Research on Earnings Management under IFRS Framework

Jun Gao

SAP Co., Ltd
williamgao1986[at]sina.com
Full Address: 138, Export Promotion industrial Park, Whitefield Road Whitefield Bangalore, Bangalore, India 560066

Abstract: ***International Financial Reporting Standards (hereinafter referred to as IFRS) which was developed by IASB have made tremendous contributions to the convergence of global accounting standards. IFRS aims at developing one set of transparent and efficient accounting standards to be used for both domestic and cross - border companies to improve financial reporting quality. However, since IFRS is a principles - based approach, it allows more flexibility for management to make decisions (Leuz, C, 2010). Therefore, companies can make earnings management under the current IFRS framework with a variety of motivations, such as tax avoidance. The purpose of the paper is to study the history of IFRS and explain its advantages brought to global capital markets, as well as the issues arising from earnings management, especially for the sake of tax avoidance. Furthermore, the paper will review some justifications for earnings management, and discuss its eligibility under IFRS.***

Keywords: International Financial Reporting Standards; Earning Management; Financial Management; Tax Avoidance

1. History of IFRS

Now that accounting techniques are used by companies to communicate underlying performance to outsiders, it is optimal that accounting standards are globally consistent. With the economic trends toward globalization, cross - border trades occur more frequently and the connection between multinational enterprises across the world becomes stronger. Tweedie, D. (2005) states that the advent of accounting standards convergence and voices of establishing one universal accounting principle is the result of economic globalization, which is an irresistible trend in today's world.

The history of IFRS dates back to as early as 1972. In that year, IASC was founded aiming at promoting accounting standards convergence, and eliminating accounting principal gaps between different countries. After 27 years, IASB, chaired by Mr. Tweedie, was established as a replacement for IASC, and it was composed of fourteen prestigious experts coming from different countries (Zeff, S. A, 2012).

Before IFRS was introduced, USGAAP had been the most widely adopted accounting standard at that time. Since USGAAP is a rules - based approach, it establishes particularly detailed rules for companies to prepare their reporting. Prior to 2000, USGAAP won wide recognition and high praise, because of its high quality and dominance of US market scale and trading. As such, initially, USGAAP was seen as the best option of converged accounting standards towards international accounting harmonization.

On the contrary, IASB tended to establish more flexible and universal accounting standards to be widely used by multinational companies, because it is believed such standards could be more helpful to companies having managerial discretion needs, rather than those in full compliance with it. Rules with too many details would reduce the quality of financial statements. (Tweedie, D., 2005)

As one of the worst accounting scandals, Enron was a wake - up call for the global financial industry and resulted in the speeding up of the IFRS popularization process. As a result, US companies become more receptive to globally converged accounting standards distinct from USGAAP (Zeff, S. A, 2012). With the assistance of professional associations, regulatory authorities, and multinational companies, IASB played a leadership role to move the international accounting harmonization process forward. Shortly thereafter, they established two significant landmarks: Firstly, all European public firms are required by the Council of Europe to implement IFRS after 2004. Secondly, in September 2002, IASB and FASB met together to sign "The Norwalk Agreement", which aimed for removing discrepancies of IFRS and USGAAP and joining together to solve potential problems.

IFRS was widely adopted by European companies on schedule after 2004, which marked an important step forward. Next, Hong Kong and Australian companies started to adopt IFRS in 2006. Over the last couple of years, a growing number of countries and organizations adopted IFRS, or in the process of conversion, including several largest developing countries such as Brazil and China. What is more, world - class financial institutions including IMF and World Bank promote and support countries to use IFRS so as to foster developments in the global economy. (Tarca. A, 2012). Up to 2020, over 140 jurisdictions had implemented IFRS (Nurunnabi, 2020).

2. Advantages of IFRS

The mission of IFRS aims at the convergence of international accounting standards, through the provision of harmonized and high - quality accounting rules, which could contribute to the development of effective financial strategies by management.

From the start, the mission of IFRS announced by IASB is to provide global economic and capital markets with more transparent, accountable, and efficient accounting standards, and commit to working in the public interest, by strengthening and promoting a trustworthy, expanding, sustainable and stable global economic environment. (Ismail, 2018)

Subsequently, scholars have conducted a lot of research since the enforcement of IFRS for the EU and other countries. These documentary studies indicate that the advantages of implementing IFRS could have country - to - country variance, however, it turns out that the global economic environment is benefiting from IFRS eventually. Tarca. A, (2012) summarized advantages of IFRS as producing more transparent and comparable financial reports, as well as reduction of time/labor efforts to release financial reports. IFRS enables stakeholders to make a comparison of operating results from different companies, thus improving asset allocation efficiency and identifying investment opportunities by more effective decision - making. He also discovers that these countries which adopt IFRS have more merge and acquisitions in comparison to those do not adopt it. The reason could be that cost of information for investors abroad is decreased by financial reports with enhanced consistency and comparability. Therefore, geopolitical obstacles are removed to promote cross - border investing activities. According to Leuz, C. (2010), overall economic activities benefit from reduced costs brought by IFRS, because investors can easily have access to companies' financial results and make comparisons with each other under a standardized reporting standards framework. On top of that, IFRS provides a higher level of protection for overseas investors and thus makes it easier and safer for investors abroad to access these countries' financial markets.

3. What is Earnings Management

As the most widely used accounting standard, IFRSis a principle - based approach, so it does not give too many detailed instructions to financial staff or external auditors, therefore, it provides companies with managerial discretion and freedom to affect the financial statements, which poses a problem named earnings management.

Earnings management has been defined by several scholars. Strakova (2006) defined earnings management to be accounting techniques used by managers to produce financial reports that would distort the actual operating results or manipulate the outcome of contracts of their firms. Earnings management is also defined by Sun and Rath (2010) that the management selects and applies some accounting methods to influence financial results, in order to meet predetermined revenue goals.

According to McGregor (2012), there are three types of earnings management: changing accounting principles, manipulating operational results, and related party transactions. Changing accounting principles is associated with selecting favorable financial rules while manipulating operational results is known as activities of deliberately manipulating earnings, and related party transactions are also referred to as fraudulent related parties' activities. Since a firm's net profit is derived from the sum of operating cash flow, noncash expenses, and working capital adjustments, changing accounting principles does not alter cash flows but manipulating operational results does alter cash flows (Weston, 2014). Changing accounting principles change financial results, but it does not influence company operational results. Conversely, manipulating operational results could have more hazards because it can lead to a company losing out on longer - term interests for the sake of short - term gains, for example, by reducing research and development expenses.

The focus of the paper will be on the topic of earnings management utilizing changing accounting principles, on which IFRS has an influence.

According to Teixeira (2005), since both accrual accounting and cash accounting are accepted by IFRS, managers have much flexibility in deciding whether revenue/expense should be recorded on the balance sheet as deferred items, or recorded on the income statement as accrued items, and it will affect the timing and amount to recognize revenue/expense. Since IFRS allows flexible judgment, companies can use their managerial discretion to select the most favorable accounting treatment, such as accrual or deferral, capitalizing, or expensing.

There are several earnings management motivation factors such as a firm's size, leverage, and ROA. The primary motivations are described below (Lenka, 2021):

1) Compensation contract: management with earnings - based compensation is motivated to maximize bonuses, which can drive them towards increased earnings to achieve the lower limit goals specified in the bonus plan, or reduced earnings to the maximum profit level to ensure the growth of their bonus.
2) Tax avoidance: the company could use earnings management to decrease its tax liabilities, in order to maximize their net profit through decreasing their earnings to be taxed.
3) Political factors: manager will implement earnings management to reduce the political costs that the company would incur, for example, management can select accounting policies to defer the revenue from the current year to next year so as to avoid government intervention once the company is thought to make the excessive earnings. It is also likely that companies seek financial assistance and shelter from the government as well.
4) Debt covenant: management is motivated to use earnings management to avoid breach of the debt contract covenant. An example is return on assets ratio, or equity ratio cannot be lower than the benchmark set by creditors. Since some financial ratios are calculated from earnings, companies would revise their earnings upwards in order to comply with the covenant.
5) Management reputation: managers are motivated to manipulate their earnings, in order to meet the pre - defined goals and avoid losing their jobs as a result of managerial failure.
6) Information communication: companies are motivated to use earnings management as a tool to disclose inside information to shareholders, in order to facilitate external parties to predict the future performance of the company.

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Previous research in the same field indicates that earnings management varies from country to country. Edeigba (2016) 's studies demonstrate that cultural diversity influences the application of IFRS because nations of egoism civilization have more earnings management activities than nations of certainty - seeking civilization. Lobo (2014) examined 150 financial statements of various companies and concentrated on financial statement disclosures. His discovery indicates that earnings management with discretion has strong ties with the number of financial report notes because earnings revised upwards require more justifications than earnings revised downwards.

Campbell (2017) examined Hong Kong and Singapore and studied their changes before and after IFRS adoption. The study shows that earnings management activities were not lower after IFRS was implemented, conversely, higher for Hong Kong.

4. Earnings Management and Tax Avoidance

Tax avoidance has no precise definition. In tax law, it is defined to pay the minimum possible amount of taxes in legitimate ways, such as making adjustments in their taxable income but within the legal restrictions of the law. Crabtree (2017) defined tax avoidance as all actions aiming at cutting or delaying tax burden in a broad sense.

Since fiscal revenue mainly comes from taxation, tax avoidance would greatly decrease the government's ability to serve the public. Accordingly, fulfilling tax payment liabilities is the bottom line for socially responsible companies (Dowling, G. R, 2013). Syofyan (2014) states that earnings are managed within the scope, with one side being law and morality while another side being crime and immorality. Thus, tax avoidance is generally considered to be legitimate but immoral, because of lacking a sense of corporate social responsibility. According to Sikka, P. (2015), it is roughly estimated that there is a global annual loss of $450 billion tax income, which would otherwise be spent on supplying medical service, higher education, and alleviating poor population.

Sikka, P. (2015) has a new stand point of tax avoidance, which states that various types of capital are required by the sustainability of the company, including economic capital invested by creditors or shareholders, manpower capital contributed by staff, as well as social capital supported by local authorities. As was expected, every stakeholder seeks rewards from their contributions. More specifically, creditors and shareholders' seek rewards from interests or dividends, staffs seek rewards from wages, and local authority seeks rewards from tax revenue. Hence, tax avoidance would lead to a shift in wealth from the social public towards stockholders.

There are many companies in the Standard & Poor's 500, which paid no income taxes in 2019 while reporting a positive pre - tax profit. Take Level 3 Communications, which reported over $3 billion income tax credit in 2019 though its pre - tax profit was only $283million. They made use of accounting rules to offset income tax with losses in past years and received a bad reputation.

Prior to accepting IFRS, numerous companies in Europe including UK and Germany used a conventional accounting system mainly formed by tax law (Zeff, S. A, 2012). As mentioned above, IFRS aims at providing external parties with helpful reporting to make an investment, instead of meeting the requirements of the tax bureau. Hence, numerous countries retain local accounting standards on tax ledger while implementing IFRS for external reporting, because the tax bureau does not allow flexibility of earnings management provided by IFRS. Accordingly, it results in differences between accounting and tax laws. For example, there are large gaps between India's tax law and accounting standards after Indian companies adopt IFRS (Jain, 2011), which generates the problem of book/tax nonconformity.

Conflicting view points of book/tax nonconformity are inevitable. Supporters said that parallel systems of book and tax enable companies to manipulate reported earnings upwards for shareholders but manipulate taxable earnings downwards simultaneously (Dharmapala, 2009). It will lead to fewer taxes to pay in comparison with earnings reported on the income statement, resulting in decreased tax revenue due to tax avoidance activities. A highly aligned book/tax system would drive management to strike a balance between earnings managed upwards or downwards, thereby mitigating the consequences of book/tax nonconformity. High - quality accounting standards such as IFRS provide the benefit of high book/tax conformity (Dharmapala, 2009). For example, Hong Kong companies plan to adopt IFRS as the first step to reduce book/tax nonconformity.

On the contrary, Okafor (2019) suggests that the implementation of principles - based IFRS will decrease the level of earnings management. He also states that there are differences in the degree of earnings management in firms before and after IFRS, and companies that accept IFRS will take fewer earnings management activities, and they are more likely to avoid taxes after accepting IFRS. Based on the explanation above, Wang, Campbell (2012) discovered that there are differences in the level of earnings management among firms listed on the Chinese Stock Market before and after their fully applying IFRS. Besides, firms of highly aligned book/tax conduct more tax avoidance activities than those with lowly aligned book/tax. The reason is that highly aligned book/tax accounting implies that more book revenue results in more paid taxes that firms want to circumvent. That is, faced with choices of higher reported incomes with higher tax, or higher book/tax alignment but with lower income, the company is more likely to pay less tax by reporting less taxable income.

Zeff, S. A. (2007) states that the completed contract method applied in project accounting rely heavily on managerial judgment. The company will only book income after the construction of the project is finished, because managers prefer to defer income taxes rather than pay it in advance.

Apart from the flexibility provided by IFRS to facilitate companies' earnings management activities, there are indications that IFRS also facilitates those international enterprises' tax avoidance activities as well. These enterprises benchmark their earnings against the average level in the same industry, ensuring that earnings are within reason to avoid potential government intervention. As the most widely used standard, IFRS helps those corporations make comparisons with other companies in the same industry.

Research by Braga (2017) demonstrates that implementing IFRS results in lower tax avoidance than countries accepting country - specific GAAP, especially for those having weak regulatory mechanisms; IFRS offers a robust framework to reduce tax avoidance. This indicates that the regulatory environment determines financial statements' qualities, that is, the stricter laws and regulations, the less tax avoidance.

As was expected, some research reveals that avoiding the tax is not only related to book keeping but also associated with other elements. For example, Teixeira (2005) states that avoiding the tax mirrors the justice of the country's taxation mechanism and how the general public trusts their judicial system and government's credibility. The above viewpoint was additionally backed by Bayar (2018). He examined 40 developing and developed countries and discovered that more companies in incorruptible and democratic countries comply with tax laws and regulations than others. Moreover, as mentioned above, cultural diversity of economic situation, political and social system is playing an important part in accounting policies. For example, companies in those conservative countries prefer prudent policy, resulting in less pre - tax profits. Moreover, the level of tax avoidance is closely related to firm sizes. For instance, Susanti (2017) researched Indonesian companies' tax avoidance activities among SMEs and large companies. The discovery powerfully shows that larger companies conduct lower tax avoidance activities than small and medium companies. The possible reason is that larger firms are audited with higher quality so they are less likely to avoid tax no matter these activities are conducted to increase or decrease their earnings.

5. Justifications for Earnings Management

It is easy for legal authorities to distinguish earnings management from financial statement fraud that is deliberate and deceptive. It is summarized by Dowling, G. R. (2013) that avoiding the tax is not related to moral issues, while the activity of evading tax is thought to be illegal and immoral to society. An example is the financial fraud of WorldCom, which made use of financial standards vulnerability to underreport airline costs by capitalizing rather than expensing and inflating earnings by making false entries. It leads to 30, 000 people losing jobs and $180 billion in investment losses, which is certainly an unlawful act and crime. Such conduct can be categorized as financial statement fraud instead of earnings management.

Earnings management was defended by NING, Y. P. (2009) as rational and legitimate management decisions in order to produce predictable and consistent financial reports.

Dharmapala (2009) argues that because of the principal - agent issue, management is not motivated to maximize stockholder value by means of tax avoidance. However, a performance - based compensation plan which connects with revenues motivates management to use tax avoidance maneuvers and earnings management. Syofyan (2014) researched two earnings management strategies and concluded that downward earnings management by decreasing pretax profits is more adoptable than upward earnings management.

Doupnik (2008) classified earnings management as positive and negative earnings management and states that because of the principal - agent problem, there is information asymmetry that management inside companies possesses greater material knowledge than external parties. Accordingly, management will use earnings management as a tool to convey messages to outsiders, which is a more effective way compared with a general meeting of stockholders or issuing bulletins. Moreover, it does not make sense for managers to declare excessive earnings within a single reporting period while potentially decreasing in the subsequent period. Accordingly, it could be said that management could release underlying performance, and leverage skills to yield expected and trustable reports, in order to communicate their company's long time and sustainable earnings to investors. Furthermore, steadily growing earnings would send out a coherent message that allows shareholders to forecast the company's prospects for the future well. In return, it would add value to investors over the long term while avoiding short - sighted speculations.

Leuz, C. (2010) agreed with the above viewpoint, stating that management maintains information superiority compared with investors, and discretionary judgment enables it to leverage financial knowledge to the results, which could create financial reports with more accuracy and information to deliver companies' operational results to investors. In fact, this is one of the most cost - effective methods to communicate underlying performance to outsiders.

On the other hand, positive earnings management allows the company to avoid things it could not predict, like fixed terms that frequently appear in debt contracts, which provide for finishing predefined goals. Being unable to reach certain targets will lead to severe effects, even threatening the very existence of the company, thereby negatively affecting the investors.

Syofyan (2014) examined past research on earnings management, and cite some practical examples, such as companies' stock prices having a close relationship with smoothing income. Companies in danger present positive stock performance in response to bad debt accrual to reduce earnings, which is considered by shareholders that managers are committed to overcoming challenges. Moreover, companies prefer releasing positive information in the first three quarters, while delaying the announcement of negative things until the fourth quarter, with the purpose of managing excessive incomes to the extent of sustainability. Actually, behaviors to manage earnings are widely adopted, which are used to avoid government intervention if the company is thought to make excessive earnings.

Getting back to the discussion of tax avoidance, because of the accrual principle of IFRS, any accruals with discretion should be reversed at a future time, which results in higher pretax earnings. Consequently, activities of managing earnings could only delay paying their taxes from the current year to future time instead of evading taxes. Thus, it has less detrimental impacts than behaviors of tax evasion, including keeping business off books or hiding money in offshore bank accounts that will lead to real taxation loss.

In summary, the conclusion is that positive earnings management activities benefit financial statements as a whole, only if they are not misused and managerial judgment is exercised properly, namely neither speculatively nor at the cost of the company's long - term development and interests of stakeholders. Positive activities to manage earnings could represent the mission of the company and good prospects for development in the long run. As Okafor (2019) said, the extent of tax avoidance could be mitigated by IFRS because the transparency of reporting and management commentary is useful in disclosing managerial discretion and speculative activities.

6. Conclusion

IFRS has certainly contributed a lot to the economic efficiency of capital markets and thus improve capital allocation by helping firms produce more comparable, transparent, and high - quality financial statements. Moreover, accounting standards convergence has brought advantages of reducing companies' efforts to prepare and audit reports.

Notwithstanding controversy on earnings management for purpose of avoiding tax, there is an argument that as long as companies accountably manage their earnings within reasonable limits, several activities to manage earnings are beneficial and ought to be permitted by IFRS. Thus, positive earnings management is an effective manner to convey companies' underlying performance to outsiders and provide management with discretionary judgment to deal with unpredictable things to come, address and get through the effects of being unable to comply with provisions of the contract. (Syofyan, 2014)

Those who argue in defense of IFRS state that, since IFRS is a principles - based approach instead of a rules - based approach, it is not advisable to impose too many restrictions on financial decisions. Moreover, corporate compliance with the substance of law should be more important than literal words, therefore tax avoidance should be governed by local regulatory authorities rather than IFRS. Of course, these viewpoints are worth further study in the future.

It is generally agreed that tax avoidance is wrong behavior as it increases social cost, so companies must bear the obligation of tax payment, thus facilitating more public services by the government (Dowling, G. R.2013). Reduction of tax avoidance is not just establishing a standardized accounting principle. According to Tweedie, D. (2005), a sound reporting framework should consist of four components: accounting rules, legal supervision, audit function, and monitoring mechanism. In other words, legal authorities should commit to other components besides IFRS to meet the goals of reducing tax avoidance.

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