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Earnings Management during Crisis Periods: Motivations, Ethical Challenges, and the Role of Regulatory Oversight

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INTRODUCTION

Crisis periods, such as pandemics, natural disasters, and financial crises, influence firms' actions leading to adverse economic firms. A notable outcome of crisis periods for firms is financial distress, which might incentivize managers to engage in earnings management (EM) (Rueangsuwan & Jevasuwan 2022). Earnings management entails managers exercising judgment when structuring transactions and reporting financial statements in order to mislead stakeholders regarding the firm's economic performance or influence the outcomes of contracts that are tied to accounting information (Beneish 2001). During crises, managers engage in EM due to capital market and contractual motivations. Regulators can prevent EM through strengthening internal controls, corporate governance, and enforcement of rules and regulations.

Financial analysts and investors use accounting information to assess the value of stocks, which can incentivize managers to undertake EM in order to influence the performance of their stock price. Often, EM to influence stock price occurs in periods when the performance of the firm is not consistent with the expectations of investors and analysis (Beneish 2001). During crisis periods, firms experience significant financial distress, which serves as a strong incentive for managers to manipulate earnings in order to mislead stakeholders about the firm's performance. When firms experience financial trouble during crisis periods, their earnings may not meet the expectations of investors, which would lead to a decrease in their firm value and stock price (Hu, Weng & Wang 2021). The overall inference is that crisis periods lead to financial distress; hence, managers have an incentive to mask the declining performance and boost the confidence of stakeholders in the firm using EM.

Contracting Motivations

Accounting information is used for monitoring and regulating contractual agreements between the firm and its stakeholders, such as lenders and employees. One area where the management can be incentivized to undertake EM is compensation contracts. Managers may be incentivized to increased earnings, especially if compensation is tied to reported earnings, such as salary increases and annual bonuses. For instance, Healy and Wahlen (1999) reported that managers are likely to defer income if the earnings targets specified in the bonus plan are not in the present financial year; they may defer income to a financial year when they are entitled to receive the maximum permitted bonuses. During crisis periods, managers can defer earnings to future years in order to obtain maximum compensation when the firm is performing optimally. In addition, Healy and Wahlen (1999) showed that income-deferring accruals are more likely to occur in firms having bonus caps after the bonus is attained compared to those that do not have bonus caps. Therefore, managers can lower reported income in order to increase their compensation in future. Moreover, EM is more common during periods when the job security of the top manager is being threatened, such as during crisis periods (Healy & Wahlen 1999). As a result, managers might be incentivized to manage earnings to mask their performance.

Lending contracts also create incentives for managers to adopt EM practices. Lending contracts are designed to ensure that management's actions do not benefit stockholders at the expense of creditors. Lenders use accounting data to regulate the activities of a firm, such as requiring specific performance objectives or posing limits in a firm's financial activities (Beneish 2001). However, debt covenants can encourage managers to undertake EM to either boost their earnings with the goal of reducing accounting restrictions from lenders or mitigate the costs associated with violating the covenant (Roychowdhury 2006). Research shows that EM is more prevalent in firms that are on the verge of violating their debt covenants compared to those that are not (Healy & Wahlen 1999). Firms that are close to violating their debt contracts are likely to engage in income-smoothing EM in order to negotiate for debt restructuring since debt agreements are often tied to earnings (Healy & Wahlen 1999). Firms are more likely to violate their debt covenants during crisis periods because of financial distress; thus, they may embark on EM as a way of mitigating these violations. Alternatively, some firms might adopt income-increasing EM as an approach to mitigate accounting restrictions from lenders – these firms revise their earnings upwards to show lenders that they are complying with the debt agreement in order to avoid the lender from taking actions, such as increasing the interest rate, demanding additional financial security, or calling for asset liquidation (Hu, Weng & Wang 2021). During crisis periods, the financial distress experiencing financial difficulties might adopt income-increasing EM in order to increase their odds of accessing debt financing. By avoiding losses through EM, these firms can get the needed support from investors and lenders to navigate a crisis period (Li et al. 2020).

Role of Regulators in Mitigating EM Practices

Regulators can mitigate EM through adopting regulations aimed at strengthening internal controls. Internal controls refer to auditing and accounting processes adopted to enhance the integrity and quality of financial reporting. Internal controls became an important component of corporate governance following the wave accounting scandals that occurred in the early 2000s (Hu, Weng & Wang 2021). Internal controls can be preventive, detective or corrective. Preventive controls, such as segregating accounting duties and access control, can prevent EM. Detective controls, such as internal audits and reconciliation of financial statements, can be used to spot EM after they have occurred (Taylor, Awuye & Cudjoe 2023). Corrective controls take the form of disciplinary actions against those found to engage in EM. Effective internal control systems lessen the deliberate manipulation of financial statements and diminish the risks of random estimation errors, which subsequently increase the accuracy of accounting records. The overall outcome is improved quality of accrual based earnings. In addition, stronger internal controls ensure proper allocation of internal capital, which makes it difficult for managers to engage in real EM (Walker 2013). Consequently, internal control regulations are being adopted across various countries, including Japan, Australia, Canada, the UK, France, and Germany. For instance, in the US, the Sarbanes-Oxley Act of 2002 was adopted to enhance the reliability and accuracy of financial statements (Hu, Weng & Wang 2021).

This legislation was instrumental in improving corporate governance by requiring auditors and managers to improve and report the effectiveness of internal control mechanisms. The adoption of SOX had resulted in improvements in financial reporting quality. Using evidence from French companies, Boulhaga, Bouri and Elbardan (2022) demonstrated that weak internal controls were associated with real EM; thus, the authors concluded that strong internal controls lessen accrual-based EM and enhances financial reporting reliability. Li et al. (2020) also reported that internal controls moderate the relationship between financial distress and EM by suppressing real and accrual EM behaviors. Taken together, regulations to strengthen internal controls can help enhance the quality of financial reporting.

Additionally, regulators can mitigate EM by strengthening corporate governance in firms, especially with respect to oversight over managements' activities by the board and the audit committee. An independent board is an effective corporate governance mechanism that can be used to safeguard the interests of shareholders and monitor the management (Chatterjee 2020; Sanad, Shiwakoti & Kukreja 2019). Board independence can improve managerial responsibility and transparency. Evidence points to a negative relationship between the degree of board independence and the occurrence of EM using discretionary accounting accruals (Ferris & Liao 2019). Audit committees also monitor management's activities in order to ensure corporate accountability and reliable and quality financial reporting (Sanad, Shiwakoti & Kukreja 2019). The independence of the audit committee has been reported to reduce the occurrence of EM.

Regulators can mitigate EM through intensifying the enforcement of regulations. According to Oz and Yelkenci (2018), the effect of internal control regulations can be realized if they are accompanied with enforcement and compliance. Oz and Yelkenci (2018) reported the positive effect of enforcement intensity on reducing opportunistic EM. Enforcement plays a key role in enhancing the quality of financial reporting. Enforcement enhances compliance with regulations and rules on internal controls, corporate governance and audits (Krishnan & Zhang 2019). Without proper enforcement, financial reporting processes can deteriorate because of inconstant implementation of regulations (Oz & Yelkenci 2018). Overall, complying with internal control regulations can help firms maintain and strengthen effective controls, which in turn plays a role in mitigating EM.

Ethical and Financial Reporting Challenges in the Case of Beta Computers

a. Budgeting is a vital strategy that is highly recommended for every business to implement within their systems. The financial roadmap that is planned in advance displays the routes an entity envisions for itself for longevity to meet its operational goals. Some of its advantages include augmented stability, improved financial health, and coordination within the company's departments to run cohesively. Unfortunately for Beta Computers, this is an example of a company that is facing economic turmoil with dysfunction coming from multiple avenues. In the first half of the year, poor business decisions made with the diminishing sales, the loan from Midland State Bank, and the opportunity with Rembrant has the potential to dig them into more of a crisis.

Adding to these challenges, the company—working with CPA Edgar Gamm and Midland State Bank—has considered reserving a significant receivable from a customer with a poor credit history in an effort to prevent collapse. However, this approach would violate the company's debt covenant ratios and create overly optimistic financial projections, placing Edgar Gamm in a difficult ethical position. Thankfully, a rebound has been observed from Beta in the third and fourth quarter of the year. With this newfound momentum, now is the time to make more rational decisions in order to salvage the company. Some concerns and doubts remain however, as creditor pressure, questionable collectability of key debtor accounts, and overly optimistic budget projections begin to cast serious doubt onto Beta's business operations.

As a CPA, Edgar Gamm reviews Beta's financial statements quarterly. This quarterly review is not as comprehensive as a full annual audit examining various facets of the company and ensuring that Edgar can give an unqualified assurance of the firm's financial health. However, despite Edgar not being provided this scope in executing his duties, he still needs to adhere to the professional standards expected of him in this capacity (Williams et al., 2021). The fiduciary duty of a CPA is to provide to various stakeholders, whether it is the firm management, customers, shareholders, or the general public, accurate, reliable, and independently verifiable financial information; therefore, as a CPA, Gamm should ensure the financial integrity of the documents that the firm produces.

Gamm should insist on the uncollectible classification as the customer, Rembrant International, has bad credit. This classification can be attributed to the principle of conservatism, where CPA Gamm should exercise prudence when it comes to the disclosure of financial statements, especially when it relates to losses and profits (Williams et al., 2021). In this scenario, the firm's losses should be given more precedence over the projected profits that the firm might make, as the customer has a history of loss-making. Also, the matching principle applies in this case as the revenue generated from the firm's operations should match the bad debts that the firm has accumulated. Thus, the bad debt should be reserved, which will contravene the matching principle. The firm should also adhere to the principles of objectivity and materiality (Williams et al., 2021). Failing to reserve this account will be a material misstatement, as the amount would give the impression that the firm is in a far better financial position than it is. Concerning the principle of objectivity, not reserving this account will overstate the firm's assets and income.

The optimistic projections that the firm creates are a significant issue that CPA Gamm should consider. These projections should be perceived with an increased level of professional skepticism based on the firm's profile, as it showcases that the individuals responsible for their creation want to provide a far rosier picture than the actual financial condition (Williams et al., 2021). This aspect demonstrates the lengths to which the management of Beta is trying to manipulate the firm's financial position to deceive those who rely on its financial reports to invest in it in the long term. As a result, CPA Edgar Gamm should view this as confirmation that he should adhere strictly to accounting principles to ensure that his assurance does not provide stakeholders with an inaccurate understanding of Beta's financial standing (Williams et al., 2021). The optimistic third and fourth quarter master budget does not demonstrate the firm's lack of realism in its projections, as it borders on an attempt to engage in earnings management to deceive stakeholders who might rely on these budgets.

Gamm should insist Beta adhere to proper accounting principles in its financial reporting. They can achieve this by writing off the Rembrant International account or creating a full allowance for the firm's doubtful accounts. This action would ensure that the financial reporting by Beta is an accurate and reliable account of its current state. Suppose the management of the firm refuses to adhere to these accounting principles proposed by Gamm. In that case, he should refuse to give an assurance through the quarterly review of the assurance of the financial statements (Williams et al., 2021). Additionally, Gamm should consider resigning from this engagement if the management refuses to account for Rembrandt International as he suggested, as it will adversely impact his professional integrity and reputation.

Gamm should adhere to accounting principles because they will demonstrate his professional independence. He might lose this engagement and the fee attached, which would quash any self-interest risk associated with the engagement. This action would illustrate that Gamm values his independence and the significance he places on ensuring public trust in the financial statements issued by companies (Williams et al., 2021). Gamm's adherence to these accounting principles illustrates that he is exercising due care by ensuring that the financial misstatements issued by Beta do not adversely impact various stakeholders who rely on the firm's financial statements to make investment or business decisions.

b. Midland State Bank's role in this scenario is to rely on the financial information provided by Beta to make its decisions. The lender depends on the debt covenant that Beta has entered with the bank, and it uses this to monitor the health status of its loan to protect its investment (Williams et al., 2021). The bank expects that the financial statements Beta provides are as accurate and reliable as possible, as they give the most objective representation of the firm's financial health status.

When discovering Rembrant International's accounts, especially with its credit risk rating, Midland State Bank is likely to perceive Beta's financial position as in default, as it depends on a customer who is not creditworthy. The bank's immediate reaction to this disclosure would be dismay and distrust of Beta's management. Also, the CPA's sign-off of this financial misstatement would be seen as his attempt to defraud the bank by giving an inaccurate assurance of Beta's financial position (Williams et al., 2021). Additionally, this would call into question the CPA's lack of professional independence and integrity when reviewing the firm's financial statements and those of other firms where he was also engaged in their audit. The lender would perceive the accounting profession as being full of dishonesty, as a professional of Edgar Gamm's standing would have sullied their outlook that it has.

Upon concluding Beta's finances, especially with its overreaction to Rembrant International's creditworthiness despite their bad credit risk profile, the lender would term the loan that they issue to Beta as in default. This transaction with Rembrant constitutes a significant part of the future projections presented in their third and fourth quarter budgets (Williams et al., 2021). Hence, Midland State Bank will begin Beta's foreclosure proceedings to recover the debt that the firm owes. The bank would also institute legal proceedings against Beta for its breach of contract in fraudulently overstating its financial position and the debt covenant it entered into. The firm will also launch legal proceedings against CPA Edgar Gamm for his complicity in giving Beta an unreliable assessment of its financial health. The actions taken by Beta will eventually lead to its financial ruin and loss of 750 jobs and damage the reputation of CPA Edgar Gamm, which could result in the loss of his accounting license. To sum up, this case demonstrates the role of the CPA in safeguarding the financial reliability of financial statements as other stakeholders rely on their assurance to rely on these documents. This situation could have some pathways to prevent both future job loss and instill better confidence within the business if investors or some forms of continued operation were to be reached. For example, formal allowance for doubtful accounts, engaging an independent valuation of receivables, and enhancing internal review controls to prevent overly optimistic forecasts could be instated. Therefore, Edgar Gamm's ethical dilemma illustrates the ethical dilemma that professionals in this sector face and the need to maintain their independence, integrity, and uphold the professional standards of the accounting profession.

CONCLUSION

When experiencing a crisis, managers of a firm might be incentivized to adopt EM practices to improve the firm's stock price and influence contractual outcomes. Crisis periods are often characterized by declining firm performance. The resultant financial distress is an incentive for managers to adopt income-increasing EM to boost the firm value and stock price in order to boost stakeholder confidence. Management compensation and lending contracts are tied to earnings, which are severely affected during crisis periods. Managers can defer earnings to a later date after the crisis in order to maximize their compensation. Managers can also use EM to prevent debt covenant violations and negotiate for debt restructuring when a crisis occurs. Regulators, through strengthening internal controls, corporate governance, and enforcement of rules and regulations, can mitigate EM. Stronger internal controls and corporate governance reduces the likelihood of opportunistic EM.

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