AUDITORS' VIEW ON ACCEPTABILITY OF CLIENTS' EARNINGS MANAGEMENT PRACTICES

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Abstract

The purpose of this paper is to assess the views of auditors on earnings management in Malaysia. This study uses a questionnaire designed by Merchant and Rockness (1994), which consists of thirteen (13) short scenarios. Each scenario describes a potentially questionable earnings management activity undertaken by the general manager. The respondents were asked to judge the acceptability of each of the scenarios using a five-point (5) Likert scale. Based on responses, this study finds that acceptability varies with the type of earnings management. The auditors believe that discretionary accrual manipulation is more unethical than real activities manipulation, while the consistency with MFRS and the direction of effect on earnings management do not seem to be an issue to the respondents regarding the acceptability of earnings management.

Keywords: Earnings Management, Auditors, Clients' Practices

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1. INTRODUCTION

Corporate scandals in business seem to become a common occurrence in the business environment. Some examples in Malaysia include the Transmile Group Bhd[1] and Megan Media Bhd for accounting manipulation, such as overstated sales and fabricated transactions (The Edge, 2009). The Transmile Group Bhd overstated their profits of RM75 million and RM158 million for two consecutive years (2005 and 2006, respectively). In regards to Megan Media Bhd, the company was involved in fraudulent trading. In addition, inappropriate accounting treatment was found in the 2005 audited financial statement of Southern Bank Bhd (Krishnan, 2011). However the auditor failed to detect the accounting irregularities and fraud occurred as a result of that error. These cases demonstrate auditors in Malaysia conducted inferior audit that did not reach the expected standards (Krishnan, 2011). Another corporate accounting scandal that shook public confidence in corporate governance and the stock market was the sudden and unexpected collapse of Enron Corporation in the United States. This scandal involved Arthur Anderson regarding a conflict of interest that toppled Enron Corporation and affected the US economy (Li, 2010). This scandal led to questions concerning how the auditors in these kinds of companies functioned in the auditing process and how they were embroiled in the scandals. In the case of Enron, they aggressively managed their earnings by recording fictitious sales transacted with a special purpose vehicle (SPV), which resulted in increased revenue and profit. In addition, they overstated their reported earnings by omitting the SPV from consolidated financial statements (Wearing, 2012).

Earnings management practices are a significant ethical issue because they are related to the manipulation of information concerning company performance. Many decisions by stakeholders are made based on a company's financial report. If a decision is made by using incorrect information, the decision is questionable and can cause many problems for both the company and the financial statement users, i.e. investors and shareholders. Hence, the prevention of this practice should be strictly enforced and monitored by the relevant authorities. For that particular purpose, many regulatory requirements were established to reduce irregular and deceptive accounting practices from becoming more pervasive (see e.g. Malaysian Code on Corporate Governance 2012, The UK Corporate Governance Code 2012, German Corporate Governance Code 2012, Corporate Governance Principles and Recommendations 2010, Principles of Corporate Governance 2012, Guidance on Good Practices in Corporate Governance Disclosure 2006, at www.ecgi.org/codes/all_codes.php). However, compliance with the requirement has not been encouraging. Masruki and Azizan (2012) report that firms listed on the Main Board of Bursa Malaysia manage earnings widely after the Asian financial crisis, which also appeared to be dependent on the level of the operating performance of the firms. While their study reported the empirical evidence on earnings management practices among public listed companies in Malaysia,

1 The Star, 19 June 2007, Audit uncovers more irregularities in Transmile.

the authors did not address the extent to which the external auditors find the earnings management practices acceptable. Therefore, there is great need to determine auditors' views on earnings management practices in Malaysia. Their views play a significant role as an external control mechanism in curbing earnings management practices.

As mentioned by Zhou (2012), auditors in the course of an audit are responsible for assessing the risk of material misstatements, whether caused by fraud or error. Under the International Standard of Auditing (ISA) 240, "an auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error (paras 5, p.7). They need to identify, assess and respond to the risk of material misstatement due to fraud (paras 25-32)." Therefore, in most cases of fraud or exploitation of earnings, auditors are the first group considered delinquent and negligent in their duties. This is because the nature of the auditing function and the purpose of auditing is to protect the reliability of financial reporting. Thus, it is most appropriate for our study to use auditors as respondents to assess the extent to which the earnings management activities are acceptable.

This study is in response to the call by Merchant and Rockness (1994), who elicited information concerning the acceptability of earnings management from the preparers of financial statements. Merchant and Rockness' study suggest the need for further research to explore the acceptability of earnings management practices from different segments, such as external auditors. While there is a growing body of research that examines earnings management in Malaysia, most studies examining this issue used archival data as opposed to measuring perceptions from auditors due to limited response rates using survey questionnaires. Therefore, it is imperative to examine the auditor's acceptability of earnings management practices and perceptions toward them to provide empirical evidence to further inform debates over earnings management practices in Malaysia. The results of the current study fills a gap and will enrich the knowledge of earnings management activities, thus increasing the awareness of regulators and auditors so that they can take necessary action to improve their competency in identifying and addressing earnings management issues. Furthermore, the majority of earnings management is the result of the manipulation of real operating activities, which is relatively less discussed than the accrual management. The current study further contributes insight to this area.

This paper is organised as follows. Section 2 discusses the relevant literature dealing with earnings management practices. Section 3 explains the research method used, followed by the analysis of the results in Section 4. Finally, the discussions and conclusions are considered in Section 5.

2. LITERATURE REVIEW

2.1. Earnings management

A number of studies interpreted the meaning of earnings management differently. Schipper (1989) depicts earnings management as an action that managers use to manipulate financial reports in order to gain extra profit. Healy and Wahlen (1999) define earnings management as an action of management in applying their self-assessment when communicating the company's financial information. Also related to this is management-led transactions to modify a financial report for the purposes of: 1) giving misleading financial information to stakeholders; or 2) influencing any contractual business that relies on the financial reporting. In a similar vein, according to Prencipe and Bar-Yosef (2011, p.200), earnings management "occurs when managers' discretion is used to alter financial statements with the aim of misleading stakeholders about the company's performance or influencing performance-based contractual outcomes". Additionally, Goel and Thakor (2003) viewed earnings management activities to be a means of customizing an income statement so that the statement does not present the actual performance of income for that period.

2.2. Types of earnings management

Two types of earnings management were discussed by past researchers - discretionary accrual manipulation and real activities manipulation.

2.2.1. Discretionary accrual manipulation

Discretionary accrual manipulation involves modifying accruals to meet the target of window dressing. According to Gunny (2010), accrual management involves the manipulation of information within the range of Generally Accepted Accounting Principles (GAAP)2 to hide the actual financial condition. If the manipulation is beyond the range of GAAP, it will be considered to be a violation. Another study by Goel and Thakor (2003) describes earnings management to be artificial and real. They define artificial as being achieved principally by using the reporting flexibility provided by the GAAP. Artificial smoothing has costs that are not visible like those related to the loss of integrity or consumption of the manager's time in such activities. In contrast, real smoothing has costs that are obvious, such as providing promotional discounts or vendor financing to risky customers to push up sales towards the desired target.

According to extant literature, there are many situations in which discretionary accrual manipulation may occur. Teoh, Welch, and Wong (1998a) indicate that accrual manipulation occurs during seasoned equity offerings. They find that discretionary current accruals grow before the offering, peaking in the offering year, and declining thereafter. Such a situation is illustrated in a study by Teoh, Welch, and Wong (1998b). They find that discretionary current accruals, which are under the control of management and are a proxy for earnings management, are high around the IPO compared to those non-issuers. They also mention in their study that by making adjustments using discretionary

2 The study refers to the GAAP in the US context because the study was conducted in the US. Our study refers to the Malaysian Financial Reporting Standards (MFRS) that were adopted from the International Financial Reporting Standards (IFRS). All entities are required to comply with the MFRS in the preparation of their Financial Statements.

accrual, the issuers can report unusually high earnings compared to the actual earnings. Ahmad-Zaluki, Campbell, and Goodacre (2011) indicate that over the period 1990-2003, Malaysian initial public offerings (IPOs) used income-increasing earnings management in the IPO years. He, Yang, and Guan (2011) suggest that the income-increasing accounting accruals made at the time of private placements predict the post-issue long-term stock underperformance, implying that the higher the level of earnings management before the issue of private placements, the poorer will be the post-issue stock performance.

A study by McNichols (1998) further suggests that the provision for bad debt also relates to discretionary accrual. Kasznik (1999) also finds that firms that are in danger of falling short of the management earnings forecast use accrual management to manage earnings upward. In addition, Aljifri (2007) observes that dividends have a connection with stock prices. This is because dividends are paid not only to satisfy the expectation of shareholders, but also to attract potential investors who are looking for a higher return on their capital. Therefore, managers will look to smooth earnings to pay dividends as a means to increase the company's share price. Daniel, Denis, and Naveen (2008) find that dividend-paying firms view the expected dividend level to be an important earnings threshold. As a result, these firms might manage earnings to meet the expected dividend levels using discretionary accrual even though it does not affect the firms' capacity to pay dividends.

2.2.2. Real activities manipulation

Although the majority of earnings management results from manipulation of the real operating activities, this area is relatively less discussed compared to accrual management. Real activities manipulation involves operation activities and accrual manipulations that do not affect operation activities. According to Gunny (2010), accrual management can occur after the fiscal year end, which is when the need for earnings management is the most required, while real activities management decisions would usually be made prior to the end of the fiscal year. Chen and Tsai (2010), who employed a survey questionnaire based on Merchant and Rockness (1994) to elicit data from financial managers and auditors, suggest that real activities manipulation (also known as production/ distribution manipulation) is the action to alter the production and distribution of information to enhance financial reporting performance in achieving the targeted plan. Real activities manipulation happens when managers alter any transaction regarding the business operation purposely to affect the accounting outcome (Dechow & Skinner, 2000).

Matsuura (2008) suggests that real earnings management consists of real production and investment decisions, such as reducing research and development expenditures that affect selling and administrative expenses. According to Gunny (2010), this real production and investment decision is positively associated with firms minimally meeting the earnings benchmark. She also finds that the firms engaging in real activities management have better performance in subsequent years compared to firms that do not engage in real activities management. Therefore, she suggests that conducting real activities manipulation is not a selfish action but consistent with the firms' aspiration to achieve current period benefits and perform better in the future. This course of action is called signalling.

Earnings pressure can motivate managers to engage in real activities manipulation. Osma (2008) finds that managers tend to decrease their research and development expenses due to short-term earnings pressure. Furthermore, based on the feedback from the Certified Public Accountants (CPA) in public practice, industry, accounting faculty and accounting students, Elias (2002) finds that the respondents believed that the operating manipulation of earnings is ethical compared to accrual manipulations.

According to Mizik (2010), real activities manipulation may also be called myopic management, which may be done through the alteration of operational practices to reduce the actual economic earnings and to generate favourable market reactions. She further asserts that there are two incentives that lead managers to engage in earnings management: concern for their stock price and to have private information unavailable to the stock market. Additionally, a study by Roychowdhury (2006) suggests that the presence of debtors may lead to real activity manipulation. He believes that firms will try to hide the real situation about the financial condition just to maintain the contract with the debtors. He finds evidence of a positive relationship between the stock of inventories and receivables, and growth opportunities with real activity manipulations. He states that firms reporting positive profits in smaller amounts and smaller positive forecast errors were managing earnings using real activities.

Nevertheless, evidence from Japan suggests that the relationship between real earnings management and accounting earnings management (i.e. discretionary accrual manipulation) is complementary (Matsuura, 2008). He reports that Japanese managers use real earnings management and/or accounting earnings management to smooth earnings. His study shows that in Japan, real earnings management occurs before accounting earnings management. In other words, managers use real and accounting earnings management sequentially to smooth earnings. Cohen and Paul (2010), in examining seasoned equity offerings, observe that firms engaging in real activities manipulation are more severely affected than those firms that practice accrual management. This is because real activities management affected the real consequences of the operational decisions made to manage earnings.

2.3. Earnings management and auditors

As mentioned in the preceding paragraph, there are many situations that can lead managers to engage in earnings manipulation. Past researchers, such as Chi, Lisic, and Pevner (2011), suggest that firms could resort to real earnings management when their opportunities for earnings management are constrained. They find evidence that higher audit quality can prevent firms from applying accrual earnings management. Bedard, Chtourou, and Corteau (2004) also suggest that an audit team with members who have more audit expertise is more effective in detecting earnings management.

As suggested by Merchant and Rockness (1994), assessment of the acceptability of earnings management is important to improve the understanding about the earnings management issue and the means for improvement of those issues. Their study shows that the acceptability of earnings management was judged to vary with the type, size, timing and purpose of the earnings management actions. Further, they also note that the judgment varies across respondent populations (i.e. general managers, staff managers, operating unit controllers, and internal auditors). The study calls for further research to elicit responses from other groups of respondents, i.e. external auditors, because their judgments about earnings management might relate to the role they play in the financial reporting process. In the audit process, the auditor addresses the risk of misstatements in the financial reports, including aggressive earnings management. Failure to identify the aggressive earnings management will impair the quality of audit performed by the auditors. Therefore, this study poses the following research question:

What is the perception of external auditors regarding earnings management actions relating to the three different attributes of earnings management (i.e. the types, consistency and the direction of the effect on earnings)?

3. RESEARCH METHOD

3.1. Survey instrument

This study adopted a quantitative approach using survey questionnaires. The questionnaire consists of thirteen (13) short scenarios, each of which describes a potentially questionable earnings management activity undertaken by the general manager. The respondents were asked to give their judgment and rating using the following scale:

Table 1. Likert scale

1	2	3	4	5
Ethical practice	Questionable practice	Minor infraction	Serious infraction	Totally unethical

The second section elicited the demographic information – gender, race, age, highest education and professional qualification that were included to obtain basic information about the background of the respondents. This questionnaire was based on the earnings management scenarios questionnaire designed by Merchant and Rockness (1994). Their target group comprised general managers, corporate staff, operating unit controllers and internal auditors. The questionnaire provided an understanding concerning the type of earnings management action, consistency with GAAP, direction of effects, materiality, the period of effect and the purpose in mind for earnings management activities. Merchant and Rockness (1994) find areas of general agreement about some characteristics of the practices. They find that judgement is affected by the type of earnings management (e.g. operating vs. accounting), size (materiality), timing (accounting period-end), and purpose of the action (e.g. increase bonus). This study adopts the scenarios employed by Merchant and Rockness (1994) because it is still relevant to the current situation and most of the recent studies conducted to explore the earnings management activities also used the same instruments (Elias, 2002; Giacomino and Bellovary, 2006; Chen and Tsai, 2010; Jooste, 2011; Jooste, 2013). This study conducted extensive pilot testing before producing the final version of the questionnaire. Participants in the pilot study included ten academics with auditing and accounting experience and five audit partners. Following discussions with the pilot study respondents, minor changes were made to the content and presentation of the instruments. Particularly, the changes made were to localise the research instruments to the Malaysian setting.

3.2. Data collection

The questionnaires were distributed to auditors from the sampled audit firms through the post in March 2012. In distributing the questionnaires to the respondents, an official letter issued by the researcher was attached. The letter was sent to the audit firms to solicit participation either from audit seniors, audit managers or audit partners. The respondent firms were selected from a list of audit firms on the website of the Malaysian Institute of Accountants (MIA) using a systematic sampling design. In January 2012, the population of the audit firms in Malaysia showed a total number of 1,845 audit firms. Based on the table for determining the sample size by Krejcie and Morgan (1970), the required sample size was 320 audit firms. The audit firms were chosen randomly by selecting the first firm and those at intervals of six thereafter (e.g. 7, 14, 21, 28 and so on). Accordingly, 320 questionnaires were mailed to the chosen firms. The respondents were given one (1) month to complete and return the questionnaire to the researcher. The collected data were analysed using the Statistical Package for the Social Sciences (SPSS) version 17.0.

4. RESULTS

Out of 320 questionnaires distributed, only 101 were returned. Numerous follow ups were conducted including collection by hand of the questionnaires to increase the response rate. After checking all the returned questionnaires, four (4) questionnaires were incomplete, thus making the total number of useable questionnaires 97 and yielding a response rate of 30.30 per cent. Although this response rate appears low, it is normal inasmuch as mailed questionnaires are generally not returned (Salleh and Stewart, 2013).

Table 2 shows that 38 of the respondents (39.2 per cent) are male and 59 (60.8 per cent) are female. The age of respondents ranged from 30 to 51 years old. Forty nine 49 (50.5 per cent) out of 97 respondents are Malays and the rest consisted of Chinese (40.2 per cent), Indian (8.2 per cent) and others (1 per cent). The majority of the respondents only have a first degree for their highest education, which is 72 (74.2 per cent), seven with master's degree, and only one (1) respondent has a PhD. Other respondents did not have a degree but acquired a professional qualification. Hence, the respondents are broadly representative of auditors in Malaysia and appropriate for this research.

Table 2. Result on respondents' demographic

Descriptive items	*Frequency*	*Percent*	*Valid Per cent*	*Cumulative Per cent*
Gender				
Male	38	39.2	39.2	39.2
Female	59	60.8	60.8	100
Age				
30 or under	49	50.5	50.5	50.5
31-40	36	37.1	37.1	87.6
41-50	8	8.3	8.3	95.9
51 or older	4	4.1	4.1	100
Race				
Malay	49	50.5	50.5	50.5
Chinese	39	40.2	40.2	90.7
Indian	8	8.2	8.2	98.9
Others	1	1. 1	1.1	100
Highest education				
First degree	72	74.2	74.2	74.2
Master degree	7	7.2	7.2	81.4
PHD	1	1.1	1.1	82.5
Others	17	17.5	17.5	100
Professional qualification				
Yes	53	54.6	54.6	54.6
No	44	45.4	45.4	100
Work with company				
10 or under	89	92	92	92
11-20	6	6	6	98
21-30	1	1	1	1
31-40	1	1	1	1
Involved in decision making				
Yes	31	32	32	32
No	66	68	68	100

Fifty-three (53) respondents acquired a professional qualification, such as Malaysian Institute of Certified Public Accountants (MICPA), Association of Chartered Certified Accountants (ACCA), Malaysian Institute of Accountants (MIA) and Certified Public Accountant (CPA). Furthermore, the length of time the respondents served in their respective audit firms was generally less than 10 years, with an average of five (5) years. In addition, only 31 respondents were involved in making decisions that touched upon earnings management during their tenure. Based on the demographic information of the respondents, this study considers that the respondents had the appropriate knowledge and experience regarding the issues being examined.

Table 3. Mean acceptability rating for earnings management practices with three contrasting attributes

Attribute	*Question*	*Mean rating*	*t statistic*
Real manipulation activities	1, 2a, 2b, 4a, 4b, 4c	2.6890	-5.695 *
Discretionary accrual manipulation	3, 5a, 5b, 6a, 6b, 7a, 7b	3.1134	
Consistent with MFRS	5b, 6a, 6b	2.9759	-2.543
Inconsistent with MFRS	3, 5a, 7a, 7b	3.2165	
Increases earnings	2a, 2b, 3, 4a, 4b, 4c, 6a, 6b, 7a, 7b	2.8835	-1.821
Decreases earnings	1, 5a, 5b	2.9966	

*Note: *= p < 0.01*

The results show that ethical judgment is affected by the type of earnings management. As shown in Table 3 above, the mean rating is compared for the questions describing real manipulation and accrual manipulation. The results show a highly significant difference; the accrual manipulation is judged as questionable practice (t = -5.695; p<.001). The results are consistent with the findings by Merchant and Rockness (1994), Elias (2002), and Giacomino and Bellovary (2006) that show a highly significant difference between real activities manipulation (operating method) and discretionary accrual manipulation (accounting method). They suggest that discretionary accrual manipulation is judged much more strictly compared to real activities manipulation.

In addition, a further analysis was conducted to examine the auditors view on earnings management practices and its consistencies with Malaysian Financial Reporting Standards (MFRS). The results in Table 3 shows that there is no significant difference (t=-2.543; n.s.), which means that the consistency with MFRS is not a major concern but that it should still follow the MFRS. The results are consistent with the findings by Merchant and Rockness (1994) who suggest that the respondents perceive that manipulators do not use GAAP as a defence for their actions.

The tendency to manage earnings by managers is when earnings are extreme in either direction. For example, managers tend to overstate their earnings in the event that they have not been performing well or to reduce their earnings to make it easier in meeting profit targets in future periods. The result of additional analysis in Table 3 shows that the direction of the effect in earnings is not important, thus suggesting that increasing earnings does not record a significant difference from the decreasing earnings in the short-run (t=-1.821; n.s.). The respondents show that the direction of the effect on earnings management, whether increasing or decreasing earnings, does not seem to be considered in making their judgment. While this result is consistent with Merchant and Rockness (1994), the finding contradicts Kasznik (1999) who suggests that firms use accrual management to manage earnings upwards when they are falling short of the management earnings forecast.

5. DISCUSSION AND CONCLUSION

The primary purpose of this study is to assess the acceptability of earnings management based on the views of auditors regarding earnings management activities. This study finds that auditors believe that discretionary accrual manipulation is more unethical than real activities manipulation. Although accrual manipulation is not allowed by MFRS, since there is an excuse where the managers can make judgment and estimation, it is open for accrual manipulation but still has a limit. Therefore, the respondents chose to comply with the rules given by the standard and thereby remaining within the range given by MFRS. This result is consistent with prior research; Merchant & Rockness (1994) find that the accounting method (discretionary method) is considered to be more unethical than the operating method (real activities method). In addition, the respondents believed that real activity manipulation is hard to detect so they chose to keep quiet rather than adjust the manager's attempt to manage earnings. According to Nelson, Elliot, and Tarpley (2002), the reason why auditors do not concern themselves with issues about earnings management is usually because the practice is still compliant with GAAP or because the auditor does not have enough evidence to determine whether the client's position is incorrect or because of other reasons that are usually immaterial. This study is also consistent with the study by Cohen, Dey, and Lys (2008), which finds that the changes from discretionary accrual manipulation to real activities manipulation after SOX is due to real activities manipulation not being subject to the inquiry from the regulators, unlike accrual manipulation.

Additionally, this study also finds that auditors believe that earnings management is tolerable, irrespective of whether or not it complies with MFRS. This finding is alarming because it might indicate that the auditors are not performing their roles in the corporate governance of the firms. As auditors, they should express their views whether the financial statements are fairly presented and consistent with the MFRS. The finding from this study also provides insight into previous Malaysian accounting scandals that indicate auditors inclined to tolerate with earnings management practices. Krishnan (2011) suggests that in the past Malaysian accounting scandals, auditors failed to report accounting irregularities to the regulators and the shareholders of the companies due to inferior audit that did not reach the expected standards. Merchant & Rockness (1994) also observe that their respondents, which included internal auditors, are also not concerned whether the earnings management practices are consistent with GAAP. This is because there is very little difference in the mean rating between consistent or inconsistent with GAAP. Thus, the perception of the auditors and internal auditors is similar.

The result from this study is useful to regulators and relevant parties since it indicates that auditors still tolerate, rather than prevent, earnings management activities conducted by managers. Therefore, the regulators must become cognizant of it and have checks to ensure the reliability of financial statements and that they are free from exploitation of earnings. As an example, the regulators can restrict real activities manipulation in the financial statement. The current changes in the accounting standards that concern the recognition, measurements and presentation of elements in the financial statements, i.e. financial instruments, are of interest to regulators to improve the reporting quality reported by companies in Malaysia.

Nonetheless, there are limitations in conducting this study. This study only concerns the scenarios in the questionnaire, which are only short scenarios regarding earnings management activities. Many techniques or methods were widely used by managers to manage earnings, whereas this study only addresses a few. This study is also limited to external auditors and hence, the scope of the research only focuses on the perspective of the external auditors. In addition, the auditors employ a risk-based approach and the audit procedures are limited to addressing real earnings management. Thus, auditors are suggested to be cautious in performing audit procedures in curbing earnings management in respect of both real activities manipulation, and discretionary accrual manipulation. Future studies can expand this study through using different groups of respondents, which might provide different results, such as financial managers, general managers, and corporate staff. Therefore, the research in this area should be expanded by adding respondents from the various parties involved directly in the financial reporting process. In addition, future studies may also extend the current study to examine the effect of different ethnic groups, gender or seniority level on the acceptability of earnings management to provide more socially nuanced results in the context of Malaysia.

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