Tékhne — Review of Applied Management Studies (2012) **10**, 3-14

Tékhne

www.elsevier.pt/tekhne

ARTICLE

Evidence of earnings management using accruals as a measure of accounting discretion

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Received 21 September 2011; accepted 20 March 2012

KEYWORDS
Earnings management;
Income smoothing;
Accruals

Abstract A major concern in financial reporting is the extent to which managers engage in earnings management. This paper analyses a specific strategy of earnings management, income smoothing, whose purpose is to reduce income variability over time and it is mentioned in the literature as a rational behaviour that allows accomplishing several purposes in the long term. The aim of this paper is to identify income smoothing practices in a sample of companies listed on the Euronext Lisbon, gathered from SABI database, over a five-year period (2001-2005). The methodology employed, common among Anglo-Saxon studies, differs considerably from those that have been used in Portugal to analyse such practices. It consists of computing several income smoothing measures that use accruals as an earnings management instrument, some of them requiring the estimation of accruals models to obtain its discretionary component. Since this is a preliminary study, these measures were only applied to a particular activity sector — the construction sector. The results of this study provide some insight on the accounting nature of income smoothing, particularly on the use of accruals to report earnings with an artificially reduced variability.

1. Introduction

The presence of information asymmetries between management and third parties relating to the company creates the need for a measure that is able to summarize the activity of the company, which may be used, among other purposes, to assess the management's action or as a source of information about the company's ability to generate future cash flows. The accounting income is, in fact, the most commonly used variable as such summary measure. Income is used, for example, as a reference to set the management's variable remuneration, to analyse the

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situation of the company by creditors or to make purchasing and/or selling decisions by investors.

However, users of financial information that use the accounting income as a basis for decision making are faced with a magnitude that is easily manipulated, given the flexibility inherent to accounting standards, in considering diverse options to reflect on a particular event, or the need to make certain estimates, aspect that has some underlying subjectivity and uncertainty, and that opens, also, the way to manipulation. In fact, literature (*e.g.*, Fern et al., 1994) usually acknowledges that companies are encouraged to select accounting policies, in the latitude allowed by accounting standards and generally accepted accounting principles, which closely reflect their reporting needs, so published earnings and the financial position of the companies are, to some extent, the result of discretionary choices. The fact is that, if financial statements reflect a desired image by management, it represents a serious problem for the many users that make their decisions based on the information produced by the accounting system.

These aspects, combined with the spiral of financial scandals that, with cases such as the Italian multinational Parmalat, do not seem restricted to the North American context, triggered a great interest in earnings management practices, not only in academia but in society in general, being one of the lines of accounting research to which much attention has been devoted in recent decades.[1]

According to the literature (*e.g.*, Monterrey, 1998; Albornoz, 2003), it is possible to identify three earnings management strategies:

— Aggressive accounting policies, aimed at improving income;
— Conservative accounting policies, aimed at reducing income; and
— Income smoothing policies, aimed at increasing income in some fiscal exercises and at decreasing it in others, in order to minimize its long-term fluctuations.

According to Albornoz (2003), research carried out within the scope of the first two strategies focuses, generally, on very specific business circumstances that generate incentives for management to change the reported income, either in ascending or descending direction, as are the cases of the change of management bodies, processes such as acquisitions or mergers, takeovers, etc. (*e.g.*, Porciau, 1993; Perry & Williams, 1994; Teoh et al., 1998). When that does not occur, that is, when the company does not go through special circumstances that force management to adopt accounting policies that increase or reduce income in a continuous basis, the third strategy set out, income smoothing, seems more rational on the long-term (Chaney et al., 1998). Thus, unlike the other hypotheses of earnings management, income smoothing is a general strategy that can be tested in samples of heterogeneous companies, without requiring the presence of strong incentives to manipulate in a specific direction, being, therefore, the study object of the present paper.

Generally, to smooth income, managers create “reserves” in periods of good performance, in order to use them to increase earnings in periods of poor performance, making, hence, the reported earnings actually less variable than the true company’s economic performance (Leuz et al., 2003). Managers can use both accruals[2] and cash flows for income smoothing purposes. However, given the high costs resulting from cash flows manipulation, and since their manipulation is much more visible than the accruals manipulation, it is expected that managers prefer to use accruals to normalize the reported earnings series (Peasnell et al., 2000). Furthermore, from the researcher’s standpoint, the use of accruals as an accounting manipulation instrument offers the advantage of aggregating in a single figure the net effect on income of numerous accounting policies (Healy, 1985; Watts & Zimmerman, 1990). Thus, measures based on accruals are currently widely adopted in the test of earnings management hypotheses, among which is the hypothesis of income smoothing (*e.g.*, Tucker & Zarowin, 2006; Myers et al., 2007; Huang et al., 2009; Athanasakou et al., 2010).

Therefore, the aim of this paper is to identify income smoothing practices using accruals as an accounting manipulation instrument, within the scope of a sample of companies listed on Euronext Lisbon, as a result of: (i) firstly, the widespread adoption of smoothing measures which focus on accruals as a potential instrument available to the discretion of those responsible for preparing the financial statements; and (ii) secondly, the fact that research conducted in Portugal on income smoothing, in particular Ferreira et al. (2003) and Mendes & Rodrigues (2006), uses only smoothing measures based on the work of Ronan & Sadan (1981) and Iñiguez & Poveda (2004),[3] respectively, which shows the relevance of assessing whether the previous evidence remains using alternative methodologies. It is, thus, to the best of our knowledge, the first approach in our country to this issue from this

1. Schipper (1989), Healy & Wahlen (1999), among others, define earnings management as any practice undertaken deliberately by management to alter reported earnings, with the purpose of obtaining some specific gain. However, it should be stressed that, when performing these practices, there is not necessarily an intention to “mislead” on the part of the management. Indeed, there are two perspectives about the earnings management practices: one efficient and other opportunistic. On the one hand, when management uses discretion to provide information to the market on its expectations about the future of the company, such discretion is seen as something positive (efficient manipulation) (*e.g.*, Ronen & Sadan, 1981; Chaney & Lewis, 1995; Tucker & Zarowin, 2006; Cahan et al., 2008). On the other hand, if the management’s incentives to develop these practices aims at achieving individual goals, at the expense of other parties related to the company, such as shareholders or creditors, the discretion is perceived negatively (opportunistic manipulation) (*e.g.*, Bhattacharya et al., 2003; Leuz et al., 2003).

2. The term “accruals” corresponds to the earnings’ component that does not generate cash flows (see section 2.3).

3. Ronen & Sadan (1981) propose linear regression analyzes to determine intertemporal and classificatory smoothing. Iñiguez & Poveda (2004) propose an income smoothing index, based on the calculation of coefficients of variation, in line with the Eckel’s (1981) initial proposal.