Sylwia Czakowska, Kujawy and Pomorze University in Bydgoszcz, Institute of Economics, Department of Finance and Accounting, Toruńska 55-57, 85-023 Bydgoszcz, e-mail: s.czakowska@kpsw.edu.pl, ORCID: https://orcid.org/0000-0003-3956-8966

Earnings management versus fraud

1. Introduction

Economic crises, caused, among other things, by various disasters and pandemics, as well as recession experienced by a number of sectors and deterioration of financial situation and profitability of enterprises are compelling reasons for management boards of certain entities to undertake actions aimed at managing their earnings so that they achieve the desired level by way of influencing the amounts of revenues and expenses, as well their distribution over time (Kuzior 2011, p. 175). Consequently, financial statements present financial data which is expected by management, and which can be used to influence stakeholders and motivate them to undertake specific actions. The English-language literature on the subject defines this phenomenon as earnings management.

It should be highlighted that because of the growth in importance of information generated by financial reporting as regards decision usefulness, and spectacular accounting frauds committed by management boards of American companies, resulting in their collapse at the beginning of the 21st century, earnings management is one of the major areas of research in contemporary accounting (Kamela-Sowińska 2003, p. 4; Piosik 2016, p. 9).

An analysis of the literature on the subject induces us to propose a research hypothesis that the compliance of actions undertaken as part of earnings management with the applicable legal regulations in the field of accounting and with the accounting policy adopted by an entity makes it possible to distinguish earnings management from fraud. The main objective of the article is to indicate differences between earnings management and fraud. The achievement of research objectives is presented as part of three items below. The article describes the essence of earnings management and provides a definition of this phenomenon. Fraud and earnings management are characterised from the viewpoint of legal regulations related to auditing, and the relationship between fraud and earnings management is revealed.

The research methods applied are based on a critical analysis of the literature on the subject, both in Polish and English, a comparative analysis of legal acts and the method of inductive reasoning.

2. Earnings management as an intentional and lawful action of the management board

Financial statements are an important source of information about a given entity's financial standing and economic position, as well as its earnings, which information is essential for assessment of this entity's activity and determines investment decisions (Remlein 2015, p. 150). A significant element of financial statements are earnings, which prove the effectiveness of an entity's activities. Hence, the desire of management boards to improve their entities' results, for which purpose they sometimes take advantage of earnings management (Emerling 2016, p. 23-24).

Earnings management is a complex and multi-dimensional phenomenon, which is difficult to measure. As a result, it is variously perceived and defined by theoreticians, practitioners and accounting regulators (Callao, Jarne and Wróblewski 2014, p. 135-136).

K. Schipper (1989, p. 92) defines earnings management as a planned intervention of management in the process of preparing financial statements with the aim of obtaining certain personal benefits, which intervention interferes with the neutral course of this process. Simultaneously, the author (Schipper 1989, p. 95) emphasizes that the occurrence of earnings management is conditioned by the asymmetry of information between an entity's management and other users of financial statements.

By contrast, according to P.M. Healy and J.M. Wahlen (1999, p. 368-369), earnings management occurs when managers, using appropriately selected and applied methods and estimates, lead to changes in financial statement items and effects of transactions in order to create the right picture of an entity's financial standing and, thereby, misinform some of stakeholders or obtain benefits guaranteed in managerial contracts, the realisation of which depends on the fulfillment of specific conditions provided for in these contracts. Moreover, the authors (Healy and Wahlen 1999, p. 368-369) indicate that, in order to manage earnings to reach the desired level, managers use the following:

- judgment (estimates) in financial reporting - for example, in the case of establishing useful economic life, residual value or asset impairment, and determining pension benefits liabilities,
- the methods available from among the acceptable accounting methods allowed under the applicable accounting regulations - for example, amortisation/ depreciation methods, methods of valuating the balance and issue of inventory,
- structuring of economic transactions with the aim of selecting and designing transactions so that their effects are disclosed in accounting books in the manner planned in advance.

Yet, T.E. McKee (2005, p. 1, after: Kuzior 2011, p. 175) defines earnings management as justified and lawful decisions made by an entity's management board as regards financial reporting with the aim of achieving stable and predictable earnings. Therefore, in the author's (McKee 2005, p. 4, after: Kuzior 2011, p. 175) opinion, earnings managements fails to cover illegal actions violating the applicable law, and an entity's management can manage its earnings by way of:

- selecting specific methods, rules and models described in the accounting standards,
- making appropriate operating decisions.

P. Wójtowicz (2010, p. 83) believes that earnings management is the effect of conscious and planned activity of persons responsible for reporting in an entity, which manifests itself in the choices made in the field of financial reporting and is eventually disclosed in the earnings presented.

By contrast, A. Piosik (2016, p. 22) identifies earnings management with an objective or a set of objectives adopted by an entity's management board and an integrated set of instruments for its or their achievement related to the methods adopted, and, in particular, with accounting estimates (accounting instruments) and the transactions conducted (material instruments), as a consequence of which (short-term) earnings, which are known to management, are not disclosed, but which would have been disclosed in a financial statement if a specific sub-group of objectives and instruments had not been applied. Nevertheless, it should be noted that the author (Piosik 2016, p. 22) accepts that earnings are managed in correspondence with the balance-sheet policy adopted by a given entity, in particular, in the case of accounting instruments, and, therefore, in compliance with the applicable balance-sheet laws.

Interesting observations about earnings management are also made by K. Grabiński (2010, p. 76), according to whom:

- the occurrence in the field of financial reporting of areas which are subject to discretion and require the application of professional judgment and estimates contributes to the emergence of the phenomenon of earnings management,
- the need to apply professional judgment and estimates in financial reporting may be used by an entity's management board to provide external stakeholders with information which, on the one hand, is inside information known to the entity's management only, thereby, resulting in improvement of the financial statement's quality, and which, on the other hand, is false information used to mislead them,
- benefits guaranteed in managerial contracts are significant incentives for managers to achieve the objectives provided for in the contracts and expressed with the values of the reporting items, and to influence the values of these items,
- earnings management may contribute to an increase or decrease in the transparency of financial statements,
- taking advantage of earnings management, an entity's management may influence the behaviour of the present and potential investors,
- earnings management can be perceived in a positive way when it has a favourable influence on an entity's goodwill in the long term, or in a negative way in the case of the management board undertaking opportunistic actions.

In the context of the definitions by different authors presented above, and for the purposes of this article, earnings management can be defined as intentional actions undertaken by an entity's management board, which consist in selecting and applying appropriate methods and estimates, or undertaking actual activities, leading to changes in financial statement items, and, in particular, in the earnings disclosed, in order to present the desired picture of the entity's financial standing and, thereby, misinform some of stakeholders or obtain benefits guaranteed in managerial contracts. However, it should be highlighted that earnings management does not cover illegal actions and, at the same time, is in compliance with the accounting policy adopted by an entity; therefore, it should not be identified with fraud.

3. Fraud and earnings management in legal regulations related to auditing

The term "fraud" denotes consciously misleading a person or using this person's mistake for one's own benefit (Słownik języka polskiego PWN 2020). In turn, the Polish Penal Code (the Act of 6 June, 1997, Art. 286, paragraph 1) defines fraud, in its broad sense, as causing another person to disadvantageously dispose of his own or someone else's property with the purpose of the perpetrator gaining a material benefit by misleading this person, or by taking advantage of a mistake or inability to adequately understand the action undertaken.

Fraud-related provisions and requirements are also included in national and international legal regulations related to auditing, whereby the National Auditing Standard (NAS) 240 in Poland was adopted in the wording of the International Standard on Auditing (ISA) 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"[1]. According to this standard , fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage (ISA 240, paragraph 11a). Therefore, similarly to the Polish Penal Code, ISA 240 presents a wide approach to fraud. However, it should be highlighted that, according to the provisions contained in legal regulations related to auditing, only two types of fraud, resulting in significant distortions in financial statements, are in the area of auditors' interest, and they are (ISA 240, paragraph 3): fraudulent financial reporting and misappropriation of assets.

Fraudulent financial reporting is understood as intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users (ISA 240, paragraph A2). And, misappropriation of assets denotes the theft of an entity's assets and is often perpetrated by employees at various levels within an entity (ISA 240, paragraph A5).

According to ISA 240, fraud causing misstatements in financial statements may consist in (Wąsowski 2010, p. 15-16):

[1]The National Council of Statutory Auditors in Poland, by way of its resolution no. 3430/52a/2019 of 21 March 2019 on auditing standards and other documents, introduced NAS 240 (National Auditing Standard 240) in the wording of ISA 240 issued by the International Auditing and Assurance Standards Board (IAASB).

- manipulation, falsification or alteration of source data or documents based on which financial statements are prepared,
- misrepresentation in or intentional omission from financial statements of events, transactions and other significant information,
- recording fictitious transactions,
- misapplication of accounting principles (policy) relating to amounts, classification, manner of presentation or disclosure,
- misappropriation of assets.

Moreover, this standard pays attention to a peculiar symptom of actions undertaken by an entity's management, that is, earnings management, which is aimed at deceiving financial statement users by influencing their perception of the entity's performance and profitability. In the beginning, earnings management may manifest itself in insignificant actions or inappropriate adjustments of assumptions or changes in judgments made by an entity's management. However, an increasing number of new pressures and incentives may cause an increase in the scale of these actions, and, consequently, lead to fraudulent financial reporting, which consists in an entity's management intentionally and materially misstating the financial statements (ISA 240, paragraph A2). Therefore, it should be emphasized that, according to ISA 240, earnings management may lead to fraudulent financial reporting, which means that it is not identified with fraudulent financial reporting (Wójtowicz 2009, p. 97). This standard also indicates that earnings management may manifest itself in (ISA 240, paragraph A2):

- reducing revenues with the aim of minimising taxes,
- inflating earnings in order to meet market expectations or maximize management compensation depending on an entity's performance, or securing bank financing.

To sum up the above-mentioned considerations, it should be stated that, based on an analysis of legal regulations related to auditing, fraud should not be identified with earnings management. Nevertheless, according to ISA 240, intensification of actions undertaken as part of earnings management, manifesting themselves in operating activities or changes in the previously adopted methods or estimates, may lead to fraudulent financial reporting, which is fraud, being of interest to auditors.

4. Fraud versus earnings management

The above considerations let us conclude that a common feature of earnings management and fraud is intentional action, as both of the cases are about intentional presentation of an intended picture of an entity's financial standing with the aim of misleading financial statement users or realising management's interests. By contrast, the differences between these two phenomena include the scope of departure from the truth, the methods applied and persons responsible (Wójtowicz 2007, p. 36, 2009, p. 97).

Fraud occurs when the actions undertaken by persons responsible for financial reporting in an entity, including the management board, violate the accounting principles and are contrary to the provisions of law (Stolowy and Breton 2004, p. 9; Wójtowicz 2007, p. 37). Yet, earnings management consists in an entity's management undertaking specific actions, both intentionally and regularly, within the framework of legal regulations in the field of accounting and taking account of solutions adopted in the accounting policy (Guan, He and Yang 2006, p. 569, after: Kassem 2012, p. 31; Koumanakos, Siriopoulos and Georgopoulos 2005, p. 663, after: Kassem 2012, p. 31; Wójtowicz 2009, p. 97, 2010, p. 86). Therefore, these are legal actions related to the management board taking advantage of discretion while making estimates (professional judgment) in financial reporting, the opportunities to choose specific methods from among the acceptable accounting methods allowed by the applicable accounting regulations, or the structuring of economic transactions with the aim of achieving the planned profits or specific objectives (Healy and Wahlen 1999, p. 368-369; Jones 2011, p. 7, after: Kassem 2012, p. 31; Stolowy and Breton 2004, p. 11). Hence, in the opinion of the majority of researchers [for example, M.D. Beneish (1999), R.L. Rosner (2003, after: Piosik 2016, p. 20), T.E. McKee (2005, after: Piosik and Strojek-Filus 2013, p. 14), J. Fijałkowska (2006), A. Piosik (2016)], earnings management ends at the moment of departing from or violating accounting principles or standards.

Although the literature on the subject usually distinguishes earnings management from fraud, a number of authors [including the ones mentioned above: P.M. Healy and J.M. Wahlen (1999), M.D. Beneish (2001, after: Piosik 2016, p. 20-21), M.J. Jones (2011, after: Kassem 2012, p. 31)], as well as the above-mentioned legal regulations relating to auditing, indicate that, although actions undertaken by management boards as part of earnings management do not violate the standards and provisions contained in accounting regulations, they can lead to presentation in financial statements of inaccurate and unfair information about an entity's earnings and financial standing, and, consequently, mislead stakeholders, and, in particular, the present and potential investors. Furthermore, in the opinion of M.J. Jones (2011, p. 7, after: Kassem 2012, p. 32), earnings management may in certain circumstances turn into fraud, especially when the actions undertaken by management, including creative accounting[2], fail to bring the desired effects in the form of achieving the planned figures. Therefore, some of the authors, including A. Higson (2003, p. 129, after: Kassem 2012, p. 32), P. Wójtowicz (2010, p. 86), R. Kassem (2012, p. 32) and A. Piosik (2016, p. 22), believe that the bounds enabling distinction between earnings management and fraud are defined by the intentions and motives of management. However, intentions are not quantifiable, and so they are not subject to research (Dechow and Skinner 2000, p. 238; Wójtowicz 2010, p. 86).

To sum up, although their common feature is the consciousness of the actions undertaken, earnings management should not be put on a par with fraud, as fraud is identified with illegal actions that are beyond the scope of actions undertaken as part of earnings management.

5. Summary

Earnings management involves intentional and lawful actions undertaken by an entity's management, aimed at changing the reported figures, and, in particular, the earnings, in order to present the desired picture of the entity's financial standing and economic position, as well as its achievements in financial statements for the purpose of misleading financial statement users or obtaining benefits guaranteed in managerial contracts. This is achieved by way of applying accounting judgment and estimates, changing these estimates, choosing specific methods from among the acceptable accounting methods allowed by the applicable accounting regulations, structuring of economic transactions or undertaking actual activities.

---

[2]Creative accounting consists in taking advantage of the rights to choose, "fields of free action" and legal loopholes in national and international accounting regulations in order to disclose financial data in financial statements so that it provides the most favourable picture of an enterprise (Śnieżek i Wiatr 2011, p. 115, 119).

Having analysed the above-mentioned considerations, it has been established that earnings management should not be identified with fraud. Although a common feature of these two phenomena is the consciousness of action, contrary to fraud, earnings are managed within the framework of legal regulations in the field of accounting and taking account of solutions adopted in the accounting policy of a given entity. However, any abuse in this field, whether it involves departing from or violating the accounting principles or standards, may lead to intentional misstatements in financial statements, that is, fraud in its broad sense.

According to the literature on the subject, earnings management can be distinguished from fraud on the basis of management's intentions and motives. However, it should be noted that intentions are not quantifiable, and so they are not subject to research.

Bibliography

Beneish M.D. (1999), *Incentives and Penalties Related to Earnings Overstatements that Violate GAAP*, „The Accounting Review", vol. 74, no 4, https://doi.org/10.2308/accr.1999.74.4.425.

Callao S., Jarne J.I., Wróblewski D. (2014), *The Development of Earnings Management Research: A Review of Literature from Three Different Perspectives*, „Zeszyty Teoretyczne Rachunkowości", vol. 79, no 135, doi:10.5604/16414381.1133395.

Dechow P.M., Skinner D.J. (2000), *Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulators*, „Accounting Horizons", vol. 14, no 2, https://doi.org/10.2308/acch.2000.14.2.235.

Emerling I. (2016), *Kształtowanie wyniku finansowego przedsiębiorstwa a oszustwa finansowe (Shaping a Company Financial Results versus Financial Fraud)*, „Studia Ekonomiczne. Zeszyty Naukowe Uniwersytetu Ekonomicznego w Katowicach", no 253, https://www.ue.katowice.pl/fileadmin/user_upload/wydawnictwo/SE_Artyku%C5%82y_251_270/SE_253/02.pdf (accesed: 18.10.2020).

Fijałkowska J. (2006), *Zarządzanie zyskiem w warunkach globalizujących się rynków kapitałowych – motywy, techniki i sposoby identyfikowania (Earnings Management in Globalizing Capital Markets – Incentives and Ways of Detection)*, „Zeszyty Teoretyczne Rachunkowości", vol. 35, no 91.

Grabiński K. (2010), *Zarządzanie zyskami jako jeden z kierunków rozwoju pozytywnej teorii rachunkowości (Earnings Management as a Direction in Positive Accounting Theory Development)*, „Zeszyty Teoretyczne Rachunkowości", vol. 56, no 112.

Healy P.M., Wahlen J.M. (1999), *A Review of the Earnings Management Literature and its Implications for Standards*, „Accounting Horizons", vol. 13, no 4, https://doi.org/10.2308/acch.1999.13.4.365.

Kamela-Sowińska A. (2003), *Skąd się wzięła sprawa „Enronu"? (Where did the Enron case come from?)*, „Rachunkowość", no 4.

Kassem R. (2012), *Earnings Management and Financial Reporting Fraud: Can External Auditors Spot the Difference?*, "American Journal of Business and Management", vol. 1, no 1, https://www.researchgate.net/publication/256029162_Earnings_Management_and_Financial_Reporting_Fraud_Can_External_Auditors_Spot_the_Difference (accesed: 18.10.2020).

Kuzior A. (2011), *Wycena operacyjnych aktywów trwałych a możliwości kształtowania zysków bilansowych w jednostkach stosujących MSSF (Possibilities of Earnings Management Based on Tangible and Intangible Fixed Assets Measurement Rules Resulting from IFRS)*, „Zeszyty Naukowe Uniwersytetu Szczecińskiego nr 668. Finanse, Rynki finansowe, Ubezpieczenia", no 41, http://wneiz.pl/nauka_wneiz/frfu/41-2011/FRFU-41-175.pdf (accesed: 18.10.2020).

Piosik A. (2016), *Kształtowanie wyniku finansowego przez podmioty sprawozdawcze w Polsce: diagnoza dobrej i złej praktyki w rachunkowości (Earnings Management by Reporting Entities in Poland: Diagnosis of Good and Bad Practice in Accounting)*, Wydawnictwo Uniwersytetu Ekonomicznego w Katowicach, Katowice.

Piosik A., Strojek-Filus M. (2013), *Procesy kształtowania wyników bilansowych i ich podstawowe cele (Processes of Earnings Management and their Basic Golas)* (in:) *Kształtowanie zysków podmiotów sprawozdawczych w Polsce: MSR/MSSF a Ustawa o rachunkowości (Earinings Management of Reporting Entities in Poland: IAS/IFRS versus the Accounting Act)*, A. Piosik (eds), Wydawnictwo C.H. Beck, Warszawa.

Remlein M. (2015), *Doświadczenia polskich grup kapitałowych w zakresie zintegrowanej sprawozdawczości (The Experience of Polish Corporate Groups in Integrated Reporting)*, „Studia Oeconomica Posnaniensia", vol. 3, no 1, https://bazawiedzy.ue.poznan.pl/info/article/UEP955b39535b1040b8a971be6d4255f191/#.X6sNAsRCeUk (accesed: 18.10.2020).

Schipper K. (1989), *Commentary on Earnings Management*, „Accounting Horizons", vol. 3, no 4, http://connection.ebscohost.com/c/articles/4816073/commentary-earnings-management (accesed: 17.01.2019)

Słownik Języka Polskiego PWN (2020), *Oszustwo*, https://sjp.pwn.pl/szukaj/oszustwo.html (accesed: 18.10.2020).

Stolowy H., Breton G. (2004), *Accounts Manipulation: A Literature Review and Proposed Conceptual Framework*, "Review of Accounting and Finance", vol. 3, no 1, https://doi.org/10.1108/eb043395.

Śnieżek E., Wiatr M. (2011), *Rachunkowość a tendencyjne kreowanie obrazu działalności przedsiębiorstwa (Accounting and Creating a Biased View of Company Activities),* „Prace i Materiały Wydziału Zarządzania Uniwersytetu Gdańskiego", no 1/1.

Krajowy Standard Badania 240 w brzmieniu Międzynarodowego Standardu Badania 240 *Obowiązki biegłego rewidenta podczas badania sprawozdania finansowego dotyczące oszustw (*The National Auditing Standard 240 in the wording of the International Standard on Auditing 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements),* Uchwała nr 3430/52a/2019 Krajowej Rady Biegłych Rewidentów z dnia 21 marca 2019 r. w sprawie standardów badania oraz innych dokumentów, https://www.pibr.org.pl/assets/meta/4138,1.5%20KSB%20240.pdf (accesed: 18.10.2020).

Ustawa z dnia 6 czerwca 1997 r. - Kodeks karny (The Act of 6 June, 1997 - the Penal Code), Dz. U. z 1997 r. nr 88, poz. 553 z późn. zm.

Wąsowski W. (2010), *Kreatywna rachunkowość: fałszowanie sprawozdań finansowych (Creative Accounting: Falsifying Financial Statements),* 2nd ed., Difin, Warszawa.

Wójtowicz P. (2007), *Unikanie ujawniania strat w sprawozdaniach finansowych: wyniki analizy empirycznej (Avoiding the Disclosure of Losses in Financial Reports: The Results of an Empirical Analysis)*, „Zeszyty Naukowe Uniwersytetu Ekonomicznego w Krakowie", no 752, https://r.uek.krakow.pl/bitstream/123456789/2450/1/153761544.pdf (accesed: 18.10.2020).

Wójtowicz P. (2009), *Oszukańcza sprawozdawczość finansowa wobec teorii kontraktów i teorii agencji (Fraudulent Financial Reporting in the Face of Contract Theory and Agency Theory)*, „Zeszyty Naukowe Uniwersytetu Ekonomicznego w Krakowie", no 796, https://r.uek.krakow.pl/bitstream/123456789/2251/1/163970346.pdf (accesed: 18.10.2020).

Wójtowicz P. (2010), *Wiarygodność sprawozdań finansowych wobec aktywnego kształtowania wyniku finansowego (Earnings Management and the Reliability of Financial Statements)*, Wydawnictwo Uniwersytetu Ekonomicznego w Krakowie, Kraków.