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**Review Article**

# Earnings Management, Conceptual Framework and Literature Review: Saudi Arabia as a Case Study

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## Abstract

This article provides the conceptual framework for earnings management, which begins by presenting the concept of earnings management, then the actions, motives, techniques, measurement, and then the consequences of this practice. This article also presented studies that dealt with earnings management in the Saudi context. This is because the Kingdom of Saudi Arabia has recently witnessed a clear development in companies and changes in accounting systems which in turn provides an opportunity for more research on earnings management in Saudi Arabia. Several studies provide evidence that EM occurs in Saudi companies, and there are many motivations to practice earnings management in Saudi companies.

**Keywords:** Earnings Management, Measurement, Effect, Saudi Arabia.



## 1. INTRODUCTION

Recently, accounting thought has turned towards an attempt to understand a controversial behavioral practice known as earnings management. This practice appears when there is freedom owned by corporate management to choose between accounting policies and methods that may be exploited by management to affect net earnings either positively or negatively in pursuit of achieving its goals and interests, which are often personal.

To either maximize the company's interests or their interests, managers use earnings management (Juhmani, 2017). Earnings management takes place when managers use discretion in financial reports and structure transactions to change financial reports to either deceive some stakeholders about the company's true economic performance or influence contractual outcomes that depend on reported accounting numbers, as (Healy & Wahlen, 1999) confirm. Furthermore, (Al Shetwi, 2020) makes it clear that as the earnings management scale expands, earnings quality declines, which undermines investors' confidence in financial reporting. Therefore, academia and society at large are quite interested in these activities (Mendes *et al*., 2012).

This chapter will discuss earnings management in detail by elaborating on its concept as perceived by researchers and specialists. Furthermore, the actions of this practice that managers may be engaged in the company. Furthermore, the managers' motives for practicing earnings management. Also, techniques to practice earnings management will be presented based on previous studies. Also, the measurement of this practice by clarifying its models and presenting studies that use these models based on foreign and Saudi contexts. Furthermore, the consequences of this practice. Moreover, studies that dealt with earnings management in the Saudi context are presented in this chapter. Finally, this chapter ends with a summary of the main topics discussed.

### 2. Earnings Management Concept

There are different attitudes among many researchers and specialists regarding the concept of earnings management, as they have defined this phenomenon as follows:

The use of managerial discretion over or within GAAP, accounting alternatives, earnings reporting options, and real economic decisions to affect how underlying economic events are reflected in one or more earnings measurements is known as "earnings management" (Walker, 2013). Earnings management is a practice by company management to influence the earnings contained in the financial statements (CFI)[1]. Earnings management is accrual management, which means using accruals to achieve a pre-determined goal (Goel, 2016). Earnings management is the intentional manipulation of financial statements by managers driven by various purposes (Ruiz, 2016). Earnings management is the management discretion of external financial reports within GAAP, through which some contract deficiencies are exploited, the bounded rationalities of stakeholders, as well as market information asymmetry, by some economic decisions or changing the accounting treatment or other complex methods (El Diri, 2017).

Thus, it is possible to say that using managerial discretion is what earnings management is to consciously change the earnings represented in the financial statements to achieve a specific goal.

## 3. Earnings Management Actions

(Nia *et al*., 2015; Toumeh & Yahya, 2019) suggest, that there are two deliberate activities taken by managers to perform earnings management in the organization as follows:

- **Legitimate Earnings Management:**

Earnings management may be acceptable if managers adhere to the IFRS guidelines (Toumeh & Yahya, 2019). Actions that managers take to reach the target level of reported earnings are acceptable also legitimate. If these actions comply with GAAP requirements, managers should report how their decisions will affect the financial statements (Nia *et al*., 2015).

- **Illegitimate Earnings Management:**

Earnings management could be illegitimate if the managers violate IFRS (Toumeh & Yahya, 2019). Actions that intend to deceive or improperly the company's resources or assets through premature revenue recognition, deferral of expense recognition, also recognition and measurement abuse are financially fraudulent and illegitimate (Nia *et al.*, 2015).

## 4. Earnings Management Motives

According to some researchers (Rahman *et al*., 2013; Arkan, 2015; Nia *et al*., 2015; Jiang, 2020), there are three primary reasons why managers may engage in earnings management in organizations. Which are: contracting motivation, capital market motivation, and regulatory motivation.

[1] Corporate Finance Institute is a financial analyst certification organization that provides training and education online for finance and investment professionals.

- **Contracting Motivation:**

When two parties sign a contract, they fulfill the contract's terms and contents, and the contract's terms and contents also judge it. Therefore, when the terms of the contract relating to the company's earnings, the management will have a motive to manage earnings to ensure that the contract terms of earnings have been completed (Jiang, 2020). Because management bonuses are frequently based on the success of the company, managers have an incentive to control earnings to enhance their compensation contracts. Hence, it is predicted that income will be increased through the use of earnings management (Rahman *et al*., 2013). Contracts between the business and the management, staff, customers, lenders, and suppliers are in place. Based on it, this business seeks to reduce the various contracting expenses (Arkan, 2015). Therefore, managers can be encouraged to control their accounting numbers to avoid these kinds of contracts (Nia *et al*., 2015).

**Capital Market Motivation:**

These motives relate to investor expectations regarding the risk and return associated with the company's performance (Arkan, 2015). So managers have incentives to manipulate earnings to meet financial analysts' expectations and some investors (Jiang, 2020). Because missing an earnings benchmark has negatively impacted returns and CEO compensation (Rahman *et al*., 2013). Therefore, meeting analysts' expectations may be a fundamental earnings goal for companies and may provide managers with strong incentives to use their discretion to over-report earnings (Nia *et al*., 2015).

- **Regulatory Motivations:**

Policies, regulations, and laws in many countries and regions are related to company earnings. Thus, some industries and companies practice earnings management due to the government's regulations, laws, and policies (Jiang, 2020). Compliance with rules relating to accounting ratios and numbers is checked in some industries. In particular, banks and insurance companies are frequently required to have sufficient capital or assets to cover their commitments. For example, banks close to minimum capital requirements tend to practice earnings management to not breach the regulatory requirements (Rahman *et al*., 2013). Because earnings have a strong relationship with taxes, many companies manipulate earnings for tax planning purposes to pay a more economical and appropriate price. Companies that are concerned about antitrust laws have an incentive to report earnings that are lower than they should be (Jiang, 2020). Additionally, businesses that are exposed to political agendas could be motivated by earnings to change how visible they are in politics and the media (Arkan, 2015).

**5. Earnings Management Techniques**

The earnings management techniques in influencing the financial reports are multiple according to the management's objectives, not the company's actual financial performance. Several studies, such as (Rahman *et al*., 2013; Omar *et al*., 2014; Nia *et al*., 2015; Franceschetti, 2018; Toumeh & Yahya, 2019) explain the most common of these techniques as follows:

**1- Cookie Jar Reserve:**

This technique is based on the manager's judgment to overestimate future expenses, hoping that actual future expenses will be less than provisions. Thus, they create a reserve that they can tap into and enhance their future performance (Omar *et al.*, 2014). When looking at the uncertainty in the future, management resorts to estimates. Consequently, it is practiced to manage current and future earnings by overestimating expenses that have been incurred during the current period. If it appears that the actual expenses are less than estimated, the difference can be placed into the "cookie jar" to be used later when the company needs an increase in earnings to meet expectations (Nia *et al*., 2015).

**2- Big Bath:**

This technique is based on the belief that if the management wants to report bad news about losses, it is better to report it in one go and keep it away from it. It is used when the company has some charges or losses, for example, operations restructuring or asset impairment and write-down (Omar *et al*., 2014). One of the earnings management techniques is the "big bath," which is used to clean up the financial position statement and make the company's current-period results appear worse to improve future results (Toumeh & Yahya, 2019).

**3- Big Bet on the Future:**

This technique is frequently used following the acquisition of another company. It involves management judgment in writing off the cost of research and development and incorporating the acquired company's earnings into the parent company's consolidated results (Omar *et al*., 2014). By acquiring another company, the business might use this strategy to secure a future earnings boost (Nia *et al*., 2015).

**4- Flushing the Investment Portfolio:**

The manager can use this approach to manage earnings by timing the sale of securities that have appreciated or depreciated value (Rahman *et al*., 2013). For instance, the company sells securities that contain unrealized gains when it wants to increase its earnings. By contrast, the company sells securities that contain unrealized losses when it wants to reduce its earnings. After that, operating earnings will include any gain or loss from the sale of securities (Nia *et al*., 2015).

**5- Use of Derivatives:**

Because derivatives are financial instruments that derive their values from other assets, managers use them as a technique to manage their earnings by hedging against future business risks such as price changes, fluctuations in exchange rates, and commodity scarcity (Omar *et al*., 2014). Numerous opportunities exist to control earnings with derivatives. For instance, a business that has a sizable number of fixed-rate bonds outstanding might engage in an interest rate swap to turn those fixed-rate bonds into variable-rate bonds. The corporation will track an increase in interest expense for the bonds when the interest rate rises and a drop in interest expense when it falls. The timing option gives managers the chance to manage earnings because the timing of the company's swap is up to the company (Rahman *et al*., 2013).

**6- Early Retirement of Debt:**

Management can conduct earnings management by deciding upon an early debt retirement time. The corporation pays long-term debts like bonds with cash that is paid earlier than the book value. Any profit or loss is added to this period's earnings as an exceptional item at the bottom of the income statement (Rahman *et al*., 2013). To use any gain or loss from early retirement, managers choose an accounting period to retire debt (Omar *et al*., 2014).

**7- Operating Vs. Non-operating Income:**

There are two sorts of earnings: operating earnings, which are anticipated to resume soon, and non-operating earnings, which have no bearing on upcoming earnings and include discontinued operations, unusual gains, and losses (Rahman *et al.*, 2013). Therefore, to identify and report objects that are operating or not operating, this technique requires management's judgment (Omar *et al*., 2014).

**8- Sale/Lease Back:**

This technique includes management decisions on the outright sale of assets to obtain more revenues in specific periods, the sale and leaseback of the same asset to obtain some revenues, and exchanging similar productive assets without recognizing any gain or loss (Omar *et al*., 2014). By selling a long-term asset with unrealized gains or losses, a business can increase the earnings shown on the financial statements (Rahman *et al*., 2013).

**9- Shrink the Ship:**

In this technique, the company buys back its shares without reporting losses or gains in its financial data. The main goal of this technique, in most cases, is to increase the company’s earnings per share (Omar *et al*., 2014). Although this technique doesn't affect earnings, it does impact earnings per share (Rahman *et al*., 2013).

**10- Depreciation, Amortization, and Depletion:**

Management must exercise discretion when using this technique to determine the depreciation method. For instance, balance reducing and straight-line approaches to choosing an asset's usable life, also estimate the salvage values (Franceschetti, 2018; Omar *et al*., 2014).

**11- Throw Out a Problem Child**

In this technique, the manager's judgment includes disposing of a subsidiary company when a less-or non-performing subsidiary company drags down the group's earnings. To save or improve the financial results of the group (Omar *et al*., 2014). Earnings can be handled by selling the subsidiary, spinning it off, and exchanging the shares for one in an equity method subsidiary. Therefore, a gain or loss is disclosed in the statement for the current period when a subsidiary is sold. By trading or sharing a subsidiary's shares with current shareholders, the problem child becomes their property. Additionally, it is feasible to exchange the shares of a subsidiary using the equity method without recording a gain or loss (Rahman *et al*., 2013).

**12- Introducing New Standards:**

A new accounting standard must be adopted every two to three years. Consequently, voluntary early adoption may present a chance to engage in earnings management (Rahman *et al*., 2013). The financial statement components are impacted by the application of IFRS, which could alter the reported earnings. Therefore, through the early or late application of these standards, managers maybe practice legitimate earnings management (Toumeh & Yahya, 2019).

**6. Measurement of earnings management**

Earnings management comes in two types. The first type is known as accrual earnings management, and it is characterized by the utilization of the financial statements accrual aspects at its discretion (Fallatah, 2021). With no immediate impact on cash flow, management manipulates accruals to engage in earnings management (Oraby, 2017). Total accruals and non-discretionary accruals must first be determined, followed by a subtraction to yield the discretionary accruals. The non-discretionary accruals can be estimated using a variety of models. The following are the most popular models of this type:

- **Jones Model:**

The model put out by Jones (1991) relaxes the notion that non-discretionary accruals are constant. To try to control how non-discretionary accruals are affected by changes in a company's financial situation. The following is how Jones (1991)'s non-discretionary accruals operate:

$$NDA_{it} = \alpha_1(1/A_{it-1}) + \alpha_2[\Delta REV_{it}/A_{it-1}] + \alpha_3[PPE_{it}/A_{it-1}]$$

Where: ΔREVit = change in revenue for the company i in year t, PPEit = plant, propriety, and equipment for the company i in year t, Ait-1= total assets for the company i at the end of year t-1.

Studies that use the Jones Model (1991) (Mohammad & Wasiuzzaman, 2019), use this model by applying it to Malaysian companies from 2004 to 2009. To examine how board diversity, family ownership, and audit committee independence affect earnings management. Then find a beneficial relationship between the independence of the audit committee and earnings management. Additionally, there are important moderators and influences for family ownership of the relationship between independent directors and earnings management. There is no discernible moderating relationship between ethnicity and earnings management in contracts. Additionally, the association between ethnicity and earnings management is not significantly moderated by family ownership. Additionally, this model was applied to the Saudi Stock Exchange in 2018 by Malo-Alain *et al*., (2019). They use discretionary accruals as a proxy for financial report quality to evaluate the impact of accounting disclosure of sustainable development on that quality. The accounting disclosure of sustainable development and discretionary accruals should then be seen to be significantly and negatively correlated.

- **Modified Jones model:**

Dechow *et al*., (1995) advise altering the variables by including the change in receivables in the equation to improve the original Jones model's parameters. Applying this modification will lessen the measurement error of discretionary accruals. They discover that this model offers a more reliable test for earnings management. According to Dechow et al. (1995), non-discretionary accruals operate as follows:

$$NDA_{it} = \alpha_1(1/A_{it-1}) + \alpha_2\,[(\Delta REV_{it} - \Delta REC_t)/A_{it-1}] + \alpha_3\,[PPE_t/A_{it-1}]$$

Where: ΔREVit = change in revenue for the company i in year t, ΔRECit = change in a net receivable for the company i in year t, PPEit = plant, propriety, and equipment for the company i in year t, Ait-1= total assets for the company i at the end of year t-1.

Studies that use the modified Jones model (1995) (Mishra & Malhotra, 2016), use this model by applying it to Indian companies from 2013 to 2015. To study the audit committees' effectiveness in restricting earnings management practices. Then find a negative impact of the size, meetings, and multiple directorships of the audit committee on earnings management. At the same time, independence and expertise have no significant impact on earnings management practices. Moreover, Alareeni (2018) uses this model by applying it to GCC countries from 2010 to 2015 to study the effect of companies' specific characteristics on EM practices. Then, it concludes a company size and leverage in GCC countries have an insignificant impact on EM, while company losses affect EM for GCC countries except for Bahrain.

- **Performance-Matching Model:**

The performance-matching model is a new one that Kothari *et al.*, (2005) introduce for measuring earnings management. By accounting for a company's operating performance, they create the Jones model and the modified Jones model. The rate of return on assets is an addition to this model that can have an effect on the DA measurement. According to Kothari et al. (2005), the non-discretionary accruals function as follows:

$$NDA_{it} = \alpha_1(1/A_{it-1}) + \alpha_2[(\Delta REV_{it} - \Delta REC_{it})/A_{it-1}] + \alpha_3[PPE_t/A_{it-1}] + \alpha_4 ROA_{it-1}$$

Where: ΔREVit = change in revenue for the company i in year t, ΔRECit = change in a net receivable for the company i in year t, PPEit = plant, propriety, and equipment for the company i in year t, ROA it-1= return on assets for the company i in year t-1 (net income divided by lagged total assets), Ait-1= total assets for the company i at the end of year t-1.

Selahudin *et al.*, (2018) use this model by applying it to Malaysian companies from 2015 to 2016 to research how the characteristics of the audit committee, the audit quality, and female directors affect earnings management. Then find a strong inverse association between female directors and earnings management. Contrary, there is no meaningful connection between (audit quality, AC competencies, AC meetings, AC size) and earnings management. Also, Habbash & Alghamdi (2017) use this model by applying it to non-financial Saudi listed firms from 2006 to 2009. To ascertain whether there are any meaningful connections between audit quality and earnings management. They look at five different factors that affect audit quality: the size of the auditor, the auditor's opinion, the auditor's industry specialization, the auditor's change, and the timeliness of the auditor's report. The only factor limiting EM practice, you will then discover, is the auditor's opinion.

Real earnings management, the second type, entails modifications to regular operational tasks (Fallatah, 2021). By altering actual activities with clear cash flow implications, management practices earnings management (Oraby, 2017). The following is the most popular model for this type:

- **Roychowdhury Model**

Roychowdhury (2006) develops a model consisting of three components: cash flow from operations, production costs, and discretionary expenses. This model by (Roychowdhury, 2006) works as follows:

1- Cash Flow from Operations:

$$CFOt/At-1 = \alpha_0 + \alpha_1(1/At-1) + \beta_1(St/At-1) + \beta_2(\Delta St/At-1) + \varepsilon_t$$

2- Production Costs:

$$PRODt/At-1 = \alpha_0 + \alpha_1(1/At-1) + \beta_1(St/At-1) + \beta_2(\Delta St/At-1) + \beta_3(\Delta\, St-1/At-1) + \varepsilon_t$$

3- Discretionary Expenses:

$$DISEXPt/At-1 = \alpha_0 + \alpha_1(1/At-1) + \beta_1(St/At-1) + \varepsilon_t$$

Where: CFOt = cash flow from operations in year t, PRODt = production costs in year t, DISEXP$t$ = discretionary expenses in year t, At: a total asset in year t, ΔSt: sales change in year t, $\varepsilon_t$ = regression residual.

Sanjaya & Jati (2015) use this model by applying it to the Indonesian manufacturing sector between 2007 and 2011. To research the effects of gender, age, and educational level of AC on real activity manipulation. Then you discover that every audit committee attribute has no bearing on real activity manipulation. Additionally, from 2012 to 2016, this model was used by Oraby (2017) to analyze Saudi listed firms. To research how earnings management strategies affect the accounting information relevance. It is found that the accrual earnings management has not of value relevance because it has no impact on share prices. In contrast, the real earnings management is statistically significant and also of value relevance.

## 7. Consequences of Earnings Management

Although the corporation gains from profit management in the near term, it causes serious issues over the long run that has an impact on this company and other associated parties. According to Nia *et al.*, (2015), the effect of profit management is harmful to businesses when managers utilize it opportunistically for their interests rather than stockholders'. Furthermore, Rodriguez-Ariza *et al.*, (2016) demonstrate that discretionary earnings management techniques harm corporate reputation. Not only on economic and financial considerations but also on stakeholder and market views. Furthermore, Ruiz (2016) explains that earnings management has a negative impact on stakeholders and regulators. As a result, investors and auditors must proceed with caution when analyzing information derived from potentially falsified financial statements. Furthermore, both investors and the board of directors should be aware of managers' opportunistic behavior.

## 8. Earnings Management in Saudi Arabia

In Saudi Arabia, from 2015 to 2016, Habbas & Haddad (2019) investigated the connection between corporate social responsibility and earnings management in Saudi listed companies. Then find a significant and positive relationship between earnings management and corporate social responsibility. Habbash & Alghamdi (2015) look into the drivers behind the management of earnings in Saudi listed companies. Then identify the four primary reasons why managers control earnings: to raise compensation levels; to secure a bank loan; to report reasonable earnings and minimize losses, and to raise stock prices. Habbash & Alghamdi (2017) examine the relationship between audit quality and earnings management in Saudi listed firms from 2006 to 2009 to see if any relationships are significant. The only factor limiting EM practice, you will then discover, is the auditor's opinion. On the other hand, the auditor's size, industry specialization, tenure, and timeliness of reports have no impact. Fallatah (2021) investigates the impact of the independent board of directors on EM in Saudi Arabian banks between 2010 and 2019. They then discover that a director's independence has no impact on earning management. Al Shetwi (2020) examines the effects of IPO events, company size, and leverage on EM in Saudi listed companies in 2015. Then find that company size significantly negatively affects EM, while leverage and IPO events do not affect EM. El-Halaby & Ragab (2018) look at the relationship between CSR and EM in Gulf Cooperation Council Islamic banks from 2012 to 2016. Afterward, you won't discover any connection between corporate social responsibility and EM.

The relationship between earnings management and the relative value relevance of book value and earnings in Saudi listed firms from 2014 to 2018 is examined by (Al-Shattarat, 2021). Then discover that, for the long-term compared to the short-term, earnings management has an impact on the value relevance of book value and earnings. In Saudi listed firms between 2005 and 2007, the relationship between the political process and earnings management was examined by (Al-Moghaiwli, 2010). Then, identify the managers in those major companies with a high percentage of foreign workers who manage profits to prevent potential political costs. The impact of accounting disclosure of sustainable development on the caliber of financial reports in Saudi listed firms in 2018 is measured by (Malo-Alain *et al*., 2019). They use DA as a stand-in for financial report quality. The accounting disclosure of sustainable development should thus be seen to have a significant negative association with DA. Alareeni (2018) investigates how EM in GCC nations changed as a result of company-specific features between 2010 and 2015. The size and leverage of GCC corporations have an insignificant effect on EM, and company losses influence EM for all GCC nations except Bahrain. From 2001 to 2004, Asehaly (2006) looked at EM practices in Saudi listed firms. Then discover that EM happens in businesses and that EM behavior varies depending on the industry type.

Zainuldin & Lui (2018) investigate the practice of earnings management also the impact of the ownership structure on EM of Islamic and conventional banks in emerging nations, including Saudi Arabia, from 2006 to 2011. They discover that Islamic banks engage in more earnings management than conventional banks and that high ownership concentration exacerbates these activities. The impact of profit management methods on the relevance of accounting information in Saudi listed businesses from 2012 to 2016 is examined by Oraby (2017). It is found that the accrual earnings management technique has no value relevance because it has no impact on share prices. In contrast, the real earnings management plan is statistically significant and of value relevance. Amin & Amin (2015) investigate how accounting standards have affected earnings management in several Middle Eastern nations, including Saudi Arabia, between 1996 and 2010. Then, in all the chosen Middle Eastern countries, they discovered a strong negative association between accounting standards and earnings management. Alshetwi (2016) examines the effect of members' multiple directorships and ownership of AC on EM in Saudi listed companies for 2013. Then find that the multiple directorships of AC are not statistically associated with reducing the level of EM. In contrast, ownership of AC is significantly related to reducing the level of EM.

## 9. CONCLUSION

Finally, it is clear from the above that earnings management is the use of managerial discretion to intentionally influence the earnings contained in the financial statements, intending to achieve a pre-determined goal. This practice is either legitimate if these actions are within the GAAP or illegitimate if these actions intend to deceive or misuse the company's resources or assets, which means they violate the GAAP. The management has many motives for practicing earnings management, which is: contracting motivation, capital market motivation, and regulatory motivation. Until it achieves its goal, it has many techniques to practice this phenomenon, which summarized 12 techniques based on previous studies. There are various models for calculating earnings management. But the most common of these models are the Jones model, the modified Jones model, and the performance-matching model that is based on accrual earnings management. At the same time, the Roychowdhury model is based on real earnings management. Even though the practice of earnings management benefits the company in the short term, it leads in the long term to much damage to companies and other parties associated with these companies.

This chapter ends by presenting studies that deal with earnings management in the Saudi context. Some studies take this practice and correlate it with different variables, which are: corporate social responsibility, audit quality, and the independent board of directors. IPO events, company size and leverage, the relative value relevance of book value and earnings, and sustainable development accounting disclosure. Moreover, the audit committee, companies' specific characteristics, accounting information relevance, ownership structure, accounting standards, and political process. These studies reveal mixed findings concerning the relationship between investigation issues and earnings management. Moreover, other studies look at this practice only. One of them investigated EM practices in Saudi listed companies and found that EM occurs in companies. And the other investigates the motivations of earnings management in Saudi listed companies and finds four main motivations, which are: to increase remuneration amount; obtain a loan from a bank; report reasonable earnings and avoid losses; and increase share price. Finally, the essential recommendation based on previous studies is (Habbash & Alghamdi, 2015) which recommends CMA find solutions to mitigate earnings management motivations.

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