the management of the company.

As regards the reasons for the earnings management, accountants/auditors think that when legal (including the change of the depreciation of the long term assets), it has been used in order to defer the payment of state dues. When the earnings management is illegal, they have considered it a fraud for personal gains.

In their daily practice of work accountants/auditors have seen cases of earning smoothing such as the deferring of some extraordinary expenses into the next period, in order to report a smaller profit for this period and pay less taxes to the state. Among expenses to be deferred into the next period may be the expenses of repair and maintenance of long term assets. If the normal procedures of maintenance of these assets are not done in a fiscal period it may be that the company will have higher operating costs for the period. According to the accountants/auditors this is an earnings management case, because it increases the net income of the period from which the maintenance expenses were deferred while decreasing the net income of the other period in which this maintenance expenses will occur.

One of the specific problems of Albania is the dependency of employed accountants from managers of the company. This is why they mostly agree with managers decisions to misrepresent earning figures.

During the transition years in Albania it emerged the phenomena of reporting losses for several consequent years (even from big production companies) by omitting an economic and financial reality, as an evasion practice to pay less tax duties.

### **Conclusions**

The "legal" or "illegal" earnings management affects the quality of the profit, and at the same time the quality of the financial reporting of the companies.

Based on the Accounting Standards, there is not a bright line between the earnings management and the financial fraud which means between the legal earnings management and the illegal one. In this context, it's up to auditors and financial analysts to give their opinion. As it results from this paper, it is quite possible to make the difference. The difference

can audit the materiality of transactions as an option. Auditors are in a good position to evaluate the quality of the profit because they are familiar with general accepted accounting and auditing principles, internal auditing and business practices.

The earnings management is considered an ethical issue when it has to do with a slight deviation from rules.

The earnings management is also related to the materiality of the transactions. When the amount included on the earnings management is a small amount then this practice may be listed as a slight deviation from the law, while if the amount is a large one then this practice is considered as serious violation of the law.

The earnings management phenomenon is perceived differently among men and women. It results that women are more strict in their perception than men are.

### **Recommendations**

From the study of the business management practices it results that there is not enough information among accounting professionals regarding earnings management practices, or methods used for the earnings management.

One of the recommendations of this research is for the Albanian financial journals and press to provide more information regarding the manipulated financial reports which in many cases are a product of the earnings management.

Another recommendation is to include issues of fair and ethical reporting in the modules of the faculty of economics especially on the master level.

In order to improve the financial reporting quality, the accounting regulating bodies must be more involved in this informing process with the aim to achieve a more efficient education and training.

The auditoriums of the universities may invite experienced managers and accounting professionals in order to stimulate realistic discussions about the earnings management.

The accountant's organisations must be involved in the process of training the Certified Public Accountants to better identify the earnings management techniques.

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