

Accounting I Section of IBS

The accounting section of IBS will focus on the issue of earnings management. This will be done in a separate class as well as throughout the semester. Specifically,

- As we cover each topic, we will discuss how the related accounting choices can be used to manage earnings. In addition, we will look at examples of companies that allegedly used these choices to manage earnings, and ways for outsiders to detect such activities.
- The last class will be devoted to a review and extension of the discussions on earnings management. We will examine the causes and consequences of earnings management as well as insights that we can learn from academic research on earnings management. The readings for this class will include several recent articles and a set of detailed class notes.

An understanding of how firms manage earnings, as well as the causes and consequences of earnings management, would allow users of financial information to better evaluate the true economic performance of businesses. This, in turn, would enable users to make better financial decisions. Furthermore, if preparers of financial statements are aware of the negative consequences and how these activities are often detectable, it may deter firms from managing earnings.

The remainder of this document contains selected material from the Accounting I section of IBS.

EARNINGS MANAGEMENT

Definition

Financial fraud, an extreme case of earnings management, is defined as:

“the intentional, deliberate, misstatement or omission of material facts, or accounting data, which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision.” (National Association of Certified Fraud Examiners, 1993)

But earnings management is more general than financial fraud. In particular, earnings management activities may occur within GAAP choices. SEC Chairman Levitt (1998) noted 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 decisions.”

That is, accounting choices which are made within-GAAP can still be construed as earnings management, if they are used to “obscure” or “mask” true economic performance.

Similarly, accounting researchers have defined earnings management as:

“a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say, merely facilitating the neutral operation of the process).” (Schipper, Accounting Horizon, 1989)

“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.” (Healy and Wahlen, Accounting Horizon, 1999)

People often refer to earnings management as synonymous with earnings overstatement. However, earnings management also includes situations where firms make accounting choices that result in understated earnings. Moreover, firms may manage line items from the financial statements or footnote information in ways that do not affect bottom line earnings.

Earnings are the total of cash flow from operations and accruals (“non-cash earnings”). Thus, firms may manage earnings either by manipulating estimates of accruals or cash from operations. Traditionally, earnings management has been conducted by manipulating accruals estimates. However, firms increasingly manage earnings through transactions that affect cash from operations. Unlike accruals, the management of cash from operations involves real transactions (e.g., selling assets). Yet, if the primary objective of these transactions is to inflate earnings (or otherwise manipulate financial disclosures), they are viewed as earnings management activities.

Why do firms overstate earnings?

- To improve market participants’ perception of the firm’s performance (e.g., to beat targets such as analysts’ forecasts, previous year’s earnings, or positive earnings)
- To smooth earnings or earnings growth (when unmanaged earnings are unusually low)
- To avoid violating debt covenants
- To increase management’s compensation or job security
- To improve the terms of capital raising transactions or in M&A activities (e.g., increase issue price in IPOs, SEOs or mergers, or borrow at a lower interest rate)
- To increase regulatory capital (relevant for financial institutions)

Why do firms understate earnings?

- To smooth earnings or earnings growth (when unmanaged earnings are unusually high)
- To create reserves for future periods
- To set a low benchmark (target) for future compensation
- To reduce transaction price in management buyouts
- To appear less profitable when negotiating with unions, regulators (antitrust, import relief, rate determination), or major customers and suppliers (in some cases)

Why do firms manage disclosures that do not affect bottom line earnings?

- Investors and other market participants pay more attention to recurring revenues and expenses than to “one-time” items. This may induce firms to classify one-time gains as recurring revenues, or classify recurring expenses as one-time losses. Moreover, firms often disclose “proforma” measures of income that exclude items that are deemed by management to be non-recurring, even when these items are classified as recurring in the income statement.
- For some firms (e.g., firms in early growth stages, firms operating in industries where expense measurement is particularly problematic), investors often focus on revenue rather than earnings. In such cases, companies may have an incentive to overstate revenue even when there is no effect on earnings. Examples include the recognition of barter revenues and gross revenues by internet companies in the late 1990s.
- In addition to profitability, shareholders and (particularly) creditors also care about a firm’s solvency and liquidity risk. Accordingly, some firms manage the balance sheet and the statement of cash flows in order to appear less risky. Examples include the use of off-balance sheet financing, sale of receivables, and classification of short term debt as long term debt.
- Although the FASB is moving towards the direction of recognizing fair value estimates in the financial statements, most assets and liabilities (and therefore earnings) are still reported at historical cost. For most financial instruments, however, companies are required to provide fair value estimates in the footnotes. Some analysts and investors use this information to prepare proforma financial statements based on fair value information. Companies may therefore manipulate fair value disclosures in an attempt to affect decisions of these users.

Situations where earnings overstatement is more likely to have occurred:

- Earnings are just above one of the following benchmarks: zero, prior year's earnings, analysts' consensus forecast
- The firm is likely to raise capital or engage in a major M&A transaction in the near future
- The accruals (i.e., non-cash) component of earnings is relatively large
- Change of accounting policies
- Change of auditors, lawyers, executives or directors
- The firm is engaged in significant related parties transactions

Situations where earnings understatement is more likely to have occurred:

- Earnings are substantially smaller than expected primarily due to one-time / unusual items
- Earnings are substantially larger than expected and the firm is not likely to raise capital or engage in M&A activities in the near future (there is a good chance that the firm had a very strong year and used this opportunity to create reserves for the future)
- Change of CEO (likelihood of a "big bath")
- The accruals (i.e., non-cash) component of earnings is relatively small
- The firm is negotiating with unions, or is subject to antitrust or import relief investigations

What are the Consequences of Earnings Management?

- Market participants may lose confidence in the firm's disclosures
- Managers may suffer a loss of reputation
- Over the long run, earnings equal cash flows. Thus, when firms overstate current earnings, future earnings will be understated.
- SEC enforcement activities
- Shareholders' law suits

Review of Earnings Management

This section contains a summary of common earnings management activities related to various accounting topics. For each topic, we discuss common abuses, ways to detect the abuses, and examples of companies that allegedly engaged in the particular form of earnings management.

[This material is restricted to registered students]