Chapter 6  Earnings Management

1. Identify the factors that motivate earnings management
2. List the common techniques used to manage earnings
3. Critically discuss whether a company should manage its earnings
4. Describe the common elements of earnings management meltdown
5. Explain how good accounting standards and ethical behavior by accountants lower the cost of obtaining capital
1. Identify the factors that motivate earnings management

**Government Budgetary Arena**

The following statement, though perhaps a bit overstated, still contains a grain of truth:

“Perception dictates policy, accounting determines perception, therefore, accounting rules the world.”
Motivation for Managing Reported Earnings

Forces that push managers to manipulate results:

1. Meet internal targets.
2. Meet external expectations.
3. Provide income smoothing.
4. Provide window dressing for an IPO or a loan.

(continued)
Meet Internal Targets

- **Internal earnings targets** represent an important tool in motivating managers to increase sales efforts, control costs, and use resources more efficiently.

- As with any performance measurement tool, it is a fact of life that the person being evaluated will have a tendency to forget the economic factors underlying the measurement and instead focus on the measured number itself.

(continued)
Meet External Expectations

• Employees and customers want a company to do well so that it can survive for the long run and make good on its long-term pension and warranty obligations.

• Suppliers want assurance that they will receive payment and, more importantly, that the purchasing company will be a reliable purchaser for many years into the future.
(continued)
Meet External Expectations

• Extensive research has shown that announcing net income less than the income forecast by analysts results in a drop in stock price.

• Companies have an incentive to manage earnings to make sure that the announced number is at least equal to the earnings expected by analysts.
Provide Income Smoothing

The practice of carefully timing the recognition of revenues and expenses to even out the amount of reported earnings from one year to the next is called *income smoothing*.
Provide Window Dressing for an IPO or a Loan

For companies entering a phase in which it is critical that reported earnings look good (especially before the IPO of stock), accounting assumptions can be stretched. This is known as *window dressing*. 
Earnings management can range from savvy timing of transactions to outright fraud. The display of the range of possibilities for earnings management is called the *earnings management continuum*. 

**Earnings Management Continuum**

- Savvy Transaction Timing
  - Strategic matching
- Aggressive Accounting
  - Change in methods or estimates with full disclosure
- Deceptive Accounting
  - Change in methods or estimates but with little or no disclosure
- Fraudulent Reporting
  - Non-GAAP accounting
- Fraud
  - Fictitious transactions
Change in Methods or Estimates with Full Disclosure

• Companies frequently change accounting estimates respecting bad debts, return on pension funds, depreciation lives, and so forth.

• Although such changes are a routine part of adjusting accounting estimates to reflect the most current information available, they can be used to manage the amount of reported earnings.

(continued)
Change in Methods or Estimates with Little or No Disclosure

• Making an accounting change in method or estimation is acceptable as long as there is full disclosure.

• One might debate whether the new estimated amount is more appropriate, but what is certain is that failing to disclose the impact of a change can mislead financial statement users.

(continued)
Non-GAAP Accounting

• A more descriptive title for “non-GAAP accounting” is “fraudulent reporting.”

• It can be the result of inadvertent errors.

• Some firms, like Enron, violated the spirit of the accounting standards.

• In some cases, Enron also violated the letter of the accounting standards.

(continued)
Fictitious Transactions

- Creating fictitious transactions is outright fraud.

- A classic case of fictitious fraud is Barry Minkow and ZZZZ Best.

- Today, because he is considered a fraud expert, he speaks to college and business communities in an effort to prevent fraud.
Chairman Levitt’s Top Five Accounting Hocus-Pocus Items

1. Big bath charges
2. Creative acquisition accounting
3. Cookie jar reserves
4. Materiality
5. Revenue recognition

(continued)
Big Bath Charges

The concept behind a *big bath* is that if a company expects to have a series of hits to earnings in future years, it is better to try to recognize all the bad news in one year, leaving future years unencumbered by continuing losses.

(continued)
Company D recognized its bad news in one year, and thus took a “big bath.”
Creative Acquisition Accounting

• Since 1998, new acquisition account rules have been adopted (*FASB ASC Topic 805*); these standards give more extensive guidelines on how the purchase price of business acquisitions should be allocated.

• The SEC staff informed companies they would be skeptical of large amounts being allocated to in-process R&D.

(continued)
Cookie Jar Reserves

• Recognizing high estimated expenses when revenue is high so that less estimated expenses can be recognized when earnings are lower and deferring revenue for “tougher times” are examples of building a cookie jar reserve.

• The SEC has issued SABs 101 and 104, identifying more carefully the circumstances in which it is appropriate for a company to defer revenue.

(continued)
Materiality

• Falling short of the market’s expectation of earnings by one penny per share can cause a company to lose billions of dollars in market value.

• If a questionable practice helps a firm meet analysts’ expectations, the firm should be required to change the data or to convince the auditor that it complies with GAAP.

• The SEC released SAB 99 that outlines a more comprehensive definition of materiality.

(continued)
Revenue Recognition

• Firms would like to report revenue when contracts are signed or partially complete rather than waiting until the promised product or service has been fully delivered.

• The SEC has released **SAB 101**, which reduced the flexibility companies have in the timing of revenue recognition.

(continued)
Pro Forma Earnings

• A pro forma earnings number is the regular GAAP earnings number with some revenues, expenses, gains, or losses excluded.

• The key question is whether the number helps financial statement users better understand a company or whether it is a blatant attempt to cover up poor performance.

• If a manager is trustworthy, the GAAP earnings are reliable, and the manager can reveal even better information about the underlying economics of the business through appropriate adjustments in computing pro forma earnings.
### Intuit Inc.

**GAAP to Pro Forma Operating Income Reconciliation**

<table>
<thead>
<tr>
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<th>Three Months Ended</th>
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<tbody>
<tr>
<td></td>
<td>January 31, 2010</td>
<td></td>
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<tr>
<td>GAAP operating income</td>
<td>$139</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of purchased intangible assets</td>
<td>16</td>
<td>14</td>
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<tr>
<td>Acquisition-related charges</td>
<td>11</td>
<td>13</td>
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<td>Professional fees for business combinations</td>
<td>3</td>
<td>—</td>
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<tr>
<td>Share-based compensation expense</td>
<td>37</td>
<td>34</td>
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<tr>
<td><strong>Non-GAAP operating income</strong></td>
<td><strong>$206</strong></td>
<td><strong>$172</strong></td>
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*Share-based compensation expenses. These consist of non-cash expenses for stock options, restricted stock units and purchases of common stock under our Employee Stock Purchase Plan. When considering the impact of equity awards, we place greater emphasis on overall shareholder dilution rather than the accounting charges associated with those awards.*
EX 6-6 RECONCILIATION OF PRO FORMA EARNINGS TO GAAP EARNINGS

Amortization of purchased intangible assets and acquisition-related charges. When we acquire an entity, we are required by GAAP to record the fair values of the intangible assets of the entity and amortize them over their useful lives. Amortization of purchased intangible assets in cost of revenue includes amortization of software and other technology assets of acquired entities. Acquisition-related charges in operating expenses include amortization of other purchased intangible assets such as customer lists, covenants not to compete and trade names.

Professional fees for business combinations. We exclude from our non-GAAP financial measures the professional fees we incur to complete business combinations. These include investment banking, legal and accounting fees.

Gains and losses on marketable equity securities and other investments. We exclude from our non-GAAP financial measures gains and losses that we record when we sell or impair marketable equity securities and other investments.
3. Critically discuss whether a company should manage its earnings

Financial Reporting as a Part of Public Relations

QUESTION. Does a manager have an ethical and fiduciary responsibility to carefully manage the resources of a publicly traded company in order to maximize the value to the stockholder?

ANSWER. Yes. In fact, this is the very definition of the responsibility of a corporate manager.
QUESTION. Does the public perception of a company impact the company’s success in terms of finding customers, securing relationships with suppliers, attracting employees, etc.?

ANSWER. Certainly. It is impossible to rally people to put their time and money behind a company unless they are convinced the company can be successful.

(continued)
QUESTION. Does the amount of reported earnings impact the public’s perception of a company?

ANSWER. Absolutely. Accounting net income is not the only piece of information relevant to assessing a company’s viability, but it certainly is one influential data point.
QUESTION. Does a manager have a responsibility to manage reported earnings, within the constraints of GAAP?

ANSWER. It is difficult to answer “no” to this question. In light of the answers to the preceding questions, it would be an irresponsible manager indeed who did not do all possible, within the constraints of GAAP, to burnish the company’s public image.

(continued)
Everybody agrees that the creation of fictitious transactions is unethical.
There is wide disagreement as to whether or not these categories are ethical or unethical.

(continued)
Does the manager have the responsibility to try to report earnings numbers exactly in the middle of the possible range.
In an effort to increase the personal cost to company executives of allowing a company to report earnings that violate GAAP, in 2002 the SEC began requiring CEOs and CFOs to submit sworn statements asserting that they had personally confirmed that their company’s financial statements contained no materially-misleading items.
4. Describe the common elements of an earnings management meltdown

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<td>Massive loss of reputation</td>
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Downturn in Business

• Excessive earnings management almost always begins with a downturn in business.

• When operating results are consistently good, the need for earnings management is not as great.
Enron Wholesale Services: Return on Assets

Return on Assets

Years


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Through stage 5, the firm is unaware of an earnings management meltdown.
Pressure to Meet Expectations

• A powerful factor motivating managers to manage earnings is the desire to continue to meet expectations.

• The accounting manipulation carried out by Xerox is a good example of pressure to meet expectations.

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**EX** 6-10 SEVEN ELEMENTS OF AN EARNINGS MANAGEMENT MELTDOWN

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Through stage 5, the firm is unaware of an earnings management meltdown.
Attempted Accounting Solution

• When the accountants, instead of the operations or marketing people, are asked to return a company to profitability through earnings management, the solution is a temporary one at best.

• At worst, the counterproductive mentality associated with papering over a company’s problems through earnings management can ultimately lead to even larger business problems.

(continued)
Auditor’s Calculated Risk

• The financial statements represent a negotiated settlement between the management of the company and the company’s auditor.

• An auditor is frequently required to decide whether to accept a debatable accounting treatment, engage in further discussion with management, or, as a final resort, withdraw from the audit.
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Through stage 5, the public is unaware of an earnings management meltdown.
Insufficient User Skepticism

• In October 2001, just before Enron’s earnings restatement led to the company’s bankruptcy less than two months later, 11 of the 13 financial analysts following Enron recommended the company’s stock as a “buy” or “strong buy.”

• Enron’s published financial statements had indications in them that should have led a skeptical analyst and investment community to question the company’s fundamental business model.  (continued)
Insufficient User Skepticism

- Financial statement users have usually accepted companies’ financial statements at face value with the realization that there was some risk of deceptive reporting.

- Some analysts and members of the investment community have not exhibited enough financial statement skepticism because these parties often stand to benefit economically as companies obtain loans, issue stock, and engage in merger and acquisition activity. (continued)
Insufficient User Skepticism

From 1997 through 2010, five major periods of decline in worldwide stock prices occurred.

- **1997**: Concern about the reliability of banking and financial information in a number of Asian countries.

- **2000**: A return to reality after initial euphoria about the business possibilities associated with Internet.

- **2001**: The wake of political and economic uncertainty created by the 9/11 attack on the World Trade Center.

(continued)
Insufficient User Skepticism

- **2002:** The widespread uncertainty about the credibility of financial reports of U.S. corporations.
- **2008:** The real estate greed that had inflated U.S. real estate prices coupled with investor uncertainty about what was really inside the mortgage-backed securities that had flooded the market.
Regulatory Investigation

• Investigations are often conducted when companies are suspected of passing outside the boundary of the GAAP oval in Exhibit 6-7 into the area of fraudulent financial reporting.

• In addition to regulatory investigations, fraudulent financial reporting can also lead to criminal charges.

**EX 6-10** SEVEN ELEMENTS OF AN EARNINGS MANAGEMENT MELTDOWN

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Through stage 5, the public is unaware of an earnings management meltdown.
Massive Loss of Reputation

• The final step in an earnings management meltdown is the huge loss of credibility experienced by the company that has been found to have manipulated the reported earnings.

• The loss of credibility harms all of the company’s relationships and drastically impairs its economic value.

EX 6-10 SEVEN ELEMENTS OF AN EARNINGS MANAGEMENT MELTDOWN

1. Downturn in business
2. Pressure to meet expectations
3. Attempted accounting solution
4. Auditor’s calculated risk
5. Insufficient user skepticism
6. Regulatory investigation
7. Massive loss of reputation

Through stage 5, the public is unaware of an earnings management meltdown.
5. Explain how good accounting standards and ethical behavior by accountants lower the cost of obtaining capital

**Transparent Financial Reporting**

An important fact often forgotten by financial statement preparers and users is that the entire purpose of accounting, both financial and managerial, is to **lower** the cost of doing business.
What is the Cost of Capital?

• The *cost of capital* is the cost a company bears to obtain external financing.

• The *cost of debt financing* is simply the after-tax interest cost associated with borrowing the money.

• The *cost of equity financing* is the expected return necessary to induce investors to provide equity capital.

(continued)
What is the Cost of Capital?

• A company often computes its weighted-average cost of capital, which is the average of the cost of debt and equity financing weighted by the proportion of each type of financing.

• A company’s cost of capital is critical because it determines which long-term projects are profitable to undertake.

(continued)
What is the Cost of Capital?

• In a capital budgeting setting, the cost of capital can be thought of as the *discount rate* or *hurdle rate* used in evaluating long-term projects.

• A key factor in determining a company’s cost of capital is the risk associated with the company.
Cockroach Theory

When managers are willing to try to deceive lenders and investors through misleading financial reporting, those same lenders and investors naturally wonder what other types of deception the managers are attempting. This is called the “cockroach theory.”
The Role of Accounting Standards

- The FASB and the AICPA help lower the cost of capital by promulgating uniform recognition and disclosure standards for use by companies in the United States.

- The SEC has the primary mission of protecting investors and maintaining the integrity of the securities market.

(continued)
The Role of Accounting Standards

- The IASB is playing an increasingly important role in enhancing the credibility of international financial reporting.
- Financial statement users are concerned that increased reliance on accounting judgment will make the reported numbers under IFRS more vulnerable to management manipulation, increasing information risk and thus increasing the cost of capital.
The Necessity of Ethical Behavior

• Managers have strong economic incentives to report favorable financial results, and these incentives can lead to deceptive or fraudulent reporting.

• Managers also have strong incentives to maintain a reputation for credibility for both the company and for themselves personally.
AICPA Code of Professional Conduct

“In discharging their professional responsibilities, members may encounter conflicting pressures....

In resolving those conflicts, members should act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients’ and employers’ interests are best served.”