2 Definition of Earnings Management

It is always difficult to frame a useful definition for a broad subject. Precise definitions are likely to be inadequate at best, and often positively misleading. (Paton, 1922, p. 3)

In this chapter, we introduce a formal definition of earnings management and compare it to alternative definitions. Given the generality of the term, we expand the definition by an examination of the means to manage earnings. We conclude with a thorough presentation of earnings management achieved by supplying pro forma earnings with GAAP earnings.

2.1 Definition

Table 2.1 summarizes the different definitions of earnings management, classifying them as white, gray, or black. Beneficial (white) earnings management enhances the transparency of reports; the pernicious (black) involves outright misrepresentation and fraud; the gray is manipulation of reports within the boundaries of compliance with bright-line standards, which could be either opportunistic or efficiency enhancing.

Table 2.1 Alternative definitions of earnings management

<table>
<thead>
<tr>
<th>White</th>
<th>Gray</th>
<th>Black</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings management is taking advantage of the flexibility in the choice of accounting treatment to signal the manager’s private information on future cash flows</td>
<td>Earnings management is choosing an accounting treatment that is either opportunistic (maximizing the utility of management only) or economically efficient</td>
<td>Earnings management is the practice of using tricks to misrepresent or reduce transparency of the financial reports</td>
</tr>
</tbody>
</table>
Definition of Earnings Management

<table>
<thead>
<tr>
<th>White</th>
<th>Gray</th>
<th>Black</th>
</tr>
</thead>
</table>

⁠¹ “...under [the information perspective of earnings management],... managerial discretion is a means for managers to reveal to investors their private expectations about the firm’s future cash flows.” (Beneish, 2001, p. 3)

⁠² “The push for increased transparency in financial reporting and corporate governance serves the shareholders only up to a point. Beyond that, managerial inhibitions induced by a lack of privacy can damage the interests of shareholders.... That earnings management reduces transparency is a simplistic idea. (Arya, Glover, and Sunder, 2003, p. 111)

⁠³ Earnings management occurs “when managers exercise their discretion over the accounting numbers with or without restrictions. Such discretion can be either firm value maximizing or opportunistic.” (Fields, Lys, and Vincent, 2001, p.260, citing Watts and Zimmerman, 1990)

“Earning management is the choice by a manager of accounting policies so as to achieve specific objective.” (Scott, 2003, p. 369)

“By “earnings management” I really mean “disclosure management” in the sense of a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say, merely facilitating the neutral operation of the process).” (Schipper, 1989, p. 92)

Earnings management is “the practice ... [of reaching] a desired number instead of pursuing some sort of protocol to produce a number that gets reported without regard to what some analysts predict that you will report.” (Miller and Bahnson, 2002, p. 184)

Given our discussion of the three strands of thought on the value of earnings and the consequent demand for earnings management in Chap. 1, the definition in the literature that best describes earnings management seems to be the following:

**Definition:** Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.¹

This definition captures both the costly-contracting approach (earnings management is used to influence contractual outcomes) and the informa-

¹ Healy and Wahlen (1999, p. 368).