Earnings management

Earnings management , in accounting , is the act of intentionally influencing the process of financial reporting to obtain some private gain . Earnings management involves the alteration of financial reports to mislead stakeholders about the organization 's underlying performance , or to " influence contractual outcomes that depend on reported accounting numbers . "

Earnings management has a negative effect on earnings quality , and may weaken the credibility of financial reporting . Furthermore , in a 1998 speech Securities and Exchange Commission chairman Arthur Levitt called earnings management " widespread " . Despite its pervasiveness , the complexity of accounting rules can make earnings management difficult for individual investors to detect .

Occurrence and response by regulators

Earnings management is believed to be widespread . A 1990 report on earnings management situations stated that " short @-@ term earnings are being managed in many , if not all companies " , and in a 1998 speech , Securities and Exchange Commission (SEC) chairman Arthur Levitt called earnings management a " widespread , but too little @-@ challenged custom " . In a 2013 essay , Ray Ball , while opining that accounting research was not reliably documenting earnings management , wrote : " Of course earnings management goes on . [...] People have been tried and convicted . "

The SEC has criticized earnings management as having adverse consequences for financial reporting , and for masking " the true consequences of management 's decisions " . It has called on standard @-@ setters to make changes to accounting standards to improve financial statement transparency , and has called for increased oversight over the financial reporting process . The SEC has also pressed charges against the management of firms involved in fraudulent earnings management .

Motivations and methods

Earnings management involves the manipulation of company earnings towards a pre @-@ determined target . This target can be motivated by a preference for more stable earnings , in which case management is said to be carrying out income smoothing . Opportunistic income smoothing can in turn signal lower risk and increase a firm 's market value . Other possible motivations for earnings management include the need to maintain the levels of certain accounting ratios due to debt covenants , and the pressure to maintain increasing earnings and to beat analyst targets .

Earnings management may involve exploiting opportunities to make accounting decisions that change the earnings figure reported on the financial statements . Accounting decisions can in turn affect earnings because they can influence the timing of transactions and the estimates used in financial reporting . For example , a comparatively small change in the estimates for uncollectible accounts can have a significant effect on net income , and a company using last @-@ in , first @-@ out accounting for inventories can increase net income in times of rising prices by delaying purchases to future periods .

Detecting earnings management

Earnings management may be difficult for individual investors to detect due to the complexity of accounting rules , although accounting researchers have proposed several methods . For example , research has shown that firms with large accruals and weak governance structures are more likely to be engaging in earnings management . More recent research suggested that linguistics @-@ based methods can detect financial manipulation , for example studies in 2012 found that whether a subsequent irregularity or deceptive restatement occurred is related to the linguistics used by top management in earnings conference calls .