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Financial Facades and Sustainable Realities: Earnings Management across Distressed and Healthy GCC Enterprises

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Abstract

Earnings management remains a contentious issue in financial reporting, often obscuring the true economic performance of firms. In the Gulf Cooperation Council (GCC) region, where economic diversification and sustainability are strategic goals, the practice of managing earnings presents challenges to transparency and long-term resilience. This study examines the extent and nature of earnings management across distressed and financially healthy firms in the GCC. By leveraging accrual-based and real earnings management models, and differentiating between distressed and non-distressed entities, we explore how financial pressure influences reporting behavior. The findings suggest that distressed firms are more likely to engage in opportunistic earnings manipulation, while healthy firms tend to manage earnings for signaling stability and attracting investment. These dynamics have profound implications for regulators, investors, and policymakers seeking to foster sustainable and trustworthy financial systems in the region.

Keywords: Earnings Management, GCC Enterprises, Distressed Firms, Financial Reporting, Real Earnings Manipulation, Accruals, Sustainability, Corporate Governance, Transparency, Investor Protection

Introduction

Earnings management has long stood at the crossroads of ethical financial reporting and corporate strategy. It involves the deliberate manipulation of accounting policies or real activities to achieve desired financial outcomes, whether to meet benchmarks, influence investor

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perceptions, or defer financial distress[1]. While not always illegal, such practices blur the boundary between prudent management and deception, often compromising the transparency and reliability of financial statements. In regions like the Gulf Cooperation Council (GCC)—comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—earnings management poses unique challenges due to evolving regulatory frameworks, varying degrees of market maturity, and a growing emphasis on sustainability.

The GCC economies are in a critical phase of transition. With declining oil revenues prompting structural reforms, countries are increasingly focused on economic diversification, financial transparency, and investor confidence. These shifts have brought greater scrutiny to corporate governance and financial reporting practices. Amid these reforms, the financial health of companies—particularly in the post-COVID recovery era—has become a focal point for stakeholders. Companies labeled as "distressed" face liquidity constraints, reduced earnings, or operational risks, all of which may incentivize earnings management as a survival tactic. On the other hand, financially healthy firms may also manage earnings, albeit for different reasons, such as maintaining investor confidence or meeting market expectations[2].

The practice of earnings management in distressed firms is often driven by the need to avoid loan covenant violations, avert negative market reactions, or delay restructuring. These firms may manipulate earnings more aggressively, using either accrual-based adjustments (e.g., timing of revenue recognition or depreciation methods) or real activities manipulation (e.g., overproduction or discretionary expense reduction). Such behaviors are not only more prevalent in times of financial stress but are also more difficult to detect, especially in markets where regulatory enforcement is still maturing.

In contrast, healthy firms may engage in more subtle forms of earnings management to smooth income, reduce volatility, or project a stable growth narrative to investors and creditors. Their motivations are less about survival and more about reputation management, valuation optimization, and strategic signaling. While less harmful in appearance, these actions still distort the informational value of financial reports and may mislead market participants about the firm's true performance[3].

Pages: 28-35
Volume-II, Issue-I, 2025

Understanding the patterns of earnings management across distressed and non-distressed firms in the GCC is vital for several reasons. First, it sheds light on the integrity of financial information in a region striving to attract global capital. Second, it helps regulators tailor policies that address specific vulnerabilities in financial reporting. Third, it informs investors and analysts about the red flags and financial behaviors that may warrant deeper examination.

This paper investigates the extent, techniques, and motivations behind earnings management in GCC enterprises, differentiating between distressed and healthy firms. By applying accrual-based models (such as the modified Jones model) and real earnings management indicators, we identify key trends and test whether financial distress status correlates with higher levels of earnings manipulation. Furthermore, we explore how institutional and governance factors within the GCC influence the prevalence and detectability of these practices. Through this analysis, we aim to bridge the gap between reported earnings and economic reality, contributing to the discourse on sustainable corporate conduct and financial transparency in emerging markets.

Earnings Management Practices in Distressed vs. Healthy GCC Firms

Earnings management manifests differently in distressed and healthy firms, shaped by the underlying financial pressures, regulatory landscape, and managerial incentives. In the context of the GCC, where capital markets are still developing and corporate governance practices vary across countries, these differences are especially pronounced. This section examines the nature and intensity of earnings manipulation among distressed and non-distressed firms in the region, using accrual-based and real activities-based measures[4].

Distressed firms in the GCC face acute pressure to demonstrate viability in the eyes of lenders, investors, and regulators. These firms often engage in aggressive accrual-based earnings management (AEM) to inflate current earnings and mask poor operational performance. Techniques such as manipulating provisions, adjusting depreciation policies, or deferring expense recognition are commonly employed. The motivation behind these practices lies in avoiding loan covenant breaches, preventing credit downgrades, or delaying restructuring actions.

Moreover, distressed firms may also resort to real earnings management (REM), which involves altering business operations to influence financial outcomes. Examples include offering excessive price discounts to boost sales, delaying maintenance expenditures, or increasing production to allocate fixed costs over a larger volume. These actions, while potentially damaging to long-term sustainability, provide short-term improvements in financial ratios such as earnings before interest and taxes (EBIT) or return on assets (ROA). The evidence from GCC case studies reveals a pattern where distressed firms use both AEM and REM in tandem to paint a more favorable financial picture, especially in quarters leading up to financial disclosures or refinancing negotiations[5].

Healthy firms, in contrast, tend to engage in earnings management for different reasons. Their practices are often less aggressive and more focused on income smoothing—reducing fluctuations in reported earnings to maintain a stable performance trend. This is particularly important in GCC markets, where family ownership is prevalent, and firms may prioritize reputational capital. Smooth earnings attract long-term investors, reduce perceived risk, and may enhance valuation multiples. Moreover, public companies in the GCC may feel compelled to meet analysts' expectations, especially in more developed markets like the UAE and Saudi Arabia[6].

While healthy firms might still use accrual manipulation, their use of real activities management tends to be more conservative. These firms are more likely to comply with international reporting standards and face scrutiny from institutional investors or auditors. That said, subtle forms of earnings management—such as shifting discretionary spending across periods or delaying asset impairments—are not uncommon[7].

Comparative data suggests that distressed firms exhibit significantly higher levels of discretionary accruals and abnormal operating cash flows, signaling more frequent and aggressive manipulation. The persistence of such behavior raises concerns about the reliability of financial reports and the potential for misallocation of resources by investors. Furthermore, distressed firms often lack strong internal controls or independent oversight, making them more susceptible to opportunistic financial reporting.

Pages: 28-35
Volume-II, Issue-I, 2025

In sum, while both distressed and healthy firms in the GCC engage in earnings management, their motivations, methods, and intensity differ. Distressed firms use it as a tool for survival and short-term impression management, whereas healthy firms use it more strategically for signaling and reputation-building. This divergence highlights the need for context-aware regulatory interventions, audit enhancements, and investor education to distinguish between harmful manipulation and benign earnings optimization[8].

Governance, Regulation, and the Road to Sustainability

Effective governance and regulatory oversight play a critical role in curbing earnings management and promoting sustainable financial reporting. In the GCC context, where legal systems, ownership structures, and enforcement mechanisms vary, these elements influence the prevalence and detectability of earnings manipulation. This section explores how governance quality and regulatory reforms interact with earnings management practices and outlines pathways toward more sustainable and transparent corporate behavior[9].

GCC countries have made significant strides in improving corporate governance frameworks, particularly following the global financial crisis and the increasing push for economic diversification. Saudi Arabia's implementation of the Corporate Governance Regulations and the UAE's alignment with IFRS standards are key milestones. These regulations aim to strengthen board independence, enhance disclosure requirements, and promote ethical financial practices. However, enforcement remains inconsistent, and many firms—especially those in family-owned or closely held structures—still operate in environments with limited transparency and weak oversight[10].

In distressed firms, governance weaknesses are often more acute. Board composition, audit committee independence, and the presence of internal controls are frequently compromised. This creates an environment where management can manipulate earnings with minimal resistance. The lack of external pressure from institutional investors—who are typically more vigilant about financial reporting quality—also contributes to unchecked earnings management. Moreover, many distressed firms in the GCC rely on state support or sovereign-linked investors, which can reduce accountability and delay corrective action.

Pages: 28-35
Volume-II, Issue-I, 2025

Healthy firms, especially listed ones, are generally more subject to market discipline. They tend to attract foreign investment, face regular audits, and are monitored by analysts and rating agencies. This external scrutiny helps curb excessive earnings manipulation. Nonetheless, even among these firms, governance practices can vary. Companies with larger, more diverse boards and active audit committees tend to engage in less earnings management, as they are better equipped to challenge management's discretionary reporting decisions[11].

Another important factor is audit quality. In the GCC, the presence of Big Four audit firms correlates with lower levels of earnings manipulation. These firms bring international expertise, reputational risk, and methodological rigor that constrain aggressive accounting practices. However, the market share of Big Four firms remains uneven, particularly among smaller or family-owned businesses. Encouraging widespread adoption of high-quality audits is essential to raising the overall standard of financial reporting.

Regulatory bodies such as the Capital Market Authorities (CMAs) in Saudi Arabia and Oman, and the Securities and Commodities Authority (SCA) in the UAE, have increasingly emphasized investor protection and market integrity. Initiatives like mandatory XBRL filing, sustainability reporting guidelines, and governance rating systems reflect a growing commitment to transparency. Yet, these efforts need to be harmonized across the GCC to prevent regulatory arbitrage and foster regional investment confidence[12].

From a sustainability perspective, unchecked earnings management undermines ESG (Environmental, Social, and Governance) performance. Manipulated earnings mask real financial risks, distort ESG scores, and erode stakeholder trust. As ESG disclosures gain traction in the GCC, ensuring the integrity of underlying financial data is imperative. Hybrid frameworks that integrate financial, sustainability, and governance metrics can help create a holistic view of corporate health and deter manipulation.

To achieve sustainable realities beyond financial facades, the GCC must invest in regulatory enforcement, independent audits, and education for corporate stakeholders. Policies that reward long-term performance over short-term earnings targets can reduce the pressure to manage earnings. Investor awareness campaigns, whistleblower protections, and digital reporting tools can also play a role in fostering transparency[13].

Ultimately, governance and regulation are not just compliance tools—they are enablers of sustainable development and trustworthy capitalism. A concerted effort to align financial reporting with economic reality will help the GCC build resilient, investor-friendly markets aligned with its long-term diversification goals[14].

Conclusion

Earnings management remains a pervasive but multifaceted phenomenon across distressed and healthy enterprises in the GCC. While distressed firms tend to engage in more aggressive and opportunistic manipulation, even healthy firms strategically manage earnings to maintain market perceptions. Addressing this issue requires not only detecting and understanding these practices but also strengthening governance, enhancing regulatory enforcement, and fostering a culture of ethical financial reporting. By bridging the gap between financial facades and sustainable realities, the GCC can advance toward more transparent, resilient, and investment-worthy economies.

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