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Incentives to Earnings Management & Manipulation: The Manager's Perspective

Incentives to Earnings Management & Manipulation

Introduction

The inclination toward both legitimate and illegitimate means of creative accounting in the past years has led us to question the accounting and reporting ethics practiced by managers around the globe. Capitalization of expenses, hidden asset impairments, using off-balance sheet liabilities, inflating recognized revenues and 'cookie jar' accounting are few of many ways to over-state profitability by the management.

So, what was the root cause of corporate fiascos such as Enron/Arthur Anderson and WorldCom and what force serves as incentives for managers to resort to extreme earnings management techniques in the first place? Our analysis will cover the main factors that may encourage unethical accounting practices at the managerial level.

Possible Causes to Creative Accounting

Greed for money appears to be the most convenient explanation. Personal gain is probably why malpractice is performed in the first place. With accounting being a practice revolving entirely around money, greed is likely to strike at any level, whether it be an individual accountant or at a member of the executive board. Financial information is manipulated as managers and accounting specialists search for loopholes in standards either for misrepresentation or for direct monetary benefit.

Pressure to meet profitability targets is another important factor as to why management may choose to enter the grey area of accounting. In certain scenarios meeting analysts' expectations regarding company performance becomes more important than contractual obligations, as the company is

reputed to adhere to its market predicted growth trends. Therefore, capital market pressure may just be significant enough for managers to resort to unethical means to financial reporting. (Serwer, et al., 2002) have construed in a similar context: “ over time so much focus has been placed on levitating companies stock prices that many executives will do almost anything--legal or otherwise--to make it happen”

(Rosen, Al, 2009) regards executive compensation as the key to the dubitable practice of misrepresentation in financial reporting. Executive compensation can occur either via share-based compensatory benefits (as share prices rise) or inflated profitability by over-stating revenues.

Corporate culture plays a significant role in devising managerial ethics. If in order to achieve ‘ company’ gains the executive management is known to practice manipulation with financial information, subordinate staff is likely to use unethical means for personal benefits too (StrategicDirection, 2003).

Research suggests that tax considerations, especially in smaller entities, can also play a driving force in perpetrating unethical means to earnings management (Noronha & Zeny, 2008). Also debt covenants, (relating to a certain level of sales or profitability) can force a company’s management to inflate profits if it is in serious need to raise finance.

Intimidation from senior management can prove to be a material aspect as well. This is obvious from the statement made by Alan P. Warnick’s about Enron Corporation’s CEO Ken Lay in his interview regarding the Enron scandal (2001): “ He would go around and figure out who was going to support his position and what he was doing – and who might give him trouble. Those who would give him trouble would be gone” (Madsen & Vance, 2009).

Conclusion:

Without opportunity, of course, none of the above reasons are like to materialize into actual white-collar crimes. People who are least likely to perpetrate fraudulent practices such as insider dealing or money laundering may just succumb to temptation when the right opportunity drops by. Personal financial difficulty is likely as a catalyst in such circumstances.

List of References

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