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EARNINGS MANAGEMENT AND FRAUDULENT FINANCIAL REPORTING

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ABSTRACT

Earnings management and its theoretical connection to financial statement fraud in Nigeria were the focus of this article. A critical review of the existing literature from a conceptual, theoretical, and empirical vantage point reveals that managers may engage in earnings management activities when they have discretion over accounting or operating decisions or when they areattempting to convey confidential information to stakeholders or users of financial statements.Those who rely on financial reports need to know which method is being used and why that matters. Earnings management, which makes a firm appear better than it is, may lead to disenchantment for the individual investor and, through misdirected resource allocation, a loss of welfare for society as a whole. It is hypothesized that raising investors' level of awareness about the prevalence of profits management would lead to better investment decisions and greatersocial welfare. If standard-setters can identify areas where earnings management is widespread and has a material impact on profits and resource allocation, they might investigate measures to tighten existing accounting rules and increase disclosure requirements to improve financial reporting. When earnings management does occur, but is uncommon and has a little impact onresource allocation, there is less of a need to alter financial reporting standards.

Keywords: Earnings Management, Fraudulent Financial Reporting, Investors, Resource Allocation

INTRODUCTION

Earnings management is a catch-all term for a wide range of practices, such as income smoothing, financial statement management, the numbers game, aggressive accounting, reengineering the income statement, juggling the books, creative accounting, financial statementmanipulation, accounting magic, borrowing income from the future, banking income for the future, financial shenanigans, window dressing, and accounting alchemy. Over the years, the concept of profits management has been the subject of much analysis in the academic field of accounting (Ahmed and Scott, 2011). According to the research compiled by Chen (2008), companies that record a significant change in earnings from the previous year are more likely to include unusual items in their financial statements. The motive here is likely to be management'swish to sway public opinion. Earnings management, according to Moradi (2008), is only successful if it goes unnoticed by the target audience. The three main reasons suggested by Hossein, Sina, and Seyed (2013) for management to engage in such practices are, first, to reach the benchmark level established by the organization; second, to meet their own performance target in their cash holding; and third, to avoid violation of tax and debt, which is captured in theincome tax shields and leverage position. To deceive particular stakeholders about the underlying economic performance of a firm or to affect contractual outcomes that depend on reported accounting figures is earningsmanagement, as described by Heaty & Wahlem (2009). By using deceptive or misleading accounting practices, earnings can be inflated (or deflated) in order to manipulate financial statements. It's important to distinguish between honest mistakes in reporting and fraudulent profits management. Fraudulent financial reporting is one of the foremost types of management fraud that terrifies business organizations and has continued to haunt them in no small measure.

This type of fraud has an overwhelming undulating effect on shareholders and creditors, eroding the confidence of investors and credibility of accountancy profession. Fraudulent financial reporting manifests itself through overstatement of assets or revenue, and understatement of liabilities and expenses by cooking the books. However, this paper theoretically examined earnings management and fraudulent financial reporting. The outstanding part of this study is divided into review of related literature and the concluding remark.

Review of Literature
The conceptual and theoretical foundations and the existing body of empirical research were all covered in the review of the relevant literature.

The Concept of Earnings Management
The bottom line, or net income, is the most critical number in any set of financial accounts. They reveal how much effort a corporation has put into creating additional worth.They serve as a guidepost for the capital markets' allocation of resources. An equity's theoretical significance is equivalent to the discounted worth of the company's estimated future profits. If a company's profits go up, the value of the business goes up, and if they go down, the value goes down. Earnings are crucial to any business, so it stands to reason that upper management cares deeply about how they are presented. That's why it's crucial for every CEO to have a firm grasp of the implications of his or her accounting decisions. They need to figure out how to budgettheir money. Earnings management may be described as the practice of making and reportingon management decisions within the bounds of the law with the goal of achieving consistent and predictable financial outcomes. Financial statement manipulation and reporting results that are not reflective of economic reality are not the same thing as legitimate earnings management. Cooking the books refers to the practice of falsifying financial records to make the company look better than it actually is. When managers exercise their discretion in financial reporting and transaction structuring, they may engage in earnings management. This practice has the potential to mislead certain stakeholders about the firm's underlying economic performance or to affect contractual outcomes that depend on reported accounting statistics. To manipulate earnings, managerial purpose is required, according to all definitions, although whether or not this aim should be opportunistic is less evident. Several earnings presentations utilize the word inreference to managerial discretion with the intent of conveying information to investors that is not opportunistic but may be misleading by design (Dechow, 2000 & Scott, 2003). Subramanyam (1996) exclusively discusses earnings management in the context of opportunistic behaviour, not when managers exercise discretion to increase earnings persistence and predictability. This is important for determining whether or not income smoothing is opportunistic.

How Earnings are Management?
Due to the invisibility of earnings management, it is challenging to spot it in a company's financial statements. In most cases, profits management is only effective if no one notices that anything is wrong. Many of the earliest studies on profits management focused on identifying changes in accounting processes that were obvious to observers from the outside. In light of this, it should come as no surprise that, given a general review of earnings management, early study did not uncover the expected manipulation to effect stock prices (Watts, 1998). Butstudies that have focused on accruals more recently have indicated that the market often ignores earnings management (Healy and Wahlen, 2009). Researchers face a difficult task in spotting something that the market seemingly frequently misses. Since researchers are interested in the phenomena in general and not in its probable presence in any particular investment items, their starting point is different from that ofinvestors. If you have enough data, you can see patterns in it that would seem to be coincidental if you were just looking at one or two instances. Researchers often start

by hypothesizing potential areas of earnings management and then conduct studies to confirm or refute them. Most of the current studies on earnings management use these procedures to examine the part of accruals called "discretionary" or "abnormal" accruals, which are thought to be the product of managerial choice.

Proponents of Earnings Management

Accounting method selection and timing are the advocates or viewpoints of earnings management. Here, the term "accounting method choice" refers to both the decision to use a particular accounting technique (such as whether or not to capitalize an intangible asset) and thedecision as to how that method should be used. In the context of capitalized intangibles, the approach is used to establish a suitable depreciation schedule. There are two dimensions oftime. For starters, the accounting entries for some events, such the write-off of bad debts or damaged assets, are entirely at the discretion of the management. The timing of events that have an impact on reported earnings is another factor. Research and development (R&D) initiatives and advertising campaigns are sometimes scheduled near the end of the fiscal year to have an impact on the next period's profits. Timing asset sales such that profits or losses showup on the income statement is another illustration of this.

Companies' inventory valuation and depreciation method selections, as well as their capitalization versus expense decision regarding insubstantial assets and interest, are just a few examples of the accounting decisions that have been analyzed to determine whether or not they use income-increasing or -decreasing reporting methods (see Watts & Zimmerman, 1986; & Fields et al., 2001). Capitalizing research and development is associated with a number of negative characteristics, including more leverage, smaller size, worse profitability, and a greater likelihood of dividend limits, according to the literature (Daley & Vigeland, 1983; & Aboody &Lev, 1998). This indicates that businesses normally select capitalization to provide the impressionof being financially stronger and to boost dividend payouts.

The Concept of Fraud

The prevalence of fraud has amplified dramatically over the past several years, promptingmore and more major corporations to think about hiring experts like forensic accountants to lessen the strain and prevent the occurrence of workplace and financial fraud. According to Kohlber (2008), fraud occurs when a someone knowingly and dishonestly takes advantage of his position of authority in order to benefit financially. Criminals who commit fraud often abuse their positions of authority by, for example, grossly mismanaging or exaggerating the availability of company funds (non-current and current assets). There are several sorts of financial crime and fraud, such as swindles and trust violations among employees, that occur across all industries (Nwankwo 2015). To falsify or hide with relation to some information relevant to a transaction while knowing that it is false is a form of fraud, as described by Olatunji (2009). And with the specific goal to deceive another and for which the other person reasonably trusted and hence was harmed. According to Okoro and Okoye (2016), fraud occurs when "an individual or organization takes an activity with the specific intent to obtain something for improper purposes." Accordingto Adeniji (2014), fraud occurs when members of management, staff, or outside parties knowingly make false statements in financial reports to further their own interests. The intentional deception, omission, or concealment of a material fact in order to manipulate a company's financial statements for personal gain is also fraud.

Fraudulent Financial Reporting

Reports and statements on financial matters are frequently provided to readers offinancial statements. Comprehensive financial reports include income, cash flow, equity, and cash flow statements, as well as balance sheet and note sections. On the other hand, fraudulent financial reporting is a planned or intentional act employed by management in presenting fictitious financial statements; this act possesses a severe threat to organizations. Fraudulent financial reporting is a financial reporting gimmick or trick employed by management of organizations as a way of gaining anticipated benefits or concealing inefficiency and corrupt practices. Fraudulent financial reporting denotes a deliberate and calculated act aimed at misrepresenting transactions in financial statements in order to derive or take undue advantage. It comes in the form of misrepresentation, manoeuvring or alteration of accounting records by camouflaging the factual position of operation of an entity with a view to preventing immediate and timely detection of corporate frauds. According to Adepoju and Alhassan (2010), corporate entities engage in fraudulent financial reporting in order to achieve company's target, raise market value, instil investors' confidence, and manipulation of tax returns among others. It is important to remember that everyone is affected by dishonest financial reporting, whether or notthey are shareholders. The effect of it has a chain reaction on the entire organization because the organization plays a vivacious role in any given economy (Albrecht, Turnbull, Zhang & Skousen, 2010).The belief is that fraudulent financial reporting poses a serious threat to organization's reputation, trust and confidence. There are numerous indicators of fraudulent financial reporting. Some of the warning signs of false financial reporting, as outlined by Nwoko (2007), are as follows: The failure of top-level management; Accountants who are in on the scam; Financial strategies that are aggressive or inventive corporate governance issues and/or ineffective internal controls; Deals that are out of the ordinary for the corporation and extremely complicated; Profit-sharing for executives and other high-ranking managers; Top-down management that takes everything for granted; Board of Directors that is weak, inexperienced, and ignorant; and Journal entries do not have adequate or any accompanying documentation.

Theoretical Framework

Using Agency Theory as a theoretical foundation, this article constructed an empirical methodology for detecting earnings management and accounting fraud. The agency connection, as noted by Adelegan (2009), develops whenever two or more individuals work together towarda common goal. Ownership of the firm is delegated to the shareholders, who in turn act as agents of the executive management and the Board of Directors. Given that problems with financial reporting arise when there are skirmishes of interest between managers and ownersand information unevenness, agency theory is an appropriate framework for this study. Without this agency problem, managers have no need to intentionally misrepresent financial data, rendering this issue moot.

Ibikunle (2013) research showed that minimizing the agency problem is one of the primary aims of management. Because of this, there is an inherent connection between earningsmanagement and false financial reporting. In practice, managers may not always be honest with shareholders and other stakeholders by providing them with the whole and correct picture. Information asymmetry refers to the discrepancy between what managers know and what they are willing to share with their employees. When one party or both parties to a contract have more information than the other on a key piece of data needed to perform under the contract, this is known as asymmetrical information (Park and Shin, 2004). Earnings management and misleading financial reporting can't be discussed without first addressing the issue of knowledge asymmetry (Carciumaru, 2009).

Eisenherdt (1998) defined the assumptions of agency theory, which include the following:the agent and principal have different aims, there is an information asymmetry prior to or after hiring the agent, and the agent and principle have different risk preferences. In short, management's participation in financial reporting can lessen the impact of principal-agent conflicts. This means that agency theory has been heavily used in the past to evaluate concerns associated with earnings management and false financial reporting.

Empirical Review

In Nigeria, there is a dearth of hard data connecting earnings management with financial statement fraud. However, in Nigeria and everywhere in the globe, you may get a wealth of information on topics like earnings management and investment decisions, IFRSs, and a whole lot more. In order to curb creative accounting, Okoro and Okoye (2016) looked at IFRSs and the causes of dishonest accounting in Nigeria. In the study, 120 experts were polled using a standardized questionnaire (auditors, investors, stockbrokers). The field data was analyzed using the statistical method of PPM Correlation. The results showed that IFRSs may be utilized to rein in imaginative bookkeeping. This suggests that IFRSs curb unethical accounting practices to a reasonable degree. In addition, 'conflict of interest' was identified as one of the most important elements driving negative creative accounting in the research.

Earnings management has a detrimental effect on financial reporting, according to the research of Fizza and Malik (2015), which uses structured questionnaires to investigate the bond between the two. The purpose of corporate authority in financial reporting is the source of the unfavorable effect. They thought that earnings management was bad for the company's reputation. In an effort to distinguish between earnings management and fraud, Kiani and Malik (2015) delved into the topic. They demonstrated that earnings management falls within the bounds of the law, but fraud occurs outside of the law. There was evidence of creativeaccounting by banks, auditors, investors, regulators, and corporate governance, according to their findings.

Earnings management, often known as creative accounting, is a practice that Amat(2013) studied to better understand the nature and occurrence of it in the context of ethical issues. The research showed that accountants consider creative accounting to be immoral. Professional accountants confront an ethical dilemma due to potential conflicts of interest, demands to alter financial records, and suggestions for tax evasion on the part of their clients. Nejad, Zeynali, and Alavi's (2013) research on earnings management on the Tehran Stock Exchange using Index Eckel demonstrates that accounting is one of the ways business organizations employ to manipulate financial statements. However, there is a lack of hard dataon how earnings management contributes to inflated financial statements in Nigeria and elsewhere. They analyzed the ways in which earnings were managed at the gross, net, and operational levels of accounting. Research in this field has been primarily limited to the industrialized world. Earnings management, as demonstrated by Al-Qaisi (2011), raises both anomalous returns and market values.

Iranian researcher Moradi (2008) found a negative correlation between financial leverage and profit management. Additionally, a statistically significant inverse relationship existsbetween financial leverage and earnings management in companies with higher levels of free cash flow. In order to predict how well corporations will handle their earnings, Khajavi, Ghorbani,and Maharlouie (2011) compared the effectiveness of both classic and novel measures of liquidity. Based on their findings, it was determined that inventory levels are the single most effective factor in influencing a company's bottom line, and that traditional liquidity indices correlate positively with both company size and earnings management. Since the majority of studies on earnings management were undertaken outside of Nigeria, this article focused on a theoretical analysis of earnings management and false financial reporting.

Awidat and Vladan (2013) defined earnings management and financial reporting fraud, compared and contrasted the various frameworks used to differentiate between the two, pointedout where the two overlap, and explained why accounting standards and management intent alone are insufficient for drawing a clear line between the two. The study demonstrates that the threshold at which management manipulation of reported results becomes financial fraud is a critical topic at the heart of accountings research.

Financial earnings management and fraudulent reporting were the subjects of Rasha's (2012) research. The research aims to help external auditors better understand earnings management and how it differs from financial reporting fraud. Thorough research into the relevant literature allowed this paper to achieve its goal. The secondary data for this study was gathered using the databases Ebscohost, Business Search Premier, Academic Search Premier, Emerlad, Sciencedirect, and Jstor. Due to the fact that management objectives are the primary motivation for any potential fraudulent operations, the study provides a new approach and frameof mind for external auditors that may help them distinguish between earnings management andfraud. Ultimately, the authors argue that further investigation into management's intentions and candor is necessary, and they suggest that external auditors approach auditing from management's perspective.

Rashida, Saliza, Eiman, and Soheil (2016) investigated earnings management and falsefinancial reporting in the Malaysian case study. The research shows that the field of earnings management research has a lengthy and fruitful history. Managers commit fraud due to agency problems, perverse incentives, plausible justifications, a window of opportunity, and the knowledge and skill to alter the numbers in the financial statements. The scenario drags on because of regulatory gaps and discordance with actual business practices. In addition to this study, researchers looked at how managing accruals and real profits (as proxies for discretionaryaccruals and discretionary cash flow, respectively) influenced the two outcomes. The 57 companies in the sample were chosen after reading about their false financial reporting offenses on the Bursa Malaysia website. The sample includes information on fraudulent acts done by publicly traded companies between 2001 and 2013. The study found a significant inverse connection between accrual earnings management and real earnings innovation among Malaysian fraud corporations, suggesting the companies under investigation aggressively managed earnings downwards or upwards to evade regulators' scrutiny and to target to accomplish personal incentives. Research shows that in the year before to a fraud year, earningswere sequentially managed between accruals and real earnings. Firms choose real earnings management and fully utilize its distinguished features of not easily traceable to continue managing earnings immediately following a fraud year, suggesting that regulators, auditors, and policymakers should limit earnings management patterns that have a high probability of becoming part of fraud antecedent.

Based on their research, Narul, Zuraidah, Lee, Takiah, and Yusarina (2015) concluded that opportunities (audit quality and free cash flow) and earnings management were more significant than fraud incentives (leverage and dividend). A random selection of 230 companies from six different industries that were traded on Bursa Malaysia's main board in 2009 and 2010. Important limits on accrual earnings management are identified via the study, including dividends, audit quality, and free cash flow. The high cost of audits places constraints on accrual earnings management. The outcome benefits those who rely on the external audit to ensure accurate financial reporting by corporations by lowering the prevalence of earningsmanagement.

Johan and Barbara (2010) investigate the connection between earnings manipulationand false financial reporting. This study expands our understanding of what elements could be included in the financial accounts of dishonest businesses. Here, we create three novel fraud predictors by investigating how a company's previous earnings-management practices may have contributed to its tendency to engage in fraudulent accounting. Based on a comparison of 54 fraudulent and 54 legitimate organizations, we discover that companies who meet or exceed analyst predictions or exaggerate sales are more likely to be perpetrating fraud if they have managed earnings in the past. We further demonstrate that, even in the absence of any past financial manipulation, fraud businesses are more likely to meet or surpass analyst expectations and inflate sales than non-fraud enterprises. This research adds to the growing body of work on both fraud exposure and earnings control, and it should prove useful to both practitioners and regulators in their pursuit of ever more accurate methods of spotting fraud.

CONCLUSION/IMPLICATION

Managers may engage in earnings management (1) when they have leeway to make accounting or operating decisions, or (2) when they are attempting to communicate confidential information to users of financial statements. Those who relyon financial reports need to know which method is being used and why that matters. Earnings management, on the other hand, makes a firm appear better than it really is, which can lead to disappointment for the individual investor and, in the worst case, a loss of societal welfare due to misdirected resource allocation. It is hypothesized that raising investors' level of awareness about the prevalence of profits management would lead to better investment decisions and greater social welfare. If standard-setters can identify areas where earnings management is widespread and has a material impact on profits and resource allocation, they might investigate measures to tighten existing accounting rules and increase disclosure requirements to improve financial reporting. When earnings management does occur, but is uncommon and has a little impact on resource allocation, there is less of a need to alter financial reporting standards.

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