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An Interconnection between Earnings Quality and Earnings Management in the Business Environment

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Abstract:

This paper reviews the interconnection between earnings quality and earnings management in the business environment, through the use of flexibility in determining the practices and methods as well as accounting estimates, to change the income that affecting disclosure process when preparing the financial statements. Which will be based on many of the misinformation, through corporate management manipulation results of company profits and losses and financial position statement. These multiple reasons include capital market motivations to raise their share prices and attract potential shareholders. In addition, the motives of borrowing loans and funding. All this leads to the loss of the most important characteristics of the quality of representation is sincere of accounting information. Therefore, will negatively affect the quality of accounting profits. This is one of the most important information that concerns the shareholders. By consideration, the earnings quality and earnings management are two related challenging interwoven issues in financial reporting as earnings management is an aspect influencing earnings quality. In this paper, fundamental scientific processes such as analysis, synthesis, induction, and deduction have been utilized in order to achieve the objective of this paper. This paper concluded that earnings management has a negative impact on the quality of earnings if it distorts the information in a way that is less useful for forecasting future cash flows, which in turn result in unreliable financial reports leading to incorrect decision. Also, corporate earnings of high quality are those that have a high level of persistence, are more timely, more predictable, less volatile and have lower level of earnings management. And on the other side it is important to understand that lower earnings quality are not indicators of poor financial situation or the misapplication of accounting policies, judgments, and estimates.

Keywords:

earnings quality; earnings management; business environment

I. Introduction

The main purpose of reporting financial statements is to deliver financial information to both external and internal stakeholders in a reliable and timely manner. A major element of the financial statements report is accounting earnings which usually guide the internal users in developing corporate policies and making decisions based on the available information reported in annual reports. These reports can also be utilized by external users to make investment decisions (Ghazali et al., 2015). In the last decade, the role of reported earnings in the market place has notably increased. News that a firm has fallen short of earnings expectations can immediately send its stock price plunging.

On the other hand, firms that beat expectations are handsomely rewarded by investors, managers, and Analysts all devote a great attention to firms' reported earnings. Because of potential adverse market reactions, companies often take unusual actions to avoid reporting losses. The increased market reactions to missed earnings forecasts and the nearly constant need of corporations for external financing, incentive companies to manage earnings (Dechow et al., 1995).

The important motivation for earnings manipulation is the desire to attract external financing at low cost. The focus on earnings is so intense that it has been suggested that the market fixates on firms' bottom-line income, excluding other indicators of operating performance. Such a single-minded attention fails to recognize that reported net income is the result of an extended accounting process with considerable room for managerial discretion at each stage (Menicucci, 2020). Nevertheless, given the control advantages that managers have in reporting and collecting firm specific information they have a big opportunity to present the companies' earnings in a most suitable manner for the company or for themselves. This process is called earnings management (Ghazali et al., 2015).

Earnings management is a global phenomenon in financial reporting. The purpose of earnings management is to demonstrate reasonable earnings quality that meets the shareholders' expectations and the requirement of obtaining relevant authorization from regulators. It has much in common with earnings quality, earnings persistence, predictability, and earnings smoothness in the financial health assessment of a company (Lo, 2008).

Earnings management is closely connected to earnings quality. Typically, all managed earnings have low quality. It doesn´t mean, that a lack of earnings management is sufficient to ensure high earnings or accounting numbers quality. There is so many other elements that contribute to the earnings quality (Khanh & Thu, 2019; Khuong et al., 2020).

The earnings quality is a very important determinant that significantly impacts the decision made by shareholders in the organization. The earnings quality is directly related to the persistence of earnings. Persistent earnings can reflect the sustainability of earnings in the future that is determined by accrual components and the cash flows. Earnings persistence presents an earnings audit that is projected in the future reflected from running year earnings. This indicates that, earnings persistence may be used as future earnings marker. Sustainable earnings persistence are earnings that extremely high quality in the contrary, if unusual earnings are stated as earnings that have lean quality (Penman & Zhang, 2002). According Ball & Shivakumar (2008) high quality earnings are conservative, while low quality earnings are upwardly managed earnings. Earnings management and earnings quality can be regarded as two of the most attractive and challenging issues in accounting. Various definitions have been developed for earnings quality and in many studies it has been linked related to earnings management (Teets, 2002).

Sometimes earnings management is almost used interchangeably with earnings quality for example Abdelghany (2005) considered earnings quality and its measures as aspects of earnings management. However, it is vital to emphasize that earnings quality is definitely another concept than earnings management but it can be viewed as an aspect impacting earnings quality. Earnings management affects earnings quality as highly managed earnings have low quality. However, the lack of earnings management is insufficient to guarantee high earnings quality.

II. Review of Literature

2.1 Problem Formulation

The downturn in financial markets in most of the world countries earlier of the current century has been linked to the lack of quality and transparency of the financial accounting information. This decline caused increased investors worry regarding inadequate informative accounting, specifically with respect to earnings quality. In this context, many examples can be mentioned about large companies that suffered from financial scandals such as Enron and WorldCom, as well as financial institutions that collapsed such as Lehman Brothers and Fortis. Thus, it could be said that the economic recession has led to considerable loss in investors' confidence in corporate disclosure authenticity, which consequently reduces the reliability and credibility of corporate financial reports (Tasios & Bekiaris, 2012).

This is due to the use of earnings management to mislead users of financial statements. Through the management's exploitation of the freedom to choose accounting methods and policies and judgmental estimates, either for the purpose of realization their own gains or to mislead some stakeholders in the institution. This affected negatively on the transparency and quality of the financial statements. which led to a decrease in the confidence of users of the financial statements with the accounting information published in it, and discovered these manifestations in the form of accounting scandals that shook confidence in accounting profession. Based on the background explained above the problem of the research paper lies in the study of interconnection between earnings quality and earnings management in the business environment, from during the administration's exploitation of freedom to choose methods, accounting policies and judgmental estimates.

2.2 Significance of the Paper

The significance of this paper is due to the importance of the issue of earnings quality and the confidence of investors and stakeholders to rely on it in their investment decisions in the stock markets, where the quality of earnings is a measure of the company's performance and the main information element for users of financial information. And therefore, it is of great importance that the earnings figures contained in the financial statements the company is reliable, relevant and free from manipulation. Because reports of poor earnings quality might mislead users, leading to wrong investment decisions.

III. Research Method

Our approach to studying earnings quality and earnings management is based on the previous literature review. As well as cover a variety of theoretical models that capture the effects and rational expectations of users and interactions of managers' incentives. There are several surveys that discuss earnings quality in connection with earnings management. while others writers focus on give a comprehensive study of earnings management from both an analytical and empirical perspective and well analyze mandatory and voluntary disclosure extensively, while writers focused on examination of real consequences of earnings management on accounting reports.

IV. Results and Discussion

There are two major accounting theories related to this paper. namely, agency theory, earnings management theory, which underlie the interconnection between earnings quality and earnings management. These theories were selected in this paper based on the exploration of previous literature; the following is a brief explanation of these two theories.

4.1 Agency Theory

Agency theory is concerned with the contractual connection between manager and agent, where shareholders delegate all responsibilities to the manager to run the business, Berle and Means (1932) highlight the potential conflict between shareholders and management when ownership is distributed among shareholders, where this theory argues that when both parties are expected to increase their ownership utility, it is reasonable to believe that the manager may engage in opportunistic behavior at the expense of the shareholders interest.

Jensen & Meckling (1976) and Fama & Jensen (1983) modelled this condition in the form of agency relationship where the inability of the shareholders to directly observe the manager action potentially lead to high moral hazard, therefore increasing agency cost. From the perspective of shareholders, the goal is to grow their wealth by assuring an increase in company value while maximizing personal benefits. Agency costs are incurred by the shareholders due to the need to monitor the behavior of the agent who is being delegated the responsibility of managing the company's and whose interests are not parallel to the interests of the shareholders (Sarun, 2016). According to Kirubel and Akmel (2019) the Agency theory discusses management's involvement in earnings management, considering the stewardship relationship and agency principles. By compromising the management relationship, the company's management will safeguard their interests in front of investors. If shareholders, creditors, independent boards of directors and auditors fail to regulate appropriately use control mechanisms, management will use their power to fulfill their interests.

According to Leuz et al. (2003) reported that earnings quality is higher when earnings management is reduced because agency theory the shareholders in the companies were not permitted to be involved with an unreasonable earnings accrual strategies. Jiraporn & Gleaso (2007) offer agency theory as a tool for differentiating between the opportunistic and helpful uses of earnings management. If earnings management is utilized primarily opportunistically by managers, firms where agency costs are more severe should exhibit a higher level of earnings management. This theory is relevant in this paper based on the notion that the agency theory postulates that earnings quality may result in increased disclosure and so transparency is a way to reduce the information asymmetry that exists between the owners and agents, shareholders which leads to reduce agency costs.

4.2 Earnings Management Theory

The primary purpose from earnings management utilized by the organizations in the financial transactions activities is to persuade the shareholders with the adjustment financial transaction incurred in the production activities (Hong & Andersen, 2011). This is due to the fact that, according to its definition, earnings management theory may be classified as negative and positive accounting strategies used in the business transaction activities. As the managers will use their discretion to convey their beliefs based on the information they have as insiders (personal information) about the prospects of the company's profit in the future. Two intentions underlie managers in managing earnings. First, if management reports earnings are following investor expectations, the company's performance will decline. Second, only organizations with good prospects may maximize earnings this year while risking losing some earnings the coming year Because if the next year is lower, this move will become a disadvantage (Tucker & Zarowin, 2005). This is due to the fact that under earnings management the firms were employed with accounting accruals activities in order to persuade the potential and existing shareholders regarding the capability of the firms in generating profits in the business transaction activities. Thus, this theory is relevant in this paper based on managers in the companies will be able through earnings management theory to manipulate the difficult financial situation, especially in the event of financial distress or when paying the taxes, but all this will have an effect on earnings quality which are claimed by shareholders.

4.3 Earnings Quality

Earnings quality has attracted special interest from researchers and their efforts have been to achieve a valid and reasonable method to assess it. There are several definitions of earnings quality, but there is no agreement upon (Dechow & Schrand, 2004). Regulators generally view earnings to be of high quality when they Compatible with procedures to the rules identified in generally accepted accounting principles. Bellovary et al. (2005) defined earnings quality as an important aspect of the company's financial health assessment, as the ability of reported earnings to reflect and predict the firm's real and future earnings, as well as the stability, persistence, and the absence of volatility in reported earnings. According to Hodge (2003) the earnings quality is the extent to which net income reported on the income statement differs from actual earnings.

On the other hand, creditors are likely to view earnings to be of high quality when they can be quickly converted into cash flows (Dechow & Schrand, 2004). Francis et al. (2008) focus on capital markets to set a research perspective on earnings quality, they link earnings quality with precision, it is mean that higher earnings quality is more exact with regard to an underlying valuation relevant construct that earnings is designed to reflect. Furthermore, Francis et al. (2006) earnings quality is determined by two factors: those that reflect innate features of business models and operational environments and those reflected in the financial reporting process. According to Li (2011) earnings quality differs for three reasons. First, quality of earnings is influenced by the firm's business model and economic situation of the firms. Second, earnings quality shows estimation errors. This means that firms, which have more accrual estimation errors, have weaker persistence in earnings. Third, there may be intentional distortions due to manipulation of earnings. It indicates that firms reduce the ability of current earnings to predict future cash flows because management intend to manipulate reported earnings due to compensation contracts or capital market pressure.

According to (Danisman et al., 2021; Ozili & Arun, 2018; Tran et al., 2020) earnings quality is defined as the earnings reported in the financial statements with a minimal level of earnings management. The definition utilized by Dechow and Schrand (2004) is considered the most appropriate one to be adopted as it considers all the elements for high quality of earnings (i.e., persistence, predictability, and lack of variability) in one definition. In literature, there have been proposed several approaches to measure earnings quality. Actually, there is no a generally accepted approach to measure earnings quality and empirical researchers use different empirical proxies that are likely connected to desired aspects of accounting information.

Despite the existence of a multiplicity of acceptable ways for measuring earnings quality, none of these measures has proven better since earnings quality is considered a multidimensional concept that permits various users to interpret it differently. As a result, the choice of an earnings quality measure depends on the research question posed and the availability of data and estimating methods. According to the various definitions mentioned above, it can be said that the high earnings quality is expected to assist stakeholders such as shareholders in making useful investment decisions, where high earnings quality should have represented current performance and indicator for future earnings and performance through the relationship with future operating cash flow, and this will reflect on the development of the capital market, which will be reflected on the general economy.

4.4 Earnings Management

There are several of definitions of earnings management, but none are universally agreement upon. According to Healy and Wahlen (1999) earnings management occurs when managers use their consideration in financial reporting and transaction making to change financial reports with the misleading purpose toward shareholders based on organization's economic performance or to influence the result in accordance with the contract that is dependent on the reported accounting numbers. According to Schipper (1989) the earnings management is the adjustment of a firms reported economic performance by insiders to either mislead a number of stakeholders or to control contractual outcomes.

According to (Scott, 2016) earnings management can be viewed from two perspectives, the first is the opportunistic behavior to maximize the benefit of managers to utility in facing compensation contracts, debt contracts, and political cost and the second perspective of efficient contracting, where earnings management gives manager a flexibility to protect themselves and company in anticipating unanticipated events for the benefit of the parties involved in the contract.

Dechow et al. (2010) observed that higher quality earnings afford additional information of the features of the financial performance of a firm that is pertinent to a particular decision-maker in developing a specific decision. Real activity manipulation is defined as deviations from normal operational processes prompted by managers' desire to mislead at least some stakeholders into believing specific financial reporting targets were reached in the usual course of operations. The accrual earnings management is linked with the manipulation through choosing different accounting procedures and methods selection procedure without modifying in cash flow, which comply with generally accepted accounting principles(Li et al., 2010).

On the other hand, real activities earnings management is influencing accounting earnings by changing the timing of investing/financing, or other operational arrangements, so influencing cash flow and thus financial reporting(Gunny, 2010). There are numerous methods and ways to manipulating real activities, such as sales promotions using discounted price and/or a discretionary expenditures reduction. However, it is difficult for stakeholders to detect by regulators and auditors which are in favor of the management in diverse economic circumstances (Kothari et al., 2012; Roychowdhury, 2006; Zang, 2012).

Most previous studies use a variety of measures of earnings management such as real activities earnings management and accrual earnings management. Until date, earnings management has not been defined accurately and implemented in general. Based on the previous studies and agency theory and earnings quality theory show that earnings management is an intervention that is deliberately done with certain purpose toward external financial reporting process to obtain some personal benefit.

4.5 An Interconnection between Earnings Quality and Earnings Management

Earnings management and earnings quality are central topics in theoretical and empirical research in accounting. The theoretical literature on earnings quality and earnings management has primarily concentrated on situations in which firms make a single reporting decision. The managers have the opportunity to disclose financial information in the most favorable way for them to the detriment of the external users' interests this is because of the information asymmetry and the conflict of interests between insiders and stakeholders (Beyer et al., 2019; Ghazali et al., 2015).

Earnings reported are regarded as an essential measurement, because they serve as a primary source of information in evaluating business performance. As a result, a high quality of reported earnings is demanded, especially for the purpose of making investing and financing decisions. However, the quality of accounting earnings may be affected by the behaviour of earnings management, this behaviour potentially occurs when managers attempt to manipulate the earnings numbers during the preparation of financial statements through the use of discretionary provisions allowed by certain accounting standards, in turn, earnings management may thus mislead stakeholders and influence contractual outcomes that rely on reported accounting numbers (Healy & Wahlen, 1999).

Management of earnings is a global phenomenon occurs when the companies prepare financial reporting or reporting of information related to profits. The purpose of management is to demonstrate reasonable earnings quality that meets either the expectations of the shareholders, or the requirement of obtaining the relevant permission of the regulators (Ahmadpour & Shahsavari, 2016). Earnings management and earnings quality are intertwined as two sides of the same coin in the earnings quality literature. A high level of earnings management degrades earnings quality, whereas a low level of earnings management improves earnings quality (Ohman, 2018).

From a financial reporting standpoint, managers may utilise Earning Management to meet analysts' earnings forecasts, so avoiding the large negative share price reaction that quickly follows a failure to achieve market expectations. However, it decreases earnings quality and investor ability to evaluate current net income, particularly if earnings management is buried in core earnings or otherwise not fully disclosed. The reported net income is useful to investors in evaluating future corporate performance, but excessive earning management may diminish its utility (Radzi, Islam, & Ibrahim, 2011).

Earnings quality has a close and strong interaction with earnings management in evaluating an entity's financial health. For example, well managed earnings can create low quality earnings. Nonetheless, a lack of earnings management is insufficient to secure high quality earnings (Lo, 2008). Dechow & Dichev (2002) define higher earnings quality to be when more accruals are recognised as cash. They show that the quality of earnings is lower for smaller companies, which suffer losses, have greater sales and cash flow volatility and have longer operational cycles. Each of these fundamental features makes accruals estimation.

In this regard, managers can use their managerial ability to improve the quality of estimates and judgments to form earnings quality through fewer subsequent restatements, and lower errors in the bad debt provisions, higher accruals persistence and higher quality accrual estimations (Huang & Sun, 2017). Investors are more interested in purchasing shares in companies with more stable earnings. Furthermore, investors feel that organisations with high degrees of variation take greater risks than those with flat earnings. Considering this issue, managers are prone to levelling their organisations' earnings in order to envision them with high levels of earnings stability (Teets, 2002).

Earnings quality and earnings management are related ideas; nevertheless, they are not identical, because earnings quality can be measured using alternative dimensions depending on their usefulness to different groups of users and the choice they will make. Earnings quality can be defined in terms other than earnings management, such as persistence, predictability, timeliness, variability, value relevance, informativeness, and conservatism. (Dechow et al., 2010; Francis et al., 2004).

V. Conclusion

Based on previous studies related to earnings quality and earnings management and linking them to the agency theory and earnings management theory, it has been shown to exist interconnection between earnings quality and earnings management. However, practitioners and accounting researchers have yet to agree on how this interconnection is specified. Further, it was discovered through the arguments in previous studies that the practise of earnings management can achieve benefits in the business environment in the short term, but it leads to serious problems in the long term by lowering the value of the business environment and misleading stakeholders, particularly investors, and thus affecting the prices of their shares in the financial markets.

In general, earnings of high quality are those that have a high level of persistence, are more predictable, more timely, less volatile and have lower level of earnings management. It means that earnings quality can be defined as the extent to which earnings are based on reliable measurement.

Furthermore, past research has revealed that there is no single agreed-upon and well-suited model for measuring the quality of earnings or determining the level of earnings management. On the other hand, it is critical to recognise that lower quality earnings are not indicative of a poor financial situation or the incorrect application of accounting standards, estimates, and judgments.

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