The Distinction between Aggressive Accounting and Financial Reporting Fraud: Perceptions of Auditors

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ABSTRACT
The ability to distinguish between aggressive earnings management (aggressive accounting) and financial reporting fraud (fraud) is an essential characteristic for auditors in fulfilling their responsibilities. Yet little is known of how auditors make this distinction in practice. Perhaps due to the ambiguity in defining where aggressive accounting ends and fraud begins, few studies have attempted to investigate the distinction between the two types of financial manipulation. This current research provides evidence as to how auditors distinguish between aggressive accounting and fraud in practice. Specifically, this study examines which factors auditors invoke in determining whether an identified financial manipulation constitutes aggressive accounting or fraudulent accounting. Findings from interviews with senior auditors suggest these factors include managerial intent, compliance with Generally Accepted Accounting Principles, materiality level, and measurement subjectivity. Research findings have the potential to alleviate some of the ambiguity associated with distinguishing between aggressive and fraudulent accounting. As such, this study contributes to the earnings management, financial reporting fraud, and audit judgement research literatures.

KEYWORDS
Aggressive Accounting, Earnings Management, Financial Reporting Fraud, Audit Judgement
INTRODUCTION

Despite the growing importance of the issue of both earnings management and financial reporting fraud, there has yet to be research conducted which actively investigates perceptions of the distinction between aggressive earnings management and fraudulent financial reporting. Though there exists extensive research into the identification and development of measures of both earnings management and financial reporting fraud, there is nonetheless much uncertainty and ambiguity in defining at which point aggressive earnings management becomes fraudulent. Yet to fulfil their responsibilities and to avoid suffering reputation effects, auditors must be able to distinguish between the two types of financial manipulation.

Responsibilities of auditors in relation to fraudulent financial reporting are comprehensively described in professional standards emanating from both domestic and international jurisdictions. External auditors have a responsibility to provide reasonable assurance that financial reports are free from material misstatement (AICPA 2002; AARF 2004a; IFAC 2004). Furthermore, auditors have a responsibility to invoke professional scepticism in determining whether management has attempted to manage reported earnings by intentionally misstating, either materially or immaterially, certain items (AARF 2001b; AARF 2004a). However, while there exists specific Standards in relation to fraud, there exists no such Standard in relation to earnings management in any jurisdiction. Consequently, undetected material fraud is much more likely to lead to regulatory disciplining of, and/or litigation against, auditors, than an erroneous judgement as to when earnings management becomes intolerably aggressive. However, it is possible that the ambiguity in both the research and professional literatures, in defining where aggressive earnings management becomes fraudulent, makes the task of fraud detection especially problematic.

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1 Unless otherwise stated, throughout this paper the terms ‘fraud’ and ‘fraudulent accounting’ refer specifically to financial reporting fraud.

2 The terms ‘aggressive earnings management’ and ‘aggressive accounting’ are used interchangeably throughout this paper.

3 The term ‘financial manipulation’ refers to an intentional misstatement in the financial reports, and encompasses earnings management techniques ranging from legitimate accounting discretion through to financial reporting fraud.
The importance of the issue of both managed earnings and fraudulent financial reporting to the auditing profession is reflected in recent changes to professional standards. The Australian Auditing and Assurance Standard on fraud, in line with international modifications, has become more exacting. The recently issued AUS 210 “The Auditor’s Responsibility to Consider Fraud in an Audit of a Financial Report” (AARF 2004a) now focuses entirely on fraud, as opposed to its predecessor, which dealt with both fraud and error. AUS 210 explains that while earnings management practices may start out small, pressures and incentives can heighten these actions, resulting in fraudulent financial reporting. Essentially, if the auditor does not effectively constrain or attenuate these manipulations by management, then the financial reports may not provide adequate forewarning of financial difficulties (Heninger 2001). Research has shown that quality auditors do possess the expertise to detect, and willingness to constrain, earnings management (for example, Krishnan 2003). However, evidence suggests that auditors’ direct experience with fraud is comparatively infrequent (Loebbecke, Eining and Willingham 1989), implying a level of difficulty in recognising fraud when encountered.

This current research addresses the issues of both earnings management and financial reporting fraud, and contributes to the limited body of research in this area, by exploring how auditors distinguish between aggressive accounting and fraudulent accounting. Specifically, this study utilises a qualitative research approach to investigate those factors auditors take into account in distinguishing between the two types of financial manipulation. By identifying these factors, this research has the potential to alleviate some of the ambiguity associated with determining where aggressive accounting ends and fraud begins. Research findings presented in this paper potentially provide a valuable contribution to the academic literature, to auditing standard setting, and to the auditing profession and its practices.

The structure of this paper proceeds as follows. The next section provides a brief overview of the earnings management and financial reporting fraud literature. The subsequent section examines the distinction between aggressive earnings management and financial reporting fraud. The research design is then presented, followed by a discussion of findings. The final section describes limitations, implications for the audit profession, and future research in this area.
BACKGROUND
This section provides a brief overview of existing literature in relation to both earnings management and fraudulent financial reporting. Its intent is to provide an introduction to the research areas, and to highlight the difficulties associated with forming a distinction between aggressive earnings management and fraud.

Earnings Management
The term ‘earnings management’ embodies a wide array of accounting techniques used by management to manipulate the earnings of an entity. While there exists no single accepted definition of earnings management (POB 2000), the accounting literature provides various descriptions of the practice. Schipper (1989: 92) describes earnings management as “... a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain ...”. Similarly, Healy and Wahlen (1999: 368) explain that earnings management occurs when managers use discretion to manipulate financial information “... to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.” Consistent among these definitions is the notion of intentional manipulation of reported numbers by management. However, since managerial intent is unobservable, the current definitions of earnings management are “... difficult to operationalise directly using attributes of reported accounting numbers ...” (Dechow and Skinner 2000: 238).

Earnings management is most likely to occur where there exists vagueness and subjectivity within Accounting Standards. Upon application of these Standards, management is permitted to exercise a certain level of judgement or discretion in the determination of the reported accounting numbers. Management can use this discretion to manipulate earnings in a favoured direction. Levitt (1998: 16) explains that when flexibility within accounting standards is exploited, “... abuses such as earnings management occur ... (and) trickery is employed to obscure actual financial volatility.” Although the practice of earnings management has been suggested as being widespread (see Levitt 1998), the exact pervasiveness of managed earnings is not known. Certainly, it can be assumed managers are unwilling to reveal the full
extent of techniques used in the manipulation of earnings. Interestingly, Dechow and Skinner (2000: 247) suggest that regulators and practitioners may be “overstating the extent of the problem” of earnings management, whilst academics may be understating it.

Despite similarities amongst definitions of earnings management, it has been suggested that academics have ‘no consensus’ on what earnings management actually is (Beneish 2001). There exist inconsistencies even in the attributed incentives to exercise earnings management. Beneish (2001) describes two perspectives on earnings management as being the information perspective and opportunistic perspective. The information perspective holds that the earnings manipulation is designed to signal to investors expectations about the company’s future cash flows, while the opportunistic perspective maintains that managers manipulate earnings to mislead investors. In a similar way, Scott (1997: 295) distinguishes between “earnings management from an efficient contracting perspective” and opportunistic earnings management. The definitions of earnings management provided by both Schipper (1989) and Healy and Wahlen (1999) allow for the manipulation of earnings to deceive or mislead investors by means of disguising poor performance. However, while the definition by Schipper (1989) also allows for the manipulation of earnings to inform investors, the word ‘mislead’ in the definition provided by Healy and Wahlen (1999) seems to “… preclude the possibility that earnings management can occur for the purposes of enhancing the signal in reported earnings” (Beneish 2001: 5).

“Much prior work has predicated its conclusions on an opportunistic perspective for earnings management and has not tested the information perspective” (Beneish 2001: 5). In other words, the general assumption is that earnings management is conducted to the detriment of investors because of the implied reduction in the transparency and reliability of the financial reports (Scott 1997). While providing managers with an unlimited capacity for making judgements would not be practical, the elimination of management judgement could be disadvantageous to investors (Healy and Wahlen 1999). Agency theory (see Scott 1997) suggests that permitting flexibility in reporting earnings is necessary for managers, as they are in the best position to choose the method of reporting that best aligns with shareholders’ interests. In addition, earnings
management is a vehicle by which inside information can be conveyed to the market (Scott 1997), thereby promoting efficient decision-making (Arya, Glover and Sunder 2003).

Broadly, and from a research perspective, the detection of earnings management involves determining whether accounting accruals differ from expectations (that is, whether they are “abnormal”), and whether the difference is congruent with managers’ incentives. Accrual models can be based on aggregate accruals (for example Healy 1985; Jones 1991; Dechow, Sloan and Sweeney 1995) or specific accruals (see McNichols and Wilson 1988; Beneish 1999a). Although accrual models have been extensively employed and researched, a number of recent studies have questioned the accuracy and usefulness of these models, and hence, of this type of research (see McNichols 2000; Thomas and Zhang 2000). More recent research in the area of accruals management suggests that the method (or accrual) used to manipulate earnings varies according to management incentives underlying the manipulation (Marquardt and Wiedman 2004).

In respect of earnings management, auditors have a responsibility to adopt “... an attitude of professional scepticism to determine whether management has intentionally misstated certain items (possibly by amounts below the materiality level) to manage reported earnings” (AARF 2001b: Para. 23). The implication is that auditors should not be concerned with whether intentional misstatements are invoked for opportunistic or efficient motivations; either creates opacity in financial reporting. Where the line between acceptable and unacceptable accounting practices is crossed, auditors have a professional and legal responsibility to confront those charged with the management of the entity (AARF 2001a). In addition to legal responsibilities, auditor constraint of aggressive earnings management is an essential component in providing reasonable assurance as to the truth and fairness of financial reports. Indeed, recent high profile corporate collapses have heightened the auditor’s role in credible, transparent financial reporting. Nonetheless, researchers have found that investors perceive a general decline in the quality of reported earnings and the reliability of audited financial information (see Hodge 2003). Such findings tend to suggest that auditor constraint of earnings management is perhaps more important now than at any other time.
Extant research indicates that auditors possess, to varying degrees, the ability to constrain earnings management. Several studies have found that auditors employed by first tier accounting firms are more likely to demonstrate greater reporting conservatism than auditors employed by other accounting firms (Becker, Defond, Jiambalvo and Subramanyam 1998; Francis and Krishnan 1999; Francis, Maydew and Sparks 1999; Kim, Chung and Firth 2003). Further, within first tier accounting firms, those auditors possessing industry expertise are more likely to constrain earning management than those who do not possess such expertise (Krishnan 2003).

In regard to aggressive earnings management, research suggests that auditors are more likely to permit aggressive reporting by clients where there exists flexibility within accounting standards, and significant judgement is required on behalf of management (Hackenbrack and Nelson 1996). Factors found to influence auditors’ judgement in relation to permitting aggressive reporting include the client’s financial health (Lord 1992; Braun 2001), the size or importance of the client (Lord 1992; Wright and Wright 1997), and the risk of litigation against the auditor (Farmer, Rittenberg and Trompeter 1987). Other studies have examined how auditors, when faced with aggressive earnings management, generate less aggressive financial reporting alternatives (see Johnstone, Bedard and Biggs 2002). However, despite extensive research in relation to auditor constraint of earnings management, little evidence exists as to how auditors distinguish aggressive accounting from fraud.

**Financial Reporting Fraud**

Numerous definitions of the term ‘fraud’ have been proposed within the academic and professional literatures. In the criminological, and most general, sense, fraud refers to “... any crime for gain which uses deception as its principal modus operandi” (Wells 1997: 4). Fraud encompasses a range of deceptions including employee fraud, payroll fraud, insurance fraud, credit card fraud, identity theft, bribery, kickbacks, insider trading, and the deliberate falsification of financial reports. The focus of this current research is on the latter deception, that is, financial reporting fraud.
Financial reporting fraud constitutes one of the two forms of fraud relevant to the audit profession\(^4\). Consistent with the broad definition of fraud, financial reporting fraud involves deception; more specifically, deception of financial report users by preparers of those reports. In Australia, AUS 210 describes fraudulent financial reporting as involving “... intentional misstatements including omissions of amounts or disclosures in the financial report to deceive financial statement users” (AARF 2004a: Para. 08). This definition is consistent with the revised International Standard on Auditing, ISA 240\(^5\) (IFAC 2004), and the U.S. Statement on Auditing Standards, SAS No. 99\(^6\) (AICPA 2002). The fact that the International Auditing and Assurance Standards Board (IAASB) released the revised ISA 240 in February 2004, after prior revision in only 2002, suggests the importance of this issue to the auditing profession, especially in the wake of high profile international accounting scandals and their impact on the already existing audit expectation gap (see McEnroe and Martens 2001).

Financial reporting fraud involves intentional deceit on behalf of the preparers of the financial reports, and attempted concealment of that deceit (Albrecht 2003; Albrecht and Albrecht 2004). Such actions result in the financial reports not representing a true and fair view of the company’s underlying economic position. Fraudulent accounting can be perpetrated in a variety of ways including improper revenue and expense recognition, fictitious revenues and assets, over and/or undervalued assets and liabilities, improper disclosures, and related party transactions. A number of studies have found improper revenue recognition to be the most common type of fraudulent financial reporting; specifically, premature recording of revenues and recording of fictitious revenues (Loebbecke et al. 1989; COSO 2002). Further studies have examined the relationship between the type of fraud and auditor litigation; findings indicate that frauds involving fictitious transactions result in a higher likelihood of litigation against auditors (Bonner, Palmrose and Young 1998).

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\(^4\) The other form of fraud relevant to auditors, not dealt with in this paper, relates to intentional misstatements resulting from misappropriation of assets.


Professional Auditing Standards, both in Australia and internationally, were recently revised as part of a wave of regulatory reforms, in an effort to, \textit{inter alia}, improve detection of financial reporting fraud. A key component of the resulting expanded guidelines for auditors in relation to fraud is the adoption of the ‘fraud triangle’ approach. The fraud triangle approach, which is already well established within the psychological and criminological literature (Cressey 1953; Cressey 1986; Wells 1997), involves decomposing fraud into its three basic elements: opportunity, incentive/pressure, and attitude/rationalisation (AICPA 2002). AUS 210 has also adopted this approach, and describes fraud in terms of incentives or pressures to commit fraud, a perceived opportunity, and the ability to rationalise fraudulent behaviour (AARF 2004a). Recent research suggests that decomposing fraud in this manner may, in fact, enhance auditors’ sensitivity to opportunity and incentive fraud cues (Wilks and Zimbelman 2004).

The responsibility for the prevention and detection of fraud lies with management and those charged with the governance of an entity (AICPA 2002; AARF 2004a; IFAC 2004). AUS 210 explains that the auditor’s responsibility is to provide “... reasonable assurance that the financial report taken as a whole is free from material misstatement, whether caused by fraud or error” (AARF 2004a: Para. 21). Nonetheless, research suggests that much fraud is not detected by the external auditor (KPMG 2002).

\textbf{The Distinction between Aggressive Earnings Management and Financial Reporting Fraud}

Both aggressive earnings management and financial reporting fraud involve the manipulation of reported financial information to achieve a desired result. In achieving that result, both aggressive accounting and fraud can involve (to varying degrees) the same accounting technique. Such techniques, particularly those involving discretionary accruals, result from the existence of subjectivity and management discretion within accounting standards, and fall into what has been described as a ‘grey’ area between aggressive earnings management practices and outright fraud (Levitt 1998). Consequently, defining the distinction between aggressive earnings
management and fraud, and determining the existence of either aggressive accounting or fraudulent accounting under certain circumstances, can be difficult.

Few studies have attempted to establish a distinction between aggressive earnings management and financial reporting fraud. Indeed the ambiguity associated with where aggressive accounting ends, and fraud begins, makes the task of distinguishing between the two types of financial manipulations challenging at best. The ambiguity lies not just in existing research, but also in existing Australian and International legislation. Current Auditing Standards, both in Australia and the U.S., have yet to provide guidance on distinguishing between aggressive accounting and fraudulent financial reporting. AUS 210, ISA 240 and SAS No. 99 do provide (what appear to be) relatively straightforward definitions of financial reporting fraud (AICPA 2002; AARF 2004a; IFAC 2004). However the issue of aggressive accounting, and when aggressive accounting becomes fraudulent, is provided minimal discussion.

Contributing to the ambiguous demarcation between the two types of financial manipulation are similarities amongst existing definitions of earnings management and fraud. A common factor described in definitions of both earnings management and financial reporting fraud is that of managerial intent, specifically, intent to mislead or deceive. Aggressive earnings management can involve, and fraud certainly does involve, intent on behalf of management to mislead financial report users. Earnings management, especially when conducted opportunistically, can entail the misleading of stakeholders about a firm’s underlying economic performance (Healy and Wahlen 1999). Financial reporting fraud, by definition, involves intentional misstatements in the financial reports designed to deceive financial report users (AARF 2004a). As both aggressive accounting and fraudulent accounting can involve intent to deceive, and since the concept of intent is difficult to ascertain for other than perpetrators, the distinction between aggressive accounting and fraud cannot be established through managerial intent alone.

Existing research and professional literatures do attempt to provide recognised means of operationalising the distinction between aggressive earnings management and financial reporting fraud. Such methods include the establishment of compliance or non-compliance with GAAP (Dechow and Skinner 2000; POB 2000; AARF 2001a),
and the materiality level of the misstatements (see Rosner 2003). However, operationalising the distinction between aggressive and fraudulent accounting in practice using these methods may prove difficult.

Dechow and Skinner (2000) and Audit & Assurance Alert (AAA) 107 (AARF 2001a) describe the acceptability of the accounting treatment under GAAP as the distinguishing factor between aggressive accounting and fraudulent accounting. Accounting judgements and techniques that are acceptable within GAAP are described as a continuum from conservative accounting, to neutral accounting, and to aggressive accounting. Accounting practices that violate GAAP are described as fraudulent accounting (represented diagrammatically in Figure 1).

According to this model, behaviours such as an overly aggressive recognition of provisions constitute conservative accounting, and behaviours such as drawing down provisions or reserves in an overly aggressive manner constitute aggressive accounting. As both of these techniques are described as being acceptable within GAAP, they constitute a form of earnings management. In contrast, behaviours such as recording sales before they are realisable, recording fictitious sales, backdating sales invoices, and recording fictitious inventory are described as violating the boundaries of GAAP, and hence are fraudulent by their nature.

An interesting point to note is that the models proposed by Dechow and Skinner (2000) and AAA10 (AARF 2001a) use acceptability under GAAP to present earnings management practices as separate and distinguishable from fraudulent accounting practices. Furthermore, earnings management practices are distinguished from legitimate management discretion. Dechow and Skinner (2000) propose that judgements and estimates that fall within the bounds of GAAP may comprise either legitimate use of discretion or earnings management, depending on management intent. Only those accounting practices that violate GAAP and “clearly demonstrate intent to deceive” are described as fraudulent (Dechow and Skinner 2000: 239).

### FIGURE 1: The Distinction between Earnings Management and Fraud

However, the concern with distinguishing accounting practices in this way is the restrictive nature of the classifications. It is quite possible that some of example accounting techniques described could represent *either* legitimate earnings management or financial reporting fraud. As a result, there is a potential for some of the example accounting techniques to be incorrectly classified. For example, backdating of sales invoices is described as fraudulent accounting because it violates GAAP and there exists a (seemingly) clear intent to deceive. Yet there may be circumstances (however rare) where the backdating of sales invoices represents a
justifiable business decision. In such cases, this action would constitute a form of legitimate accounting, not fraudulent accounting.

Similarly, actions described by this model as earnings management may actually represent fraudulent financial reporting. Such is the case with subjectively measured misstatements, including the estimation of provision or reserve account balances. The understating of provisions is depicted as aggressive accounting, yet could readily constitute fraudulent accounting. AUS 210 explains that “inappropriately adjusting assumptions and changing judgements used to estimate account balances” constitutes fraudulent financial reporting (AARF 2004a: Para. 09). If the provision account balances are inappropriately estimated, and there exists intent to deceive, then the understating of provisions would constitute fraudulent accounting, not merely aggressive accounting.

There exists little research into measurement subjectivity, and the resulting classification, of a misstatement. AUS 210 explains that subjectively measured misstatements can constitute fraudulent accounting, while AAA10 (AARF 2001a) and Dechow and Skinner (2000) suggest otherwise. There does, however, exist evidence to suggest that measurement subjectivity is an important factor in auditors’ book or waive decisions. Research by Braun (2001), and Wright and Wright (1997), finds that auditors are more likely to waive a detected misstatement when that misstatement is measured subjectively as opposed to objectively. The difficulty with accounting techniques involving subjectivity, however, is that intent to deceive is not easy to establish.

The Panel on Audit Effectiveness (POB 2000) takes a somewhat broader approach in describing the distinction between earnings management and financial reporting fraud. As with Dechow and Skinner (2000) and AAA10 (AARF 2001a), the distinguishing factor between aggressive accounting and fraud is described as being the acceptability of the accounting treatment under GAAP. However, the POB report describes earnings management activities as forming a continuum along which the available accounting techniques vary from legitimate discretion at one end through to fraudulent accounting (with intent to deceive) at the other. According to the POB approach, accounting techniques such as estimating provisions or accelerating sales
could constitute either legitimate management discretion or financial reporting fraud, depending upon the particular circumstances of each situation. The POB approach to describing earnings management and fraud appears to be less restrictive than that propounded by Dechow and Skinner (2000) and AAA10 (AARF 2001a), and as such, seems less likely to result in misclassifications. Nonetheless, operationalising the distinction between aggressive accounting and fraudulent accounting in practice may be no less problematic.

An alternative method of operationalising the distinction between aggressive earnings management and fraud in the research literature is adopted by Rosner (2003). She explains that accounts involving estimation, such as discretionary accruals, can represent either aggressive earnings management or fraud depending on the size of the disputed amount. In examining the earnings management behaviour of (ex post) bankrupt firms, Rosner employs quantitative materiality as the key factor in her distinction between aggressive accruals management and fraudulent accruals management. Rosner posits that material earnings overstatements (fraud under her classification) can be distinguished from (legitimate) earnings management by the magnitude of the earnings manipulation proxy variables; lower (immaterial) magnitudes are considered legitimate earnings management, with higher (material) magnitudes considered fraudulent. For accounts involving estimation, size may be a relatively straightforward method of distinguishing between aggressive accounting and fraudulent accounting in practice. However, consideration must still be held for underlying managerial intent.

Establishing a distinction between aggressive earnings management and fraud that encompasses all relevant factors is indeed challenging. While in the research and professional literatures there have been some attempts to provide a distinction between aggressive accounting and fraud, there has been little (if any) effort to explore how this distinction is operationalised in practice. This current study expands upon existing research literature by exploring how auditors distinguish between aggressive accounting and fraud in practice. Specifically, this research identifies the

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8 Rosner (2003) uses the term “earnings manipulation” to incorporate both earnings management practices and fraudulent accounting.
factors that auditors take into account when distinguishing between the two types of financial manipulation.

**RESEARCH DESIGN**

This current study utilises an exploratory research approach. Interviews with experienced auditors are designed to elicit those factors auditors invoke in forming a distinction between aggressive accounting and financial reporting fraud. It is anticipated that the experienced auditors will identify the factors described in existing literature (e.g., management intent, GAAP compliance, materiality, measurement subjectivity) as being important distinguishing factors, while additional factors may be identified also. The described factors are not intended to represent an exhaustive list, but rather provide insight from the literature into those factors considered important by auditors in forming a distinction between the two types of financial manipulation.

The research design comprises face-to-face interviews conducted by one of the authors in late 2004 and early 2005. Interviews were conducted at the relevant audit offices, or other location requested by the participant. Each interview lasted between 45 minutes and one hour. The final sample consists of six participants, each of whom has extensive audit experience. Of these participants, five are former audit partners and/or managers with first tier accounting firms; one participant is a current practicing audit partner with a second tier accounting firm. Of the five participants with prior audit experience, one is retired, and the remaining four participants are now employed in academia. Participants’ level of audit experience ranges from six years to 29 years.

The interviews were conducted in a semi-structured manner; a number of predetermined questions were incorporated, but were omitted and/or varied as required. The interviews commenced with brief demographic questions, such as the number of years of audit experience, and the type of audit firm where employed. Interviewees were then asked a number of general, open-ended, questions in relation to the distinction between aggressive accounting and financial reporting fraud, such as:
Have you ever had to make a judgement as to whether an identified misstatement constituted either aggressive accounting or financial reporting fraud?

What factors (specific, general, other) do you take into account when making the judgement as to whether the identified misstatement constituted aggressive accounting or financial reporting fraud?

Which factors do you consider to be most important in making a judgement as to whether an identified misstatement constitutes aggressive accounting or financial reporting fraud?

In your opinion, at which point does aggressive accounting become fraudulent?

Following the general discussion of the distinction between aggressive accounting and fraud, participants were presented with a number of hypothetical scenarios. The scenarios were presented to participants subsequent to the general questions, so as not to influence responses to those questions. Each scenario requests the participant to assume the role of audit manager for a specific audit engagement. The scenario then provides background information on a hypothetical audit client, and describes the accounting treatment employed by the audit client for a particular transaction. Factors such as materiality, GAAP compliance, and measurement subjectivity are varied between scenarios. Based on this information, participants were requested to complete a number of questions relating to the resultant audit actions to be taken. Interview participants were also asked to provide general comments on the realism and accuracy of each scenario.

The hypothetical scenarios presented to participants form part of a much larger research project. The scenarios are to be subsequently employed in an experimental design setting, using a larger sample of practicing auditors. Presenting the scenarios to interview participants provided a means of ensuring the experimental scenarios were grounded in both theoretical and practical bases, in addition to giving a context and commonality across the participants. In terms of the findings presented in this paper,

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9 Some participants preferred the use of the term ‘earnings management’ as opposed to ‘aggressive accounting’. In these interviews, the question terminology was modified accordingly.
the majority of the qualitative data obtained was gleaned from participants’ responses to the initial general questions.

**DISCUSSION OF FACTORS AFFECTING AUDITORS DISTINCTION BETWEEN AGGRESSIVE ACCOUNTING AND FRAUD**

Existing research and professional literature suggests that auditors should consider a number of factors, specific to a financial manipulation, in distinguishing between aggressive accounting and fraudulent accounting. These factors include the manipulation’s compliance with GAAP, its materiality level and measurement subjectivity, as well as the underlying managerial intent. Overall, factors identified during the interview process are consistent with those factors described in existing literature. Each of the factors considered important in auditors’ distinction between aggressive accounting and financial reporting fraud is now discussed.

**Management Intent**

Professional literature suggests that the fundamental element of financial reporting fraud is one of management intent to deceive financial report users (AICPA 2002; AARF 2004a; IFAC 2004). Consistent with this definition of financial reporting fraud, interviewees recognised intent to deceive as representing the crucial element in identifying financial reporting fraud.

*Fraud I think is way out in here, and that’s an intention, a purposeful intention that something’s wrong.*

*What I’m saying is, I just take the view that fraud is a clear intent to make something wrong . . . so there’s an intention.*

*I think that’s really what you’re trying to examine when you’re talking about fraud and management manipulation, you know, one blends to the other. But I think things that are blatantly wrong, and they were deliberately done, I think you’d much more now say that’s fraudulent reporting.*
As previously discussed, however, existing definitions of earnings management also incorporate management intent. Here, the intent described ranges from one of informing financial report users through to one of misleading those users. Interviewees seemed reluctant to associate managerial intent to deceive with aggressive accounting. One interviewee preferred the use of the term ‘earnings management’ over ‘aggressive accounting’, explaining that earnings management simply resulted from differing viewpoints.

*That’s why I prefer the thing earnings management, where people’s views differ from mine, and some are taking a more aggressive, and some are taking, you know, different views.*

Interviewees expressed awareness of the fact that while management intent is key feature of fraud, and possibly earnings management, it is nevertheless unobservable. A number of participants conceded that even in hindsight, management intent, specifically where intent to inform users becomes intent to deceive, is difficult to establish.

*Where does an aggressive management, things are going off the rails, get to a fraud, an intent to kind of deceive . . . I think sometimes people get caught up in it, we’ve just got to keep it going, we’ve got to keep this business afloat type thing . . . the intention may have been to keep it going, you know, if we can just get over this hurdle we’ll be right, and then unfortunately they don’t get over the hurdle, and so everything they’ve done to prop it up, and all that, is then looked at from the intention that those people who supported you, you’ve kind of defrauded them . . . it’s not that case of I’m going to take everything, it’s a belief that we will get there, but at the end of the day you just don’t get there, and then people are looking at it and saying you’ve ripped them off, even though initially the intention may have been the right, a positive one, it just hasn’t worked out.*

In summary, all interviewees acknowledged management intent to deceive as the key characteristic of financial reporting fraud, but did not perceive management intent to
be an aspect of aggressive accounting. Interviewees agreed that measurement of management intent, even in hindsight, is especially difficult.

**GAAP Compliance**

Generally Accepted Accounting Principles comprise the accounting rules, procedures, and practices for the recording of transactions. However, GAAP does not provide rules for every possible accounting situation. As is often argued, providing rules for every possible situation would be both impractical and undesirable (Shah 1996; Parfet 2000). Financial reporting that violates GAAP, or non-GAAP reporting, can lead to significant penalties for, and litigation against, the company involved (Beneish 1999b). Archival studies such as that conducted by Palmrose and Scholz (2004) have found that, in particular, revenue restatements resulting from non-GAAP reporting increase the likelihood and severity of litigation against the company.

The POB report (POB 2000) advocates the acceptability of the accounting treatment under GAAP as being the key criteria in distinguishing aggressive earnings management and financial reporting fraud. In the case of earnings management, the report explains, “. . . there indeed may be issues and debates about the quality of an entity’s earnings, but not about whether the financial statements are presented fairly, in all material respects, in conformity with GAAP” (POB 2000: Para. 3.18). Financial reporting fraud, on the other hand, not only reduces the quality of reported earnings, but also clearly violates established accounting standards and reporting principles.

The general view held by interviewees seems to support this theory. Interviewees acknowledged that acceptability under GAAP is an important element in defining a distinction between aggressive accounting and fraud. One interviewee noted that when determining acceptability of an accounting treatment under GAAP, auditors should also make use of their own knowledge and expertise.

*Use GAAP as a guide and also your own judgement and intuition and all of that sort of thing, because the auditor obviously has to, to base his opinion on his expertise and knowledge and experience and all that sort of thing so, he has an inclination as to whether something is overstepping the line or not.*
Interviewees perceived financial reporting fraud as an unmistakable violation of GAAP. In contrast, aggressive earnings management, whilst perceived as within the bounds of GAAP, was viewed as pushing the accounting principles to the limit.

_Aggressive accounting I would say would be to use the accounting principles and the accounting standards to the limit . . . to push them to the limit, you know everything that’s legal, but using it to the max . . . but there’s a very fine line between getting to that and then overstepping it into fraudulent type behaviour._

*I think earnings management then is where you make judgements that are at the high end of the acceptability or low end of the acceptability, depending on how you’re trying to manage your results._

To summarise, interview findings support the notion that GAAP compliance is an important factor for auditors in distinguishing aggressive accounting and fraud. All interviewees viewed aggressive accounting as being at the limits of GAAP, while fraudulent accounting was perceived as a clear violation of GAAP.

**Materiality**

The concept of materiality relates to whether an item should be recognised or disclosed in the financial reports. AASB 1031 “Materiality” employs a report user perspective in defining materiality; an item is deemed material if its omission or misstatement adversely affects decisions made by financial report users (AARF 2004b). Materiality can relate to either the magnitude of an item (quantitative materiality) or the nature of an item (qualitative materiality), or both. In Australia, guidelines in relation to quantitative materiality employ defined percentages; an amount that is greater than or equal to 10% of the relevant base amount is material; an amount which is less than or equal to 5% of the relevant base amount is not material (AARF 2004b).

Applying the notion of materiality to the audit engagement, AUS 306 “Materiality and Audit Adjustments” requires auditors, first, to establish a preliminary materiality
level at the planning stage of the audit, and second, to reassess that level when evaluating results of audit procedures (AARF 2001b). While several ‘rule of thumb’ materiality thresholds, such as 5% of net income and 0.5% of total revenues, have been identified, research suggests that rather than simply being a constant percentage of a base amount, materiality judgements are influenced by a variety of factors (see Bernardi and Pincus 1996; Blokdijk, Drieenhuizen, Simunic and Stein 2003). Such factors include the qualitative aspects of the misstatement, and the “...circumstances in which the misstatement or judgement has been made” (AARF 2001b: Para. 17).

**Quantitative Materiality**

A number of archival studies have examined audit adjustments in relation to quantitative materiality. Kinney and Martin (1994) found the majority of proposed audit adjustments relate to detected misstatements that materially overstate earnings. More recent research indicates that auditors are more likely to waive those misstatements that are quantitatively immaterial. Wright and Wright (1997) examine factors affecting auditors’ book or waive decisions. In regard to misstatement size, findings indicate that smaller adjustments (less than planning materiality level\(^{10}\)) are more likely to be waived than larger adjustments (greater than planning materiality); suggesting quantitative materiality to be an important factor in deciding whether to book or waive audit adjustments.

Experimental studies of auditors’ book or waive decisions exhibit similar findings. Libby and Kinney (2000) provide evidence of opportunistic recommendations by auditors for correction of quantitatively immaterial misstatements. Specifically, results indicate that auditors require correction of quantitatively immaterial misstatements only if the correction does not move earnings below the consensus forecast. Libby and Kinney explain that such opportunistic correction of misstatements represents a type of earnings management that is permitted by the auditor. In addition, findings of this study suggest that auditors believe, under the (then) current auditing standards, that quantitatively immaterial earnings

\(^{10}\) In addition to planning materiality, Wright and Wright (1997) conducted analyses using final materiality guidelines (10% of pre-tax income, 5% of the greater of assets or revenues, 3.867% of revenues), and the same conclusions were reached.
overstatements do not require correction. In relation to the number of detected misstatements, Braun (2001) found that auditors are more likely to waive a number of immaterial proposed adjustments that add up to material amount, than a single material proposed adjustment. However, Nelson, Smith and Palmrose (2004) note that these studies were conducted prior to high profile corporate collapses and resulting regulatory activity, and that the current, more conservative, financial reporting environment may affect auditors’ book or waive decisions.

As discussed previously, Rosner (2003) uses quantitative materiality as the key factor in distinguishing between legitimate accruals management and fraudulent accruals management. Certainly auditors have a responsibility to provide reasonable assurance that financial reports are free from material misstatement (AARF 2004a). In this regard, interview findings highlight the importance of quantitative materiality, and faithful representation in the financial reports, in distinguishing between aggressive accounting and financial reporting fraud.

*I think it depends on (quantitative) materiality in the end, you know.*

*Much more was the question of were the accounts a faithful representation of the results, which is a (quantitative) materiality question.*

*Well, you’re really talking about fraudulent financial reporting, and I think that really means that the accounts are not faithful on the face of representation of what they’re meant to be.*

*I’m not sure, it’s pretty difficult where it’s just grey where it stops and starts, isn’t it. But I think, if I look at it, I would have to say when you cross the line where the accounts are no longer faithful presentation, is where you’ve gone over the line.*

However, auditors also have a responsibility with respect to immaterial misstatements. The SEC Staff Accounting Bulletin (SAB) No. 99 “Materiality” (SEC 1999) provides guidance in applying materiality thresholds, and outlines auditors’
responses concerning both material and immaterial misstatements. In regard to immaterial misstatements, SAB No. 99 differentiates between those that are intentional, and those that arise during the normal course of business. SAB No. 99 describes a situation in which management of an entity has intentionally made adjustments to the financial reports in a manner that is inconsistent with GAAP; however none of the adjustments is (quantitatively) material to the financial reports either individually or in aggregate. The conclusion presented describes that even immaterial intentional misstatements are not acceptable, and may in fact be unlawful in certain circumstances. SAB No. 99 explains that immaterial misstatements that occur in the normal course of business generally do not affect the accuracy of the financial reports “. . . in reasonable detail” (SEC 1999: 6). However, “. . . it is unlikely that it is ever “reasonable” for registrants to record misstatements or to not correct known misstatements – even immaterial ones – as part of an ongoing effort directed by or known to senior management for the purposes of “managing earnings” (SEC 1999: 6).

Where an auditor has obtained evidence that fraud may exist, either material or immaterial\(^\text{11}\) to the financial report, AUS 210 requires the matter to be brought to the attention of management and, in some cases, the audit committee (AARF 2004a). A number of interviewees described the actions taken when confronted with immaterial fraudulent manipulations. These participants commented that they would bring the immaterial fraud to the attention of management, but would not push for an adjustment or qualify the audit report.

\(\text{Obviously if you’ve found maybe one or two invoices that they’ve done well you could probably say well, it’s not material in relation to the overall thing and when you do your adjustments, you’d bring it to their attention obviously, because you have to notify them of all adjustments, but you wouldn’t probably push for them to change it and insist on they change it otherwise you’d change your audit opinion, no you probably wouldn’t, because it wouldn’t be a material misstatement in the financial figures.}\)

\(^\text{11}\) AUS 210 uses the term ‘inconsequential’ (AARF, 2004a: Para. 94).
But you know, ultimately, auditors will not qualify accounts if the impact’s immaterial, they’re just, they’re not just going to be, just going to look stupid if they do.

Although interviewees acknowledged that auditors’ responsibilities lie with detecting material financial manipulations, a common theme that emerged from the interviews suggests attitudes in this regard are starting to change. Interviewees explain that whilst immaterial manipulations were previously often disregarded, there is now a growing belief that such manipulations should be corrected.

Well I think that’s where attitudes are starting to change a bit, you know.

There’s a growing belief that deliberate errors, or deliberate manipulations, are unacceptable and ought to be corrected. I’m not saying absolutely small ones, but ones that are, you know, a few percent less than 5 percent, if they’re just deliberate, then you’d have to say, they ought to be fixed.

**Qualitative Materiality**

While many misstatements are material by way of magnitude, quantitatively immaterial misstatements may in fact be material due to qualitative considerations (SEC 1999; Brody, Lowe and Pany 2003; AARF 2004b). Qualitative materiality guidelines provide examples where it would not be appropriate to determine materiality based solely on the amount of an item. Such examples include changes in risks due to expanding operations, and changes in conditions that could lead to a breach of an entity’s financial covenants (AARF 2004b: Para. 12).

Auditors have a responsibility to consider both the amount and nature of an item in determining materiality (AARF 2001b). However, as previously discussed, numerous studies have highlighted the importance auditors place on quantitative materiality. Indeed, interview findings tend to support the proposition that auditors place more importance on the size, rather than the nature, of a financial manipulation. Interviewees undoubtedly considered the size of a manipulation to be a key
determinant in distinguishing between aggressive earnings management and financial reporting fraud. Qualitative materiality factors, however, were not afforded the same level of recognition.

You’ve always got banking covenants and those sorts of things, so you do have to, you know you’ve got to have some attention to those sorts of things too, but I must say, I don’t think I ever worked on a job where that caused a materiality question, I’m not saying it couldn’t, but it didn’t on any jobs I worked on.

Yet interviewees acknowledged that this attitude is changing, and auditors are now likely to consider other, more qualitative, factors in their determination of an item’s materiality.

But I think the important thing that came out is much more focusing on well, some of these things are not just a question of materiality, but if they are deliberate, then you have to take that into account . . . of course the rules about five and ten percent are just arbitrary, absolutely arbitrary, and I think people will now pay much more attention on well, what is it that gave rise to this error, why are we in this position, management is manipulating things, or it is deliberate, then I think they’re going to take a much tougher line.

Yeah, I must say, that I think as I got older and wiser that I tended to find, well especially in more recent times, I think people are facing much more questions about, you know, what are the reasons underlying what’s going on.

Research suggests that, due to the recent emphasis on enhancing investors’ confidence and regulatory reform, auditors believe they are in a better position today to prevent aggressive earnings management (Collier 2004). The same study also found that auditors perceive their ability to take action, upon detection of aggressive earnings management practices, is greater now than it once was. Comments from interviewees in this study also suggest this to be the case.
If people are manipulating results to meet analyst forecasts or to get growth or steady profits, and these things have been stretched, I think auditors would be much more likely to really stand firm these days than what they might have done ten years ago.

Summarising, all interviewees perceived quantitative materiality to be a more important factor than qualitative materiality in distinguishing between aggressive accounting and financial reporting fraud. Participants noted, however, that attitudes in regard to qualitatively material (and quantitatively immaterial) manipulations are starting to change, as qualitative factors receive more attention.

**Subjectivity**

Subjectivity refers to the extent of judgement involved in measurement of an item. Objectively measured financial manipulations, such as recording revenue in the wrong period, do not involve judgement in measurement. However, accounts that require significant estimation, such as provisions and reserves, are more subjectively measured. In regard to subjective measurement, findings of several studies suggest that auditors are more likely to waive adjustments where an item is measured subjectively rather than objectively (Wright and Wright 1997; Braun 2001).

Unlike other qualitative materiality factors, interviewees viewed measurement subjectivity as being an important contributing factor in forming a distinction between aggressive accounting and financial reporting fraud. Indeed, participants’ views of the role of measurement subjectivity in aggressive accounting and fraudulent accounting provide interesting findings. The general view held by interviewees was that there is a clear distinction between subjectively measured financial manipulations, where significant estimation or judgement is required, and objectively measured manipulations.

I think you’ve got to distinguish between two things; one is judgemental decisions, and two, things that are blatantly wrong.
You’ve got two sorts of things, ones that are just wrong . . . where people have just done things that are absolutely wrong, and then there are the others that are more judgemental, and there are shades of judgement, so that a range of answers could be acceptable, and they’re more difficult because, in the end you know, you might prefer a judgement somewhere in the middle of the range, but the client settles at the lower end of the range, then you’re almost, you’re sort of forced to accept it.

As formerly discussed, there exists a conflicting view in the research and professional literatures as to whether manipulations of accounts requiring significant estimation constitute aggressive earnings management or fraudulent accounting. The earnings management model proposed by AAA10 (AARF 2001a) and Dechow and Skinner (2000) suggests that such manipulations are a form of aggressive, but not fraudulent, accounting. In contrast, AUS 210 describes the inappropriate altering of assumptions and judgements for the estimation of account balances as financial reporting fraud (AARF 2004a). Given the current definitional focus on intent to deceive, there appears to be no reason why subjectively measured manipulations cannot constitute financial reporting fraud. Nonetheless, in this current study, interviewees held the general belief that subjectively measured manipulations constitute aggressive, and not fraudulent, accounting.

I probably wouldn’t consider that to be fraud, if they grossly understated the provision for doubtful debts or the provision for warranty or their accruals, yeah it’s a strange thing, I wouldn’t, because that’s not something that they’ve deliberately altered, it means that they just haven’t, they just haven’t got it right . . . but yeah I, I probably wouldn’t consider that to be fraud.

I think where you’ve got the grey area, is where you’re assessing well what’s the life of an asset, what’s your depreciation, what’s your provision for doubtful debts. Now I think in those cases, there are judgements. But I don’t think that’s, I have some trouble saying that’s fraud unless it really causes the accounts not to be a faithful presentation.
Interviewees often cited objectively measured manipulations as examples of fraudulent accounting. A possible motive for the variation in judgement of subjective and objective manipulations is the implied management intent. Objectively measured financial manipulations, such as recording sales in the wrong period, appear to instinctively imply intent to deceive. For example, it seems highly unlikely that incorrect timing of revenue recognition is carried out with the intent to inform financial report users.

*I think you’ve got to distinguish between two things; one is judgemental decisions, and two, things that are blatantly wrong. For example if you got a delivery in July and you recorded it in June, well I would say that’s probably, that’s a deliberate manipulation. I don’t think that’s earnings management or judgemental, it’s being manipulative, I think, well it’s being fraudulent, because it’s just blatantly wrong.*

On the other hand, management intent becomes almost impossible to gauge with subjective manipulations; the intent could range from one of informing to one of deceiving. For example, changes to account balances that require significant estimation could represent a legitimate business decision, or they could constitute a manipulation undertaken purely for the purposes of misleading investors about the financial performance of the company.

*Yeah that’s right it is, it’s much harder to say well this is their intention to, to understate their profit or overstate it or whatever they wanted to do.*

To summarise, participants’ perceptions seem to preclude the notion that subjective financial manipulations can represent fraudulent accounting; such manipulations were instead viewed as an aggressive form of accounting. Clearly more research needs to be undertaken in the area of subjectively measured manipulations, and whether or not they can actually constitute financial reporting fraud.

As a final point, interviewees explain that other factors (past actions of the company, fraud risk factors, flexibility within standards) are indirectly taken into account in distinguishing between aggressive and fraudulent accounting. Overall, however,
interviewees consider management intent, GAAP compliance, materiality, and measurement subjectivity to be the most important contributing factors. Figure 2 provides an overview of the factors considered important by auditors in forming the distinction between aggressive accounting and financial reporting fraud.

![Diagram showing factors influencing auditors' distinction between aggressive accounting and financial reporting fraud]

**FIGURE 2 Factors Influencing Auditors’ Distinction between Aggressive Accounting and Financial Reporting Fraud**

Participants recognise the crucial element of financial reporting fraud as being intent to deceive, but acknowledge that management intent is difficult to establish. Interviewees note that GAAP violation is also an important factor of fraudulent accounting; aggressive accounting, in contrast, is viewed as being within GAAP, but pushing the limits of GAAP. Whilst interviewees express awareness of the fact that fraudulent accounting can be material or immaterial in size and/or nature, they
nonetheless indicate a higher likelihood of taking action for quantitatively material fraudulent manipulations. In regard to measurement, participants are reluctant to view subjectively measured manipulations as fraudulent, preferring to view such manipulations as aggressive accounting. Furthermore, interview findings portray a common emergent theme: the growing importance of identifying the reasons underlying financial manipulations.

LIMITATIONS, IMPLICATIONS AND FUTURE RESEARCH
Auditor interviews were undertaken primarily for the purpose of enhancing the experimental design to be used in the second stage of the research; results were not intended to be generalised to actual audit settings. For this study, therefore, the lack of external validity associated with the small sample size is not perceived to be a limitation. Rather, the primary limitation of this research stems from the ambiguity in both professional and research literatures in distinguishing between aggressive accounting and fraud. Certainly the interview findings highlight the difficulties associated with establishing a distinction between the two types of financial manipulation. Nevertheless, research findings provide an interesting insight into how auditors distinguish between aggressive earnings management and fraudulent financial reporting in practice.

The results presented in this study comprise the first stage of a much larger research project. The second stage of the project involves incorporating interview findings into the development of an experimental instrument to be delivered to a larger sample of practicing senior auditors. Results of the experiment are examined in a subsequent paper. Research in this area is still in its infancy; there exist numerous further research avenues. Further in-depth studies could be conducted of how other parties, such as internal auditors, managers, and investors, distinguish between aggressive accounting and financial reporting fraud. Comparison studies could be undertaken to identify differences in those factors taken into account by the various parties in making this distinction. Further research is certainly needed in the area of determining whether subjectively measured misstatements constitute fraudulent accounting. Finally, more research is required to develop both theoretical and practical models of the distinction between aggressive accounting and financial reporting fraud.
CONCLUSION

Auditors have a responsibility to adopt an attitude of professional scepticism in respect of aggressive earnings management (AARF 2001a), and to provide reasonable assurance that financial reports are free from material misstatement (AICPA 2002; AARF 2004a; IFAC 2004). Yet earnings management constraint and fraud detection is made particularly difficult by the ambiguity associated with defining where aggressive accounting ends and fraudulent accounting begins. This research actively investigates how auditors distinguish between aggressive earnings management and financial reporting fraud. Research results provide preliminary evidence as to how auditors distinguish between the two types of financial manipulation, and provide insight into those factors that auditors invoke to form this distinction. Findings from this research have the potential to alleviate some of the ambiguity associated with distinguishing between aggressive and fraudulent accounting. Research findings potentially provide a valuable contribution to the academic literature, to auditing standard setting, and to the auditing profession and its practices.
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