SHORTCOMINGS IN EARNINGS MANAGEMENT DETECTION RESEARCH AREA: A STATE OF THE ART OF CONTEMPORARY INSIGHTS

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Abstract:

Our paper provides a critical assemblage of the errors comprised in earnings management detection area of research. In this respect, the aim of this study is to identify the main limitations documented in the arena of the earnings management detection process. Our analysis included the assessment of the papers published in the most popular 5 accounting journals, on the last five years. The results obtained seems to confirm what most researchers publishing in earnings management are documenting: i.e. despite the fact that current research designs used in detection of earnings management are frequently used, important and significant errors appears. Potential solutions and future research directions are also discussed.

Keywords: Earnings management, accounting estimations, manipulation, errors in earnings management research area

1. Introduction

Earnings management, as main technique for manipulating financial information is extensively documented in both research and practice of accounting and auditing. In this respect an impressive number of papers are addressing the causes, motivational palette, manifestations and consequences (Armstrong et al., 2010). Although tackled systematically over the past 50 years, earnings management area of research suffered a

substantial augmentation with Jones's study (1991); that boosted the detection of earnings manipulation. After this study was published, a period of improving this model followed and is following still comprising new models of detection (Dechow et al., 1995; Dechow et al., 2010; Fan et al., 2010). In the light of sound financial scandals, both media and regulatory bodies approached and discussed the consequences of earnings manipulation that harm the image of the profession of accounting and auditing (Badolato et al., 2014) and stressed the need for fairness.

In this context, earnings management became an attractive concept for researchers everywhere, currently enjoying excessive attention. We mention here some of the most cited cases of financial scandals discussed extensively in the literature, such as: Royal Ahold (2003, USA); Parmalat (2003, Italy); Penny Stock (2006, India); Anglo Irish Bank (2008, Ireland); Sino-Forest Corporation (2011, Canada-India); Olympus Corporation (2011, Japan, Autonomy Corporation (2012, USA). It should be noted that all these financial scandals followed the Enron case, considered the most important scandal in US history, financial scandal that has shaken the confidence of the capital market in accounting and auditing profession. On this base, the detection process of earnings management became popular and important to be developed (Dechow et al., 2012).

Despite the fact that earnings management is enjoying a great success, detractors can be found. Studies aimed at detecting earnings management are accused of many shortcomings, most often accepted as commonly used methodologies are perfectible.

Therefore, the purpose of this study is to perform a critical analysis of the inherent biases found in the models commonly used in detecting earnings management. In this respect, we turned to conducting a literature review, selecting papers published in the last 5 years (period 2010-2014) in accounting journals traditionally occupying the top 5 places in the ranking of the best journals in the world. In this respect, our study is intended to be a first starting point for young researchers who are interested in the area of accounting manipulation and consequences of earnings manipulation both in the capital market and economic life, and on the other hand, to conduct a pertinent analysis of shortcomings found in one appreciated area of research in accounting and auditing.

Our study is timely and relevant for at least three reasons. First, in light of previous financial scandals, earnings manipulation has become a pivotal issue in all discussions regarding the stability and credibility of the accounting outcomes disclosed in the financial markets. Secondly, there is an increased interest in the results documented in this area of research as authors such as Graham et al., (2012) and Solomon et al., (2013) recall. Thirdly, the debate on the detection of earnings management and other

creative accounting techniques were and still are a topic that falls under the interest of most of the participants in the economic scene given the adverse consequences of such practices. In this regard, the items approached have the potential to augment current research, both at national and international level.

The originality of this research consists in the fact that we provide an overview of the biases and shortcomings faced by earnings management detection area of research, synthesis performed on a basis of the most representative papers in the field.

The structure of this paper is as follows: the first section comprises the research questions and research method used, followed by a section comprising some items of meta-analysis research method, aiming to present: the frequency of papers published in the area of earnings management detection; a summary of the main research methods employed by the scholars publishing in earnings management arena, and of course, a series of discussions on the main biases and shortcomings facing this area of research, followed by potential solutions. As a remark, we mention that this study is not meant to be a meta-analysis in the true sense. Finally, conclusions are presented, together with the limits of the study and scope for future research.

2. Research profile

The current research is aiming to augment the literature by analyzing the main limits found in the main research designs used in the detection of earnings management. Our study convers a period of 5 years, from 2010 to 2014, as stated above.

2.1. Research questions

Our analysis has the goal of identifying, assessing and addressing future research ideas, based on the discussion of the main limits and errors found in the area of earnings management detection. In this regard, two research questions were developed as follows:

1. *Which are the main biases found in the research designs used to assess the magnitude of earnings management?*
2. *Can future research limit those biases?*

2.2. Research method

This segment comprises our explanations regarding the research method employed in selecting the articles analyzed in this present paper. In this respect, we used a similar methodology as Guthrie et al., (2012), comprising five steps. Similar to Guthrie et al., (2012), the first step comprised the formulation of the research objectives, as follows: (a) identify the main limits of the research designs used in earnings management detection area; (b) identify the potential solutions to counter those limits,

being proposed either in the literature analyzed, either comprising our own recommendations.

The second stage of our research comprised the selection of journals publishing papers from earnings management detection area. In this regard, we selected internationally recognized accounting journals, traditionally considered top 5, among the most appreciated accounting journals worldwide, as in Chan et al., 2009. Table 1 below disclose the journals selected and the number of the papers on earnings management detection published by each journal. The third stage comprised the selection of papers. In this stage specific key words were used, found in the earnings management detection area (*Abnormal accruals, accrual methodology, detecting earnings management, accrual based earnings management, real earnings management, bias of accrual methodology, model misspecification, correlated omitted variables*). We obtained a number of 93 papers that were downloaded and stored in an Endnote database together with the references. In the fourth stage we analyzed all the papers downloaded and discharge the ones with marginal focus on earnings management detection, conducting to a number of 53 papers in our final sample. In the last stage we analyzed each paper under the aegis of possible limits and errors of the research designs used in detection earnings manipulation and synthesized the results obtained. Following up this last stage we could have a pertinent answer to our research questions developed.

3. Taxonomies

Using partially a dedicated method for selecting and classify scientific papers (Guthrie et al., 2012) we conducted an analysis on top 5 level of the most known and appreciated accounting journals worldwide on a period of 5 years, as we stated above. In this segment we included two description items, as follows: the frequency of the publications from the earnings management detection area and the taxonomy of the research methods found in the papers analyzed. It is important to specify that our study do not comprise a typical meta-analysis, moreover we included in our paper some segments of a traditional meta-analysis research method. The main arguments for assessing only papers from top 5 journals of accounting are twofold: (a) first, we wanted to assess the interest of those journals in the area of research approached; (b) second, we found this demarche as being helpful for other scholars interested in earnings management area of research, in terms of future trends of research in earnings manipulation.

3.1. The frequency of publications in earnings management area of research

Both the selected journals and number of articles published are disclosed in Table 1. In this regards, a total of 53 papers were analyzed on a period of 5 years (2010 – 2014).

Table 1. Number of articles published in earnings management area in top 5 accounting journals (2010-2014)

NAME OF THE JOURNAL	JURNAL CODE	NO. OF ARTICLES	PERCENTAGE
Accounting, Organizations And Society	AOS	3	5.66
Contemporary Accounting Research	CAR	17	32.09
Journal Of Accounting And Economics	JAE	16	30.18
Journal Of Accounting Research	JAR	6	11,32
The Accounting Review	TAR	11	20.75
TOTAL		**53**	**100,0**

Source: Authors` projection

As can be noticed from the information provided in Table 1, three journals published more papers from our area of interest (*Contemporary Accounting Research* (17 papers); *Journal of Accounting and Economics (16* papers*)*; *The Accounting Review* (11 papers). As main observation, all the other journals included in our sample are publishing a small number of papers annually, comprising a small number of issues, while the selection process is extremely rigorous and the rate of rejection very high. In this regard, it is encouraging to know that those journals are interested in earnings management area of research.

3.2. The methodological mix

Table 2 disclose the main research methods comprised in the papers under analysis.

Table 2. Research methodologies employed in the papers analyzed (2010-2014)

NO.	RESEARCH METHODS	NO. OF PAPERS	PERCENTAGE
1	Interview/Descriptive survey	3	5.66
2	Literature review	5	9.43
3	Mathematical analysis/statistical analysis	41	77.36
4	Experiment	4	7.55
	Total	**53**	**100,0**

Source: Authors` projection

The categories listed in the table above are adapted from Parker (2011), in the present study retaining only those research methods found in the papers analyzed and not all research methods found in Parker (2011). Similar to Parker (2011) when a mix of research methods was encountered, we decided to count only for the main research method used. All the above categories are well known in the literature, so we do not consider it necessary to define what each research method is about.

What particularly interested us was to achieve a synthesis of these research methods found in the area of earnings management detection and the outcome, to our surprise, was at least interesting. While some research methods are extensively used, others are of little use or not at all. Thus the dominant research method for this area of research was the mathematical analysis / statistical analysis (77.36%); followed by the literature review (9.43%, with authors like Solomon et al., 2013 Gerakos, 2012; Armstrong et al., 2010; Dechow et al., 2010a; Defond, 2010); and experiment (7.55% with authors as Jorgensen et al., 2014; Chen et al., 2012; Seybert 2010; Cianci and Kaplan, 2010). None of the papers under review have used the case study research method for instance.

Based on these results we can assert that researchers' publishing in top 5 accounting journals have a clear preference for mathematical analysis / statistical analysis (which is understandable given the specificities of this area of research) or top 5 journals prefer to publish works that are predominantly comprising papers using those methods. The fact is that one can easily observe that certain research methods are underused.

Given the above we can assert that to some the extant biases found in this area of research can be explained by the limits comprised in the mainly commonly used research methods. Anticipating the results of the analysis (shown below) one can easily identify the major biases in the earnings management detection area as being the lack of discriminant power of the models used to assess the magnitude of earnings management practices or misspecification of the models used. As can be seen easily, both limits are belonging to mathematical and statistical analysis.

3.3. **Biases and limits found in earnings management detection area of research**

A synthesis of the main biases and limits found in the arena of earnings management detection is disclosed in Figure 1.

Figure 1. Main biases comprised in earnings management detection area of research (2010-2014)
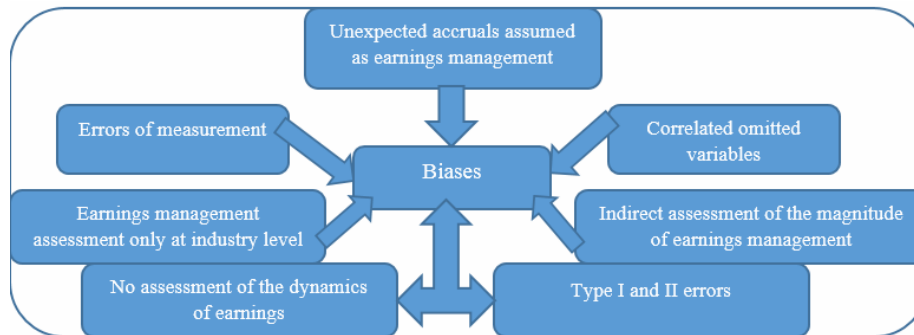
Source: Authors` projection

Despite the fact that various empirical studies document extensively the existence of earnings management, the results are commonly under the aegis of important biases (Badertscher, 2011). Thus, one of the main issue of concern is actually also the main challenge that boosts this area of research: almost all the studies analyzed are based on the assumption that unexplained accruals represents earnings management.

In this respect this assumption is acting as a main argument for constructing the proper research design to assess the existence and magnitude of earnings management. We consider this assumption plausible but we cannot stop asking whether other factors can explain the existence of abnormal discretionary segment such as the poor quality earnings, macroeconomic factors such as the financial crises, legislative factors or inefficient management. It is also known that most of the models used for assessing earnings management existence and magnitude suffer from measurement error. This issue is documented in many of the studies reviewed. In this respect, the models used very often fail to discriminate with high accuracy the abnormal discretionary segment from the normal one, considered for the business. Despite the fact that various control variables were introduced over time, many of the improvements are to be documented by future research (Resutek, 2010).

The issue of the correlated omitted variables was also addressed in the literature. For example, company size (measured by turnover, number of employees and total assets) has been identified as one of such variables in the estimation tests of the existence / magnitude of earnings management (Ecker et al., 2013). Many of the methodologies used in estimating earnings management have not considered this variable, leading to increased volatility of results.

Remaining in this segment of the discussion, another major difficulty in terms of specification models used in detecting earnings management stems from the wide variation used for measuring the proxy variables. For instance, the abnormal accruals are used as a proxy for earnings management but the estimation of such segment comprises different paths from one study to another (Dichev et al., 2013), and what we assess as estimation of the abnormal accruals is moreover an amalgam of different estimation methods using a wide variety of proxies. In this regard, the differences documented in the results of earnings management studies can be explained by the presence of different investigation methods, knowing that different investigation methods can lead to different results.

In the large majority of studies conducted the estimation of the existence and magnitude of earnings management is assessed at industry level despite the fact that an assessment at firm level can offer an estimation of the discretionary segment with greater accuracy. However, since this latter approach comprises important limitations in terms of managing the financial data used in the research process, industry-level estimation is still used extensively. One of the main disadvantages of the assessment of earnings management at industry-level consists in the calculation of constant coefficients used at benchmark. In this regard, the important biases occur when companies varies greatly from the benchmark, which may come more often, as observed Burgstahler and Chuk (2014), not because of financial accounting manipulation techniques but of simple industrial classification.

Given the fact that the whole area of research aimed at detecting earnings management is one that uses an indirect approach to assess the existence and magnitude of earnings manipulation, many of the limitations are explicable. Although is extremely difficult to assess earnings management in a direct approach, this is preferable to the indirect estimation (Dichev et al., 2013).

Further, the incentives to manipulate earnings can act a starting point for detecting other inconsistencies (Cohen et al., 2011). Thus, we want to draw attention to the fact that most often potential incentives are assessed (which is the most relevant from the point of view of the researcher, otherwise subjectively) while others are left aside. Further, most often the empirical studies testing for ways of manifestation of earnings manipulation usually focus on accrual-based earnings management, excluding from the analysis the real earnings management (Cohen and Zarowin, 2010), leading to an incomplete testing of the managerial incentives (Zang, 2012).

Another important limit found in the area of research of earnings management detection is the lack of assessing in connection the incentives to manipulate with the concrete, measurable result obtained after the

manipulation is assessed and documented. In this respect, it is important not only the statistical assessment of the magnitude of earnings management practices but moreover to demonstrate without any doubt the existence and magnitude of the gain or loss realized after managers engaged in earnings manipulation.

Given the above discussion, our first research question has an answer. The second research question approached the future of above discrepancies. So the question naturally arising is: Can we limit the biases documented?

Following we will focus on responding to the second research question formulated in this paper. So in an attempt to outline an appropriate response we can begin with the observation that most of the studies analyzed can be included in one of the two directions: either, those studies comprise consecrated research methodologies used to document new cases of earnings manipulation, either, new methodologies are developed.

Thus, while authors of the first category accepts the inherent limitations of detection methodologies used, authors of the second category continues a perpetual process of analyzing and counter the most important biases. So the answer to the second research question can only that comprised a positive message, since contemporary research efforts are being made to find solutions to the main problems found in this area of research.

Among others the study conducted by Stubben (2010) is representative, documenting the superiority of revenue based models having a higher power of discrimination compared to classical models when estimating mixed manipulative practices using concomitant revenues and expenses. Another model was the one developed by Dechow et al. (2011), which decreased the measurement errors and increased the power of discrimination in detecting the manipulative behavior of managers. Considered to be one of the best models of detection, it was developed based on a preliminary analysis conducted in order to understand the behavior of companies under financial stress.

The study conducted by Dechow et al., (2012) comprised the assessment of the reversal properties of accruals, and limit in this regard important biases previous documented in the literature. Jansen et al., (2012) proposed an innovative technique for detecting earnings management using DuPont analysis based on the idea that net current assets and operating earnings vary directly with sales.

Another model comprising significant improvements in the detection of manipulative behavior was developed by Dechow et al., (2012) and confirmed by Gerakos (2012). This model is characterized by a higher discrimination power, being currently one of the best models used to assess the manipulative behavior (Dichev et al., 2013).

4. Conclusions, limits and scope for future research

Earnings management as main techniques used for manipulating the financial information is both blamed and adored, while one idea reach consensus: this phenomena cannot be eradicated. Everything that can be done is to enhance the efforts to limit its much discussed practices, since previous literature documented important economic and social implications.

Our study is part of that trend, by trying to identify the main limits found in the research designs used for detecting earnings management practices, and synthetize some possible solutions documented in the literature. In order to achieve our goal, we analyzed the most recent papers published in top 5 accounting journals, the most known and appreciated journals worldwide. Among the limits and errors found in the research designs used in detecting earnings management practices we could find the following: measurement errors; correlated omitted variables; type I and II errors; entirely based assumption that unexplained accruals represent earnings management; indirect approach for assessing the magnitude of earnings management; most of the current models for assessing earnings management existence do not comprise the dynamics of earnings assumption. On the other side, despite the fact that this area of research comprises important biases and limits, one should appreciate the constant efforts of scholars publishing in this area, in terms of finding solutions to improve the power of existing models used to assess earnings management existence and magnitude. In this respect, studies like the ones conducted by Stubben (2010), Dechow et al., (2011); Dechow et al., (2012); Jansen et al., (2012) or Gerakos (2012) are representative.

Our paper comprises its own limits. One of the main limits can consist in the fact that we analyzed papers published in top 5 accounting journals, excluding both other published work or working-papers, conference proceedings. In this regard we excluded an important number of papers that could enrich our analysis.

As scope for future research, we can assert that the main goal of this paper can consist in a future research topic based on the permanent efforts documented in the literature to counteract and limit the biases found in earnings management detection area of research. Each on the biases documented in our paper can be found in the large majority of research designs used so far to detection earnings management existence and magnitude. In conclusion is up to future research to deal with issues as: triangulation problem in the research designs used so far conducting to important differences in the documented results; a better understanding of the consequences of earnings manipulation in the process of decision-making (Das et al., 2010); improving the data management for the data used in the estimation of the proxy variables; development of an economic

theory of manipulation, to explain both the manipulative behavior of managers, motivations and consequences.

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