

# THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

## Flexibility in Accounting: A Slippery Slope to Fraud?

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### Abstract:

*The paper explores the idea that earnings fraud follows a slippery slope wherein companies manage earnings “legitimately” to achieve pre-determined targets, then aggressively in an effort to achieve the desired results; if the desired results are still not achieved, then, the only option open is to “cook the books” by falsifying documents. Four illustrative cases of fraudulent companies were analysed qualitatively to assess how the slope of earnings management was slippery; and over time earnings management became fraud. The outcomes are that whenever there is a need to meet internal or external earnings expectations, conceal the company’s deteriorating financial condition, increase the stock price or increase management compensation based on financial results; flexibility in accounting standards have provided an opportunity to manage earnings legitimately, aggressively and then fraudulently. While flexibility in accounting is sacrosanct; it is recommended that managers be mindful that the slope of earnings management could be slippery enough to lead to fraud; they should therefore be mindful of those repetitive “small indiscretions”. If possible, managers should address those small deceptive acts; they should clearly delineate what is allowed and what is absolutely forbidden. Furthermore, managers should ensure that governance mechanisms and codes of conduct and ethics of corporations are adhered to and rigorously enforced.*

**Keywords:** accounting flexibility, slippery slope, earnings management, earnings fraud

### 1. Introduction

Accounting standards allow financial statement preparers significant latitude, flexibility or “subjectivity” in the recording of transactions, and the preparation and presentation of financial statements. Accounting flexibility is a mechanism to cope with changing circumstances and variations in conditions across companies and industries (Mulford & Comiskey, 2002). However, even “honest” companies could exploit the allowed flexibilities as opportunity to nudge earnings to achieve pre-determined targets; in some cases, the nudging slope will eventually become as slippery as to lead to fraud. The process by which earnings management by “honest” as opposed to “opportunistic” companies’ slides into a fraud scheme is as follows: Initially, the fraud scheme will start small as earnings management; perhaps as an “adjustment”, and therefore “relatively harmless” and unlikely to be detected if actual performance improves soon. However, if real performance does not improve soon, the earnings will continue to be managed in increasing amounts and in the methods employed, until the manager’s only option is to “cook the books”, falsify documents and materially misstate accounting numbers. This paper explores the idea that earnings fraud follows a path; a slippery slope which uses flexibilities in accounting that creates opportunities for earnings management legitimately. If the desired results are still not achieved, then earnings are managed more aggressively; if the desired results are still not met in spite of the aggressive accounting, the only option open is to commit fraud in order to show the desired results. The process described above is referred to as the slippery slope to earnings fraud. It proposes that earnings fraud often starts small, and gradually escalates towards more egregious and fraudulent activities.

The paper proceeds as follows: the concepts of flexibility in accounting and the slippery slope to earnings fraud are explained in sections 2 and 3. Why fraud follows a slippery slope is explained in section 4; and four illustrative cases of slippery slope to fraud are presented and discussed in sections 5 and 6; while section 7 concludes the paper.

### 2. Flexibility in Accounting

The opposite of flexibility in accounting standards is uniformity in accounting standards; the use of identical accounting practices by all businesses. Uniformity in accounting is not tenable; conditions surrounding businesses are not sufficiently similar to warrant it, even by companies within the same industry (Mulford & Comiskey, 2002). Flexibility in accounting with the use of professional judgement creates opportunity for abuse by financial statement preparers and accommodation of the abuse by auditors. It can also result in more pressure on preparers to use, and auditors to accept, “aggressive accounting treatments” (Healy & Wahlen, 1999; Field, Lys, & Vincent, 2001). In other words, accounting flexibility gives management ample opportunity to manage earnings aggressively eventually evolving into fraud. Not all share this view: Parfet (2000), a practising accountant, for example, does not believe that the use of judgement and subjectivity would by itself lead to aggressive earnings management or abuse because effective enforcement of corporate ethics with a right tone at the top, management controls, effective audit committee oversight, capable auditing, and public accountability; should constrain any improper earnings management. Thus, the practitioners’ view is to the effect that as long as the financial reporting supply chain actors (Board of directors, particularly audit committees, financial statement preparers and

management and external auditors) are professionally competent and observe clear corporate governance codes and ethical responsibilities, abusive earnings management will not arise. Parfet (2000: 482) notes about accounting flexibility that:

The use of judgment and subjectivity in accounting is important and desirable. There is no substitute for a trained professional manager or auditor applying his or her knowledge to determine the proper recording of transactions... what could really be done in the way of a rule, a definition, or a direction to erase the fundamental need for a capable and ethical person to use his or her judgment?

Academics and regulators, on the other hand, while supporting flexibility in accounting, caution about its possible abuse. For example, Healy and Wahlen (1999: 366) consider that:

- If financial reports are to convey managers' information on the firms' performance, standards must permit managers to exercise judgment in financial reporting. Managers can then use their knowledge about the business and its opportunities to select reporting methods, estimates, and disclosures that match the firms' business economics, potentially increasing the value of accounting as a form of communication. (However), because auditing is imperfect, management's use of judgment also creates opportunities for "earnings management" in which managers choose reporting methods and estimates that do not accurately reflect the firms' underlying economics.

Similarly, Mulford and Comiskey (2002:26) support and caution about accounting flexibility:

- For valid reasons, flexibility in financial reporting exists. It will and should remain as long as circumstances and conditions across companies and industries vary. The existence of flexibility in the choice and application of accounting policies, however, should not result in misleading financial statements. Rather than using that flexibility to mislead financial statement users, companies should employ it to provide a fair presentation of their financial results and financial position.

Levitt (1998: 2), a former Chairman of the American Securities and Exchange Commission (SEC), similarly supports but cautions about flexibility in accounting observing that:

- Flexibility in accounting allows it to keep pace with business innovations. Abuses such as earnings management occur when people exploit this pliancy. Trickery is employed to obscure actual financial volatility. This, in turn, masks the true consequences of management's decision.

The general message from these authorities is that accounting flexibility<sup>1</sup> is required and necessary in financial reporting; however, it could potentially be used as opportunity for earnings management and even earnings fraud (Palepu, Bernard & Healy, 1996).

Managers use these latitudes to exercise judgment and discretion to manage earnings (Healy & Wahlen, 1999; Field, Lys, & Vincent, 2001). This occurs in areas such as the timing of accruals, manipulation of the cost base of assets acquired individually and in business combinations, the modification of depreciation schedules, revenue recognition, inventories, stock options, lease expenses, fair value estimates, and changes in accounting policies (Nelson, Elliott, & Tarpley, 2003; Libby & Seybert, 2009). In other words, accounting standards such as the International Accounting Reporting Standards (IFRS) leaves it up to firms to make any accounting choices that do not contravene the principles established in the standards.

### 3. The Slippery Slope to Earnings Fraud

The term *slippery slope* refers to situations when a relatively insignificant first event leads to a significant event, which in turn leads to a more significant event, and so on, until some ultimate, most significant event is reached. In the context of this paper, slippery slope refers to situations where small indiscretions (permitted by accounting flexibility) escalate over time into larger violations not allowed by accounting standards or company law.

To illustrate the concept of slippery slope, consider a manager who has narrowly missed a specific benchmark in the current period; to which he/she can make a small, relatively innocuous accounting "adjustment" to meet this benchmark. Let us assume further that the "adjustment" relates to an inappropriately small estimate of future bad debt expense. This adjustment will affect future performance in two ways. First, because accounting accruals usually reverse in future periods; therefore, the bad debt expense will be higher in the next period, directly reducing the future period's performance. Second, expectations about the firm's future performance consequent upon the small instance of earnings management will increase. If the future periods' performance is not sufficiently high, additional adjustment/earnings management must be performed to both meet expectations and conceal past earnings management. This pattern will continue until egregious earnings management is committed to meet the highly inflated performance targets (Brown, 2012).

In line with this illustration, Schrand and Zechman (2011) posit that small misstatements designed to increase earnings usually encourage executives to increase the amount of earnings management steadily over time to meet pre-established earnings targets and cover up their initial misstatements. Furthermore, the slippery slope to fraud occurs because, engaging in a small amount of earnings management alters the manager's beliefs about the appropriateness of the act which makes further earnings management more likely (Brown, 2012).

In other ways, slippery slope refers to situations where earnings management descend incrementally to aggressive accounting and then, into earnings fraud (Senogles & Glowka, 2013). It is "marginal deceptions evolving into much larger deceptions"; which Schrand and Zechman (2011) describe as follows:

An executive believes his firm is experiencing only a bad quarter or patch of bad luck. He also believes it is in the best interest of everyone involved- management, employees, customers, creditors, and shareholders – to cover up the problem in the short term so that these constituents do not misinterpret the current poor performance as a sign of the future. He may stretch the rules (to engage) in a

<sup>1</sup>Operationally, accounting flexibility is measured in terms of (1) the use of estimates, (2) the use of multiple measurements, particularly fair value, and (3) the use of judgment and discretion in recognising and measuring assets, liabilities, revenues and expenses.

“gray area” of earnings management. But if things don’t turn around as expected, he will continue to manage earnings in increasing amounts. Eventually, the manager’s only option is to “cook the books” by falsifying documents and making the kinds of accounting misstatements that are prosecuted by the regulatory authorities.

As suggested by the above quotation, the path to earnings fraud is through a slippery slope rather than a steep cliff. In practice, the accidental fraud managers start off looking to plug small gaps in performance and may have no intention of committing fraud. If their performance does not improve in subsequent periods, the managers may continue to plug the gaps; over time, however, the amount of managed earnings becomes egregious and fraudulent. It is notable that the management neither starts out to commit fraud nor has an intention to hurt anyone, but it ends up being in a position where it feels egregious earnings management is the only way to get out of a bad situation (Schrand & Zechman, 2011). Similarly, Beasley, Carcello, Hermanson & Neal (2010) suggest that fraud often starts out small, like a “trickle”; fraud rarely starts with a grand plan or conspiracy. It often starts so small that the participants believe that they are doing nothing more than legitimately managing earnings; merely exploiting allowed flexibilities in the accounting rules. With time, the trickle becomes a torrent, cascading down the slippery slope to fraud (Young, 2000:11).

#### **4. Why Fraud follows a Slippery Slope**

The idea of slippery slope to fraud is a natural result of the overlap of the continuum of legitimate earnings management, aggressive accounting and fraud. Corporate managers are allowed flexibility to use estimates or judgments such as expected lives and salvaging values of long-term assets, obligations for pension benefits and other post-employment benefits, deferred taxes, and losses from bad debt and asset impairments. Corporate managers can also select accounting principles such as the opportunity to effect changes to depreciation or inventory valuation methods legitimately to manage earnings when they have the incentives to do so. Invariably, the legitimate earnings are managed in “small” amounts, like a “trickle”, perhaps as an “adjustment” to fill a temporary gap in earnings expectations; actions which the managers might consider to be “harmless”. If, however, the gap is not filled in subsequent year(s) as envisaged, then the companies “migrate” to the next level in the continuum.

At this “second level” the company uses estimates or judgments and selects accounting principles and applies them forcefully and aggressively to the outer limits of allowed flexibilities in an effort to achieve the desired results. At this stage, managerial actions constitute aggressive accounting.

With continued “pushing of the envelope”, a line is crossed and the accounting practices being employed move beyond the boundaries of allowed flexibility. This is usually only known with hindsight. Once the line is crossed, the resultant financial statements do not provide a fair presentation of the subject company’s financial results and position because of material misstatements, omissions or improper disclosures; they now tilt towards fraud.

It is worthy to note that the line between aggressive earnings management and fraud is fluid and very thin. A number of reasons/factors have been adduced for this fluidity: First, aggressive earnings management and earnings fraud share the same elements. They share the same objective, which is to deceive or mislead the users of financial information. Both are deliberate actions taken by the management to achieve private gains and both have the potential to cause material loss or damage to the shareholders as they rely on false information. However, Erickson, Hanlon and Maydey (2006) and Dechow and Skinner (2000) distinguish earnings management (legitimate or aggressive) as being within the provisions of accounting standards and earnings fraud as being outside of the accounting standards’ provisions.

Second, both aggressive earnings management and earnings fraud are driven by the same incentives. Prior research indicates that discretionary accruals components of earnings are managed to meet or slightly beat analysts’ forecasts (Burgstahler & Dichev, 1997; Burgstahler & Eames, 2006; Amars & Abaoub, 2010; Dechow, Richardson & Tuna, 2000); to maximize management compensation (Jiang, Petroni & Wang, 2010), to avoid tripping debts covenants (Balsam, 1998; Baker, Collins & Reitenga, 2003; Bartov & Mohanram, 2004; Shuto, 2007); and the desire to attract external financing at low costs (Dechow et al., 1996).

Third, with many accounting policies, when it comes to their application, there is no clear limit beyond which a policy might be considered fraudulent. For example, an estimate of expenses may be fraudulent if the estimated amount is extreme, but allowable if it is reasonable and within the spirit of accounting standards (Rosner, 2003). Accounting standards (e.g., IFRS) do not tell managers specifically what is normal and what is extreme; managers are required to use their judgment. Regulators indicate that they would target companies that engaged in “practices that appear to manage earnings” (Levitt, 1998). Without clearly distinguishing between earnings managed in the ordinary course of business and earnings fraudulently managed in a deliberate attempt to deceive the financial community; it is difficult to determine whether the line has been crossed. Therefore, in between these extremes are judgments that push the limits of accounting standards and often result in fraudulent misleading financial results.

Finally, the use of aggressive earnings management techniques is not necessarily fraudulent; but may be the start of slippery slope, where legitimate earnings management descend into fraudulent earnings management.

#### **5. Cases of Slippery Slope to Fraud**

In this section, four illustrative cases of the slippery slope to fraud are presented:

##### *5.1. HealthSouth, Inc.*

From very humble beginnings in 1984, HealthSouth became the largest provider of health-care services in the USA by 1996 with about 1,700 facilities all over the United States and overseas. The growth of the company was fuelled in most respects by three external factors: First, the USA government generously subsidised hospitals and health care providers in Medicare reimbursements; this financed HealthSouth’s aggressive acquisition of competing companies. Second, America’s generally accepted accounting

principles (GAAP) were “rule-based”; therefore, any accounting treatment which did not directly violate the GAAP was considered legal. Lastly, in the 1990s, investors and lenders were less focused on profitability and more on revenue growth. Thus growth, rather than profits, was the key in looking for capital. This created the pressure on companies to continue to grow their revenues to meet analysts’ expectations, quarter by quarter. HealthSouth met analysts’ expectations for 40 consecutive quarters largely through managing earnings and ultimately through managing earnings fraudulently.

In 1997 however, the government of the USA reduced Medicare reimbursement to hospitals and health care providers; this significantly impacted HealthSouth margins. By the 1998 financial year, HealthSouth’s reported net income dropped by 86%. Next, although sales only grew by 5% from 1999 to 2001, the company’s net income inconceivably rose almost 500% (Daigle, Louwers & Morris, 2013). Management of HealthSouth explained that the extraordinary performance occurred because of lowering costs and raising revenues through increased efficiency in each hospital. The truth however, is that the apparent fantastic performance was as a result of fraud which was uncovered in June, 2003 by which time investigators discovered that earnings were overstated by at least \$2.7 billion over a 17-year period (1996 – 2003).

Every quarter, senior managers of HealthSouth met to discuss strategies to “fill the gap” between actual revenues and the analysts’ expectations of the company. They adopted three strategies to achieve their objective. (i) Quarterly earnings would be presented to executive management who compared them to analysts’ expectations. (ii) If the earnings fell short of analysts’ expectations, the earnings were “fixed” by recording false earnings to make up for the shortfall. (iii) False documents, (e.g., fictitious invoices, back dating of agreements, reporting of expenses as capital assets, over-valuation of inventory *et cetera*) were created to conceal the false entries added to the accounts. Creating false documents was further facilitated by exploiting the materiality threshold (another aspect of accounting flexibility). Accountants at HealthSouth, as former employees of the external auditors, knew that the auditor’s materiality threshold was \$5,000. That is, the external auditors, Ernest and Young (E & Y) scrutinised fixed asset additions only if the amount involved was \$5000 or more. Thus, as long as a fictitious transaction was under \$5000, E & Y would not subject it to more rigorous auditing procedures. HealthSouth passed fictitious journal entries, on average, of \$2500 each to overstate earnings by \$2.7 billion and this took well over a million fictitious journals to accomplish. The company justified its fraudulent activities as it had to “make the numbers” or that activities of management in this direction are necessary otherwise “innocent people would lose their jobs and the company would suffer”.

### 5.2. Waste Management Inc.

Waste management Inc is a comprehensive waste and environmental sanitation company founded by Wayne Huizenga and Dean Buntrock in 1971. By the 1995, the company reported more than \$10 billion in sales – most of it allegedly coming from acquisitions. Between 1992 and 1997, Waste Management engaged in a systematic scheme in which earnings targets for each quarter were set and the books were then “cooked” to ensure conformance to these previously painted prognoses. Despite the fact that revenues were not growing fast enough to meet the earnings targets set by management; the company continued to fraudulently manipulate its financial results to meet pre-determined earnings targets. The favourite manipulation techniques included improper elimination and deferment of current period expenses, avoidance of depreciation expenses on plant and equipment, unsupported elongation of depreciation periods relative to property, plant and equipment, inflation of salvage values to assets even to assets that previously had no salvage values, improper capitalisation of a variety of expenses, *et cetera*. The amounts manipulated were small at first and therefore went undetected; they however escalated with time to keep up with the charade. In short, the company progressively exploited allowed accounting flexibilities aggressively to misrepresent the financial affairs of the company until a new CEO took charge of the company and ordered a review of the company’s accounting practices in 1997. In the following year, i.e., 1998, Waste Management restated its 1992-1997 earnings by \$1.7 billion, making it the largest restatement in history. By 2002, the SEC filed a suit against the founder (Buntrock) and five other former top officers, charging them with perpetuating a massive financial fraud lasting more than five years. SEC alleged that the corporate officers’ conduct was driven by greed and a desire to retain their corporate positions and status in the business and social communities.

A variety of accounting schemes were deployed to conceal the fraud including “netting” and “geography”. Current period expenses and accumulated prior period accounting misstatements amounting to approximately \$490 million were netted, i.e., offset against unrelated one-time gains on the sale or exchange of assets. Waste Management made “geography” entries moving tens of millions of dollars between various line items on the company’s income statement in order to achieve pre-determined earnings targets.

### 5.3. Satyam Computers Services Ltd.

Satyam Computer Services Ltd is an IT-services company founded in 1987 in Hyderabad, India by Ramalinga Raju. By 2003, Satyam profile included 13,120 technical associates (employees) servicing over 300 customers worldwide (Bhasin, 2013). Bhasin (2013: 33) described how the financial metrics of interest to investors grew measurably: Satyam generated \$467 million in total sales in the period 2003- 2004. By March 2008, the company’s sales revenue had grown by over three times to \$2.1 billion. The company achieved “an annual compound growth rate of 38% over that period”. Operating profits averaged from 21% to 35%. Earnings per share similarly grew, from \$0.12 to \$0.62, at a compound annual growth rate of 40%. The company was a leading star and a recognizable name in a global IT marketplace.

Regrettably, these metrics did not represent the economic performance of the company; they were based on accounting fraud which had started from about April 1999, when the company embarked on a double-digit annual growth. On December 16, 2008, without shareholder approval, Satyam went ahead to acquire 100% of Maytas Infrastructure and Maytas Properties, two companies owned by family members of the company’s Chairman. The deal was called off within twelve hours after investors opposed the takeover; yet

Satyam's shares plunged by 55% on the New York Stock Exchange. Ultimately the company's investment bankers, Merrill Lynch, appointed to look for a partner or buyer for Satyam blew the whistle effectively terminating its engagement upon discovery of financial irregularities.

On January 7, 2009, Mr. Raju resigned after disclosing in a letter to Satyam Computers Limited Board of Directors that "he had been manipulating the company's accounting numbers for years", presumably from April, 1999. Mr. Raju claimed that he overstated assets on Satyam's financial position statement by \$1.47 billion. Nearly \$1.04 billion in bank loans and cash that the company claimed to own was non-existent. Satyam also underreported liabilities and overstated income nearly every quarter over the course of several years in order to meet analyst expectations. For example, the result announced on October 17, 2009 overstated quarterly revenues by 75 percent and profits by 97 percent.

The objective of the fraud was to divert company funds into real-estate investment, keep high earnings per share, raise executive compensation, and make huge profits by selling shares owned by management at an inflated price (Bhasin, 2013:36). Satyam's Founder, Chairman and CEO, Mr. Raju's Letter to his Board of Directors<sup>2</sup> explained how he and his company came to be in its current predicament:

What started as a marginal gap between actual operating profit and the one reflected in the books of accounts continued to grow over the years. It has attained unmanageable proportions as the size of company operations grew significantly...The differential in the real profits and the one reflected in the books was further accentuated by the fact that the company had to carry additional resources and assets to justify higher level of operations—thereby significantly increasing the costs.

Every attempt made to eliminate the gap failed. As the promoters held a small percentage of equity, the concern was that poor performance would result in a take-over, thereby exposing the gap. It was like riding a tiger, not knowing how to get off without being eaten.

The aborted Maytas acquisition deal was the last attempt to fill the fictitious assets with real ones. Maytas' investors were convinced that this is a good divestment opportunity and a strategic fit. Once Satyam's problem was solved, it was hoped that Maytas' payments can be delayed. But that was not to be. What followed in the last several days is common knowledge.

The investors seemed unconvinced; the investors thought it was a brazen attempt to siphon (tunnel) cash and other assets out of Satyam, in which the Raju family held a small stake, into firms the family held more tightly (D'Monte, 2008).

#### 5.4. Cadbury Nigeria Plc

Cadbury Nigeria Plc was established in 1965 as a subsidiary of the Cadbury Schweppes Group of the United Kingdom. "Overstatements" to the tune of some \$15 million which had been built up for five years (2002 – 2006) were discovered in October, 2006. These overstatements arose from channel stuffing; recognising revenue from sham sales. Cadbury Nigeria extended credit limits to its distributors and booked the extended credit limits as "sales". The goods captured in the new credit limits had already been stamped as "received" by the distributors at Cadbury gates, whereas most of the goods were still in the warehouses and premises of the company. Cadbury assisted the distributors to secure bank loans which they allegedly deposited with the company to give the impression of partial payments for the increased credit line of goods. However, distributors were reluctant to take delivery of the goods in the new credit limits as these were beyond their actual orders and they lacked sufficient storage facilities for the overloaded trade. Worse, "forward-selling" of Cadbury wares to its distributors was passed off as completed sales transactions; attracting corporate tax liability. The supposed "forward-sales" were in fact credit lines extended to the distributors. The fraud was attributed to deliberate efforts to shore up the company's earnings in order to achieve ambitious pre-determined growth in EPS targets internally set by Cadbury Nigeria Plc executives.

## 6. Discussion of the Cases

In all these illustrative cases, presented above, similar to Beasley *et al.* (2010), the common motivations for earnings fraud were the need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price or the desire to increase management compensation based on financial results. Judging by the time period for the discovery of the frauds (Cadbury, 5 years, Waste Management, 6 years, Satyam, 10 years, and HealthSouth, 17 years); it seems the misstatement or alterations started small, perhaps intended as "an adjustment" to meet earnings targets to give the company time to improve results but the alterations increased progressively. Initially, the individuals involved may not have considered their actions as unacceptable or fraudulent. But because of the need to maintain a prognosis painted earlier, one adjustment led to another and the scope of the fraud expanded until the perpetrators were locked in and headed down the "slippery slope" to a major fraud.

The slippery slope became particularly steep when, as demonstrated in each illustrative case, (perhaps less so for Cadbury), certain conditions within the company allowed the frauds to occur: overbearing "tone at the top" bent on meeting expectations of the market, the company's fast growth in sales, diverse acquisitions and geographic spread of operations. The resulting structural complexity of each company produced the need for a large volume of estimates of assets, liabilities, revenues, and expenses that are subjective or difficult to corroborate, providing management the opportunity to commit fraud.

The metaphor "Slippery When Wet" (Arjoon, 2008) played a part in the commitment of the frauds when management justified (wetter) their actions as necessary to save their own jobs and those of innocent people, to prevent the company from suffering, until the fortunes of the company turned around.

<sup>2</sup> Available at [www.sebi.gov.in](http://www.sebi.gov.in)

## 7. Conclusion

The paper explores the idea that earnings fraud follows a slippery slope wherein companies manage earnings “legitimately” to achieve pre-determined targets, then aggressively (i.e., increasing the amounts and methods of earnings management) in an effort to achieve the desired results; if the desired results are still not achieved, eventually, the only option open is “cooking the books” by falsifying documents and making the kinds of accounting misstatements that are prosecuted by the regulatory authorities. The slippery slope logic is explained in terms of the overlapping nature of the legitimate/aggressive/fraudulent earnings management continuum whereby lines are crossed and only known with hindsight. Flexibility in accounting has been argued to create the opportunities for earnings management and for earnings fraud to occur. However, uniformity in accounting standards (the opposite of flexibility in accounting) is not recommended. Rather, it is recommended that a “prevention focus” (in contrast to a “promotion focus”) be embraced by companies. A prevention focus emphasises caution, and being mindful of the ultimate consequences of starting even small transgressions, thereby avoiding the slippery slope. Finally, it is recommended that as far as possible, management should address those small deceptive acts; they should clearly delineate what is allowed and what is absolutely forbidden. Furthermore, managers should ensure that governance mechanisms and codes of conduct and ethics of corporations are rigorously enforced.

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