Earnings Management

The recent wave of corporate accounting scandals has had a significant influence on the way corporate leaders and professional accountants are being viewed. The level of business ethics is under serious attack and the accounting profession under extreme scrutiny. It seems like every day the media is reporting new revelations of corporate deception or accounting fraud. It is not surprising that a crisis of confidence currently exists between shareholders, professional accountants and enterprises.

One topic that has come to the forefront of recent discussions concerning unethical behavior is that of earnings management, or more specifically, "abusive" earnings management. This issue has generated a great deal of talk and debate. However, earnings management isn't always perceived as wrong. Arguments supporting it have also been made. Many believe there is a "good" side to earnings management and that it "can be a device to convey inside information to the market, enabling share price to better reflect the firm's future prospects" (Scott, 2002, p. 385). The accounting profession has also acknowledged that not all earnings management techniques are fraudulent.

Nevertheless, the current popular belief among accountants, regulators and standard setters is that, more often than not, earnings management is harmful. It deceives investors and reduces the reliability of financial reporting. Many reasons have been offered for why management engages in this behavior. Some hold the intensely competitive business environment responsible. Others believe that self-interested managers are doing it to maximize their earnings-based bonuses. Others still blame Generally Accepted Accounting Principles (GAAP), citing that they are inherently faulty and enable earnings to be managed dishonorably. Whatever the reason, standard setters

and the accounting profession are gravely concerned about the practice of earnings management and the detrimental effect it has on financial reporting.

A clearer understanding of earnings management is critical before any continued discussion of the topic. Mulford and Comiskey (2002) define earnings management as "the active manipulation of earnings toward a predetermined target" (p. 51). Healy and Whalen (1998) offer a much more detailed definition, stating that:

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

Finally, the Assurance Handbook defines earnings management to include "the recording of accounting entries, without any event to justify the accounting, or the failure to record or correctly record transactions for the purposes of altering results" (Assurance Handbook, 2003). The common theme of the above definitions is one of altering results. The question is, when firms engage in this behavior, is it harmful to investors? It certainly can be, but it is often very difficult to detect. Insiders who are responsible for these activities are intent on hiding them. Additionally, outsiders cannot observe managements' day-to-day activities, making it even harder to spot deceitful financial reporting.

There have been numerous reasons offered for why firms practice earnings management. One of the most prominent is to meet analysts' forecasts. Today's business environment is very competitive. Companies are trying harder than ever to meet

both internal and external expectations. "The pressure to meet revenue expectations is particularly intense and may be the primary catalyst in leading managers to engage in earnings management practices that result in questionable or fraudulent revenue recognition practices" (Magrath & Weld, 2002, para. 10). If there is a chance that earnings are going to fall short of the consensus earnings forecasts, managers are motivated to manipulate the numbers. They cannot risk the potential drop in share price if they do not meet market expectations. If a company misses earnings estimates by even a penny it is often seen as a failure, partly because managers has a wide variety of earnings management tools at their disposal (Brewer, Angell, Mautz, 2002). Often times, when managers are adjusting the numbers to meet targets in one period, they are compelled to persist in earnings management practices in future periods so that they can continue to meet ever-increasing expectations. Once they start, they cannot seem to stop. Eventually, having dug such a deep hole for themselves, managers begin engaging in more blatant fraudulent activities to sustain the earnings myths they have been working so hard to communicate to analysts and investors.

Another reason companies are managing earnings is to maximize incentive compensation. In many firms, top management has the incentive to commit abusive earnings management practices because their compensation packages are linked to the financial performance of the firm. In fact, in a study done regarding fraudulent financial accounting between 1992 and 2000, "the overwhelming majority of fraudulent financial reporting cases studied involved the most senior financial executives in the corporations" (Martin, Aldhizer, Campbell & Baker, 2002, Involvement by top management, para. 1). This is opportunistic managerial behavior because earnings are managed to benefit the

managers' short-term interests instead of reporting the underlying financial performance of the firm.

A third possible reason earnings management occurs has to do with GAAP. The decisions that managers take to alter their financial reports can be made within the boundaries of GAAP or severely outside of them. "Decisions made within GAAP are often viewed as aggressive if the tactics push the envelope and stretch the flexibility of GAAP beyond its intended limits" (Mulford & Comiskey, 2002, p.26). This is an abuse of GAAP. However, Paul Rosenfield (2000) feels that "earnings management results less from the distortion of the application of GAAP than from the application of inherently faulty GAAP" (para. 2). He offers two reasons why GAAP fails to deter earnings management, but in fact leads to it. The first failure has to do with realization. Rosenfield believes that our current transaction-based reporting system is incomplete because it fails to recognize changes in value that are not associated with a transaction, such as increases in the price of land or inventories. However, if we did report the real-world effects of all relevant economic events, reported income would be less stable. For this reason, Rosenfield believes GAAP is designed so that financial reports present stable income. The second failure is allocation. "Allocation uses smooth ("systematic") formulas . . . and events do not occur as regularly as the use of the formulas implies" (para. 21). Again, Rosenfield believes that GAAP innately stabilizes reported earnings. "Their power (realization and allocation) to stabilize income reporting is much greater than the power individual issuers have to do so" (para. 30).

There are numerous techniques used to manage earnings. The most common involve using the flexibility that exists in GAAP. Yet, it is when earnings management

activities stretch beyond the application of the legitimate flexibility of GAAP, that ethical concerns arise. "The premature recognition of revenue, or in some cases the recognition of wholly fictitious revenue, is one of the more common forms of abusive earnings management" (Mulford & Comisky, 2002, p. 66). This is probably because deciding when revenue is earned can be difficult, especially when the buyer has the right to return the merchandise. Additionally, managers may try to recognize earnings early so that they can boost current-period income. For example, System Software Associates Inc. was found out by the Securities and Exchange Commission (SEC) to have recognized revenue on sales with significant uncertainties about collectibility of the contract price and when significant vendor obligations still remained (Securities and Exchange Commission's Accounting and Auditing Enforcement Release, 2000).

Another common technique is to underestimate expenses. For instance, if earnings are low in a particular period, managers may make unrealistically low estimates for bad debt expense. This way, they can present the illusion that their earnings are higher than they actually are. A prime example of improperly recognizing expenses occurred at Bio Clinic, a major operating division of Sunrise Medical. "In order to ensure that Bio Clinic met the parent company's earnings targets, its management intentionally understated its operating expenses by nearly $20 million" (Martin, Aldhizer, Campbell, & Baker, 2002, Improper expense recognition – Sunrise Medical, para. 1). To cover up their indiscretions, numerous expenses were reclassified to property, plant and equipment and accounts receivable accounts. This resulted in creating errors in the general ledger, so the company went on to create false entries in the ledger to cover up the fraud. Eventually, what started out as abusive earnings management had turned into a

complex web of fraudulent financial accounting. Needless to say, the perpetrators of these acts were discovered and have since been reprimanded for their behavior.

On the contrary to underestimating expenses, companies have been known to practice "cookie jar" accounting. This occurs when a firm's earnings turn out to be above analysts' expectations, and they make unrealistically *high* estimates of liabilities. This results in reducing that period's earnings so that they are aligned with the market's expectations. Then, in future periods, they can reverse the over-accrued liabilities to increase earnings. "The cookies (excess earnings) are stashed in a cookie jar (a reserve account) during good years and then are reversed when they are needed to boost earnings in a bad year" (Ortega & Grant, 2003, Earnings management techniques, para. 5). With this technique, management is practicing severe income smoothing. Supporters of this practice believe that it helps to keep financial statement users out of a "short-term" frame of mind. They advocate that income smoothing practices, like "cookie jar reserves," prevent users from judging an investment only on the basis of the immediate following years. However, I believe this activity deliberately deceives investors. If the company is experiencing some volatility in its profits, financial statement users have a right to know.

A final type of earnings management to be discussed is known as taking a "big bath." This involves recognizing all expenses relating to a major organizational change in a single year, even though they are believed to occur over many years. The motivation behind this is that if managers have to take a loss, they might as well take a big one and get it all over with at once. This way, investors will forgive the one "bad" year, and focus on the company's future earnings. "The purpose of this aggressive application of accounting principles is to alter their financial results and financial position in order to

create a potentially misleading impression of their firms' business performance" (Mulford & Comisky, 2002, p. 26). Sunbeam Corporation did exactly this in its annual report for 1996 by taking a huge restructuring charge in that year. It should be made clear that this, in and of itself, wasn't wrong. It was the company's intentional overestimation of the costs of the restructuring, enabling them to report higher earnings in future years, which raised ethical eyebrows. US GAAP states that all anticipated charges relating to the restructuring should be reported and accounted for at the time of its implementation. In my opinion, Sunbeam definitely crossed the line by inappropriately applying GAAP, which resulted in investors being mislead.

As stated earlier, it is often difficult to detect abusive earnings management practices. This is true especially when managers are making choices within the flexibility afforded by GAAP because it is hard to distinguish the motives behind their choices. However, there are some warning signs that professional accountants can look for. Firstly, they should be sure there is a correlation between the cash flows from operations and earnings. When this correlation is not present, it is a good indicator that a company is managing its earnings by improperly applying the revenue recognition principle. "Cash flows lagging significantly behind revenues could be a sign that companies are inflating revenues by recognizing sales in inappropriate periods, making sales to noncreditworthy customers, or recording fictitious sales" (Magrath & Weld, 2002, Detecting earnings management, para. 3).

Secondly, receivables should be reasonably correlated with revenues. If they are rising faster than revenues, this could indicate that the company is either in financial

distress or practicing abusive earnings management. For example, the company may be intentionally inflating accounts receivables or recording made-up sales to boost earnings.

Another warning sign is related to the allowance for doubtful accounts. "Both Lucent and Cendant decreased their reserves for uncollectible accounts at times when revenues and receivables were rising" (Magrath & Weld, 2002, Detecting earnings management, para. 5). This was a clue that the firms had recognized revenues prematurely or that they deliberately understated their reserves. Either way, the result was abusive earnings management.

Another warning sign is when earnings are consistently and accurately meeting expectations. Although many firms are able to lawfully and legitimately meet the expectations of the market, some companies engage in abusive earnings management to achieve this goal. They may cover up failures by purposefully manipulating the numbers to achieve smooth earnings. "Cendant manipulated its financial reports to ensure that revenues and expenses were consistently reported at approximately the same percentages each quarter" (Magrath & Weld, 2002, Detecting earnings management, para. 9). This type of reported earnings should send up a red flag for accountants to take a closer look at a firm's financial statements.

The warning signs discussed above can help professional accountants detect abusive earnings management activities. But, wouldn't it be better if we could prevent this unethical behavior from happening in the first place? Sankaran and Bui (2003) attempted to determine the ethical attitudes among accounting majors. In their study, they administered a survey to 50 undergraduate accounting students at a large university in California. They wanted to see if level of competitiveness, gender, personality type, or

age were correlated with a student's ethics. Their results were intriguing. Sankaran and Bui (2003) concluded that ethics are inversely related to individual competitiveness. This indicates that highly competitive accounting students tend to have statistically lower levels of ethics. Additionally, the study showed that women have a significantly higher level of ethics than men and that personality type (A or B) is independent of the level of ethics of accounting students. A final conclusion the authors came to, and possibly the most alarming, is that as accounting majors grow older, their level of ethics declines.

When we are faced with results like those from Sankaran and Bui's study, we should not take them at face value. Correlation does not necessary mean causation. However, we should not dismiss the results altogether either because they do impart some noteworthy implications. To address the last conclusion stated above, there may be many possible explanations for why accounting professionals' ethics appear to decrease as they get older. One could be that as they move up in the ranks, they have increased pressure to perform, which can lead them to make calculated compromises. With regard to gender, the results did not surprise me. I strongly feel that it wouldn't hurt having more women in executive positions to help strengthen the ethics of an enterprise. I also believe that starting ethical training early on in a business student's career will be most effective at influencing their decisions later on in life.

The United States has led the battle against abusive earnings management. In 1998, the SEC made its stance on the issue quite clear when then Chairman, Arthur Levitt, made his famous The "Numbers Game" speech. Levitt said that "in the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation" (Levitt, 1998). He was very

concerned about the quality of earnings that companies were reporting. Since then, progress has been made. The New York Stock Exchange has proposed new corporate governance standards. The Sarbanes-Oxley Act was also signed into law in 2002 and "requires publicly traded companies to disclose whether they have adopted a code of ethics for their senior financial officers, and if not, why" (Myers, 2003, para. 2). These new legislations will not completely solve the problem, but they are a step in the right direction.

Although earnings management is not new to the accounting profession, it has increased over the past decade. There is a very thin line between earnings management and management fraud that many managers are straddling. On one hand, earnings management obscures facts that users have a right to know, and this can have serious negative social consequences. On the other hand, many managers believe that when it is done within GAAP rules, earnings management can help to maximize shareholders' value. Regardless of which view you hold, one thing is certain; abusive earnings management is harmful. It is a serious problem that plagues the accounting and corporate environments. The misapplication of GAAP and stretching the rules to meet desired targets needs to be dealt with head-on. In the quest for profits, we have lost trust. It is vital that we regain the confidence of the public. When it comes down to it, I think the Chair of the Ontario Securities Commission, David Brown, said it best when he addressed the Institute of Chartered Accountants in Ontario. "Operating in our public capital markets is not an unqualified right, it carries responsibilities and one of the most fundamental is to provide full, true and plain disclosure on a timely basis" (Brown,

1999). This issue will not be solved over night, but if we continue to work at it, we will make progress.

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