

6

Earnings Management

Overview

In this chapter, we part ways with the calculation and financial statement intensive items that have filled the last four chapters and return to more theoretical and conceptual concepts somewhat similar to Chapter 1. If you liked the last four chapters better, have no fear as this is a temporary respite from calculations, journal entries, and financial statements.

Earnings management is the process by which management can potentially manipulate the financial statements to represent what they wish to have happened during the period rather than what actually happened. Reasons why management may want to manage earnings include both internal and external pressures.

Perhaps the most important section of this chapter is that of dealing with the common techniques used to manage earnings. It is through a thorough understanding of these methods that earnings management can be spotted. These strategies are important to know as an accountant, auditor, financial analyst, creditor, or investor. Healthy skepticism on the part of these various interests, and contributors, to the financial statements will further detection, and a reduction, of earnings management practices.

By improving the quality of the information in financial statements, through better accounting standards and ethical behavior, the cost of doing business decreases. Not only is this true with the cost of capital, as the chapter describes, but nowhere is it more clearly seen today than with the additional costs publicly traded companies are now faced with to come into compliance with the provisions of the Sarbanes-Oxley Act. Earnings management and unethical behavior of the past is costing businesses more today.

Learning Objectives

Refer to the Review of Learning Objectives at the end of the chapter. It is crucial that this section of the chapter is second nature to you before you attempt the homework, a quiz, or exam. This important piece of the chapter serves as your CliffsNotes or “cheat sheet” to the basic concepts and principles that must be mastered.

If after reading this section of the chapter you still don't feel comfortable with all of the Learning Objectives covered, you will need to spend additional time and effort reviewing those concepts that you are struggling with.

The following "Tips, Hints, and Things to Remember" are organized according to the Learning Objectives (LOs) in the chapter and should be gone over after reading each of the LOs in the textbook.

Tips, Hints, and Things to Remember

LO1 – Identify the factors that motivate earnings management.

How? How will you be able to remember these factors? The first thing to recall is that there are internal and external reasons. The main internal reason is to meet targets. The targets may be there for a number of reasons. Some may just be budgeted numbers, which if they are not met will look unfavorable on the person, department, or company that "blew the budget." Others may be "required" numbers, which if not met will mean that a person doesn't get his or her bonus.

The external factors are a bit more diverse. The company may have previously projected numbers that external parties are now expecting the company to meet or exceed. External analysts may have made their own predictions public, which the company would now like to achieve.

Investors, and potential investors, like to see continual upward income growth. It looks really positive and looks as if the company is doing well in the charts found in annual reports. Hence, income smoothing is the second external factor potentially contributing to earnings management.

Finally, if a company is looking for new financing, they will have an easier time obtaining it (or obtain better terms if it is debt financing) if they have good looking financial statements. Therefore, window dressing is the final factor listed.

If you like mnemonic devices for remembering things, then *WISE* is the word to remember for the factors motivating earnings management.

1. **W**indow Dressing
2. **I**nternal Targets
3. **I**ncome **S**oothing
4. **E**xternal Expectations

LO2 – List the common techniques used to manage earnings.

How? There is a spectrum of degrees to which a company can manage earnings. Some could hardly be called serious or unethical, while the other end of the continuum includes both illegal and fraudulent accounting activity. The continuum can be seen in Exhibit 6-4, which lays out the degrees in terms of seriousness from left to right with the more permissible techniques shown the further you move to the left.

How? How are companies still able to manage earnings given the concerns raised by former SEC Chairman Arthur Levitt? Part of the answer is that they aren't able to do so as easily as before. As the chapter mentions, the FASB and the SEC have issued further rules and guidelines since Levitt's comments that have reduced the amount of accounting "hocus pocus" that can be accomplished. However, the other part of the answer is that accrual accounting is not purely objective. Estimates and judgement calls are still required in many situations. Let's look at each of Levitt's top five in a bit more detail.

1. The big bath – This form of income manipulation can be thought of as part of income smoothing. What it usually does is effectively accelerate expenses and losses into a single year with already poor results so that future income looks better and smoother. Even though the FASB has issued fairly recent statements to reduce the magnitude for taking a big bath, companies can, and do, still use this technique. Examples may include recognizing losses on assets that have a fair market value below the current book, or carrying, value, cookie jar reserves (to be discussed in 3. below); and doing a restructuring (taking the expenses allowed under *SFAS No. 146*) that a company may not otherwise have done.
2. Creative acquisition accounting – As the number of acquisitions has decreased (since the late 1990s) and with the advent of *SFAS Nos. 141* and *142*, this doesn't seem to be as much of a problem as it once was. Still, when a company has made an acquisition or acquisitions during the year, the transactions should be looked at closely to see exactly how they were accounted for and what effect the treatment has on current, and will have on future, earnings.
3. Cookie jar reserves – These can go along with the big bath and are a form of income smoothing. Earnings are managed under this method by selecting the period in which a revenue or expense item is taken. This is usually done for expenses that are based on estimates. If a company is having a particularly good year and next year's results are uncertain, they can over-accrue some reserves in the current year and then have the ability to under-accrue them in the next year if needed. By doing so, they effectively inflate the following year's income at the expense of this year's. Income, thus, appears smoother, and the company may be able to publicly forecast higher profits for the following year even if their business isn't actually going to do any better in the following year. This may temporarily be good for the stock price, but it isn't good for those wanting to know how the company is actually performing.

4. **Materiality** – This topic may not be a big deal to small companies since nearly everything is material and, hence, should be accounted for. But for large, publicly traded companies with revenues and assets in the billions of dollars, they can potentially get away with millions of dollars worth of misstatements and merely write them off as being “nonmaterial” in nature. Auditors are primarily concerned with material misstatements. Materiality has the potential to allow companies to slightly fudge their numbers, just enough to get them to where the analysts forecasted.
5. **Revenue recognition** – Sort of the flip-side of cookie jar reserves, improper revenue (or expense) recognition can lead to inflated financial statements now at the expense of future earnings. Some companies that have dabbled with this earnings management technique then have to inflate revenue in the next period even more to make up for the shortfall caused by the prior period’s acceleration of revenue. It becomes a never-ending game of covering up for the previously improperly recorded revenue and can fairly easily lead to outright fraud. Several of the bigger scandals of the past few years have been the result of companies improperly, and/or prematurely, recording revenues in order to meet or exceed forecasts, only to have the house of cards eventually come tumbling down, resulting in massive restatements to the prior financial statements, new management, new auditors, and very low stock prices (if not bankruptcy).

LO3 – Critically discuss whether a company should manage its earnings.

LO4 – Describe the common elements of an earnings management meltdown.

How? Rather than try memorizing all seven of the elements as well as their proper order, it may prove more useful to think through a scenario (like Enron or a made up one) and then imagine what would likely happen (or recall what actually happened with a company like Enron). The elements flush themselves out from a situation quite naturally. Otherwise, you may get things like “massive loss of reputation” and “downturn in business” reversed when in real life, or by using using a hypothetical situation, you will never encounter a massive loss of reputation coming before an initial downturn in business.

LO5 – Explain how good accounting standards and ethical behavior by accountants lower the cost of obtaining capital.

The following sections, featuring various multiple choice questions, matching exercises, and problems, along with solutions and approaches to arriving at the solutions, is intended to develop your problem-solving and critical-thinking abilities. While learning through trial and error can be effective for improving your quiz and exam scores, and it can be a more interesting way to study than merely re-reading a chapter, that is only a secondary objective in presenting this information in this format.

The main goal of the following sections is to get you thinking, “How can I best approach this problem to arrive at the correct solution—even if I don’t know enough at this point to easily come up with the proper results?” There is not one simple approach that can be applied to all questions to arrive at the right answer. Think of the following approaches as possibilities, as tools that you can place in your problem-solving toolkit—a toolkit that should be consistently added to. Some of the tools have yet to even be created or thought of. Through practice, creative thinking, and an ever expanding knowledge base, you will be the creator of the additional tools.

Multiple Choice

MC6-1 (LO2) Excluding some revenues, expenses, gains, and/or losses from the earnings figure calculated using generally accepted accounting principles is an example of

- a. income smoothing.
- b. the big bath.
- c. a cookie jar reserve.
- d. pro forma earnings.

MC6-2 (LO2) Foster & Sons Incorporated had a particularly poor year. The CEO left halfway through the year and the new CEO wants to clean house and make future earnings look as good as possible under his new reign. Some employees have been terminated and others will likely be let go in the next year. The new CEO wants to expense the severance packages for all of these employees in the year just ended. This would be an example of which kind of earnings management procedure?

- a. the big bath
- b. materiality
- c. creative acquisition accounting
- d. revenue recognition

MC6-3 (LO2) In a year in which a company is experiencing more profit than anticipated, deferring the recognition of revenue for which the earnings process is complete or over accruing a liability and expense are examples of

- a. the big bath.
- b. strategic matching.
- c. a change in an accounting estimate.
- d. a cookie jar reserve.

MC6-4 (LO2) Recording as an asset expenditures that have no future economic benefit is an example of

- a. non-GAAP accounting.
- b. a change in methods or estimates with full disclosure.
- c. strategic matching.
- d. a fictitious transaction.

MC6-5 (LO2) Most companies that engage in earnings management typically do not go beyond which of the following activities on the earnings management continuum?

- a. a change in methods or estimates with full disclosure
- b. strategic matching
- c. a change in methods or estimates with little or no disclosure
- d. non-GAAP accounting

MC6-6 (LO2) Which of the following earnings management techniques is most associated with start-up companies?

- a. recognizing revenue when a contract is signed and before goods are delivered or services are provided
- b. recording immaterial adjustments that cause earnings to meet analysts' expectations
- c. recording extremely high warranty expense when earnings are high
- d. expensing purchased in-process research and development

MC6-7 (LO2) Which of the following statements is TRUE?

- a. Cash flow data is superior to earnings under the accrual basis for implementation of the tactics of earnings management.
- b. The National Center for Continuing Education in 2001 held a seminar that spoke out against earnings management.
- c. The flexibility in accrual basis statements allows managers to manipulate the reported numbers.
- d. All earnings management schemes are created equal.

MC6-8 (LO3) The GAAP Oval best represents the

- a. fact that only one true earnings number exists.
- b. flexibility investors have in choosing which company to invest in since all are following the same GAAP.
- c. flexibility managers have within GAAP to report one earnings number from among many possibilities.
- d. fact that GAAP is not subject to interpretation.

MC6-9 (LO4) Excessive earnings management typically begins as a result of

- a. a regulatory investigation.
- b. pressure to meet the expectations of stakeholders.
- c. a downturn in business.
- d. a violation of generally accepted accounting principles.

MC6-10 (LO5) Which of the following is the SEC authorized by Congress to do?

- I. Monitor the standard-setting process of the FASB
 - II. Set accounting standards
 - III. Investigate and punish cases of deceptive financial reporting
- a. only III
 - b. only I and III
 - c. only I and II
 - d. I, II, and III

Matching

Matching 6-1 (LO1, LO2) Listed below are the terms and associated definitions from the chapter for LO1 and LO2. Match the correct definition letter with each term number.

- | | |
|---|---|
| <ul style="list-style-type: none"> ___ 1. big bath ___ 2. earnings management continuum ___ 3. income smoothing ___ 4. internal earnings target ___ 5. pro forma earnings number ___ 6. window dressing | <ul style="list-style-type: none"> a. a practice of companies to boost their reported earnings when the companies enter phases in which it is critical that reported earnings look good b. a company expecting to have a series of hits to earnings in future years is better off trying to recognize all of the bad news in one year, leaving future years unencumbered by continuing losses c. ranges from savvy timing of transactions to outright fraud; in most companies, if practiced at all, does not extend beyond savvy transaction timing d. regular GAAP earnings number with some revenues, expenses, gains, or losses excluded because companies claim that the GAAP results do not fairly reflect the company's performance e. a tool in motivating managers to increase sales efforts, control costs, and use resources more efficiently f. a practice of carefully timing the recognition of revenues and expenses to even out the amount of reported earnings from one year to the next |
|---|---|

Matching 6-2 (LO3, LO4, LO5) Listed below are the terms and associated definitions from the chapter for LO3 through LO5. Match the correct definition letter with each term number.

- | | |
|---|---|
| ___ 1. cost of capital | a. the expected return (both as dividends and as an increase in the market value of the investment) |
| ___ 2. cost of debt financing | necessary to induce investors to provide capital |
| ___ 3. cost of equity financing | b. the cost a company bears to obtain external financing |
| ___ 4. GAAP Oval | c. the cost of debt and equity financing, measured by the proportion of each type of financing |
| ___ 5. weighted-average cost of capital | d. the after-tax interest cost associated with borrowing |
| | e. the flexibility a manager has to report one earnings number from among many possibilities based on different methods and assumptions |

Problems

Problem 6-1 (LO3) You are auditing a company whose management has intentionally made adjustments to various financial statement items that are not in accordance with generally accepted accounting principles. This behavior has occurred over a number of accounting periods. None of the individual adjustments by themselves are material, and the aggregate effect on the financial statements taken as a whole is immaterial. Top management of the client is aware of these misstatements and considers them part of their strategic management of earnings.

Explain how you, as the independent auditor, should respond to this situation.

Solutions, Approaches, and Explanations

MC6-1

Answer: d

Approach and explanation: Pro forma generally refers to “budgeted” in accounting terminology. Pro forma financial statements usually mean the same thing as budgeted or forecasted financial statements. However, when you hear about a pro forma earnings number in an earnings release, it usually has a very different meaning. In this context, it refers to a number being left out.

For instance, a company may announce that they had a net loss for the quarter of \$(0.25) per share, but their pro forma earnings per share, had they not restructured the company, adopted a new accounting pronouncement, or encountered some other (usually) negative event, were a positive \$0.10 per share. The company basically wants you to ignore, or discount, the actual GAAP earnings and look at their pro forma number that they try to sell as a better indicator of what their earnings will look like in the future.

Technically, choices *a* through *c* are accomplished within GAAP. Choice *d* is the only one that blatantly ignores GAAP. GAAP doesn't require, or even encourage, companies to come up with pro forma earnings.

MC6-2

Answer: a

Approach and explanation: This is a classic example of the big bath—taking any and all expenses in the current year so that the expenses don't have to be taken in future years, thus making future income numbers look rosier. The big bath is especially common when a new CEO takes over. The new CEO can blame the old CEO for the poor current year and then predict a better future while knowing that some future expenses have already been taken.

MC6-3

Answer: d

Approach and explanation: Recall that a cookie jar reserve is basically the opposite of revenue recognition and similar to the big bath. The main difference between a cookie jar reserve and the big bath is that a cookie jar reserve generally happens in a good year and the big bath happens in a bad year. Both serve to increase profits in future years.

The name "cookie jar" implies that earnings are being stored away to be used in the future when the sweet tooth kicks in and needs it.

The big bath can also include the over-accruing of a liability, but it doesn't usually include the deferral of revenue.

Strategic matching is the matching of one-time gains and losses so that a large gain or loss is not reported and income is smoothed.

A change in accounting estimate also tends to affect expenses more than deal with revenue for which the earnings process is complete. A change in estimates can either accelerate or defer the expenses and will do so over a different time period than normal. The expenses are still taken each year; the amount of the expense and the number of years merely changes.

MC6-4

Answer: a

Approach and explanation: This is what took place in the Worldcom case. Under GAAP, only expenditures that provide future economic benefit (the creation of an asset) can be capitalized. All others must be expensed. By capitalizing, instead of expensing, billions of dollars worth of expenditures, Worldcom not only overstated income but they also inflated their balance sheet with assets that weren't really assets.

A fictitious transaction is probably the most frequently chosen of the incorrect choices. If the question was changed to the following, then choice *d* could in fact be another correct choice:

“Recording as an asset expenditures that never took place is an example of...”

In the current question (and in the Worldcom case), the expenditures are assumed to have actually been incurred, so a fictitious transaction isn't being created out of thin air. A real transaction is merely being mischaracterized as an asset when it is really an expense.

MC6-5

Answer: b

Approach and explanation: Strategic matching is on the far left of the continuum. Basically, anything to the right of it is at least aggressive, and most companies do not venture into the aggressive accounting stage or beyond.

Most companies that make a change in accounting method or estimate do so because GAAP requires it (due to a new pronouncement or the business changing enough to warrant the change). Few companies make changes in accounting methods or estimates to try and manage earnings. Fewer still do so without disclosing the change.

Refer to Exhibit 6-4 in the textbook if you need to refresh your memory of the earnings management continuum.

MC6-6

Answer: a

Approach and explanation: The key words in the question are “start-up companies.” Start-up companies are in a different position than other companies. Typically they are looking for financing, aren't making lots of money, and are small due to their “newness.”

Based on the above, you should be looking for a choice that would enhance a start-up company's ability to have a successful IPO or to obtain a loan. A start-up company's financial statements need to be as impressive as possible *now* to secure a loan (the largest possible and at the most favorable terms available) and/or to raise as much as feasible in their IPO. Hence, you need not worry about things like the big bath or cookie jar reserves since those enhance later earnings at the expense of current earnings—not something a start-up company would be concerned with.

A start-up company's transactions are likely all material so choice *b* doesn't make much sense. Nor would analysts even be looking at a start-up, pre-IPO company yet. Choice *c* is a cookie jar reserve. Start-up companies also aren't usually in the business of acquiring other companies, so choice *d* doesn't make sense either. Nor would they want to increase expenses at this point in their business life cycle even if they were purchasing some research and development. They'd want to capitalize the expenses to make their balance sheet and income statement more attractive to obtain additional financing.

Along the same lines, in order to enhance their income statement, they may want to accelerate revenue recognition by recording it before they have performed the service or provided the good that the contract calls for. Hence, choice *a* is the correct choice for most companies in the start-up phase (or other companies looking for immediate financing).

MC6-7

Answer: c

Approach and explanation: Let's look at each choice individually.

Choice *a* is the opposite of the truth. Earnings management can most easily be performed on accrual-basis numbers since there are a number of estimates involved. Outside of strategic matching to time cash-based transactions, there is very little that can be done to manipulate the cash-based data. Cash is cash and not based on estimates and judgment calls.

Choice *b* is also false. The National Center for Continuing Education actually held an annual seminar that taught managers how to manage earnings. Recently the title of the seminar has changed, but the seminar still isn't really against earnings management so much as it is how to spot the practice.

Choice *c* is basically the opposite of the false choice *a* and is the correct one. On these types of questions, where you are asked to identify the true or the false choice, look for opposites. If you find the two opposite choices, one of the choices is likely the correct answer (unless there are two sets of opposites among the four choices).

Choice *d* is clearly incorrect once you understand the earnings management continuum. Fraud, for instance, is a far worse form of earnings management than strategic matching.

MC6-8

Answer: c

Approach and explanation: The GAAP Oval shows that following GAAP doesn't necessarily yield one number or one perfect set of financial statements. There is some interpretation and "wobble room" within GAAP for a number of transactions. Hence, within the range of the Oval, multiple numbers, or presentation of numbers, can be within GAAP. However, there are still fuzzy areas where some people would call into question certain treatments and there are also many, many numbers outside of even the fuzzy areas that are non-GAAP and, hence, not permissible.

With the above in mind, we can clearly see that choices *a* and *d* are incorrect. There isn't always only one true earnings number, and GAAP can be subject to interpretation. Choice *b* is incorrect because the GAAP Oval applies to a company's treatment of an issue or transaction, not to investor choices.

MC6-9

Answer: c

Approach and explanation: Companies that really are doing well generally don't fall into the "excessive earnings management" category. There could be some minor cookie jar reserves going on but not usually the kinds of things that one would consider "excessive."

However, once business begins to take a downturn, and especially when users aren't expecting it, excessive earnings management may creep in to the picture. Choice *c* is the beginning place. Choice *b* is usually the next phase. Choice *d* isn't technically one of the elements discussed in the chapter, although it could possibly fall under the "attempted accounting solution" label. Choice *a* doesn't usually happen until at, or near, the end of the process.

MC6-10

Answer: d

Approach and explanation: The chapter gives examples of each of the three items listed. Historically, the SEC hasn't done a great deal of II, but recently they have begun to do more in this area. Examples from the chapter of item II include *SABs 99, 101, and 104*.

Examples from the chapter of item III include *KPMG and Xerox*.

Matching 6-1

1. b
2. c
3. f
4. e
5. d
6. a

Complete these terminology matching exercises without looking back at the textbook or on to the glossary. After all, you probably won't have those as a reference at test time. Learning through trial and error causes the item to be learned better and to stick in your memory longer than if you just look at the textbook, glossary, or a dictionary and "cook book" the answers. Sure you may get the answer correct on your first attempt, but missing something is sometimes best for retention. Don't be afraid of failure while studying and practicing.

Matching 6-2

1. b
2. d
3. a
4. e
5. c

Problem 6-1

Approach: On an open-ended essay question like this one, it is probably better to do a "brain dump" of pros and cons, facts, etc., first (on scratch paper) rather than delve right into an essay. Your chances of a more complete, and better organized, answer are likely with such an approach. After you have some thoughts down, then you can better organize them and assess their comprehensiveness. At that point, you can begin your essay.

Make your essay easy to read, concise, and yet still comprehensive. Bulleted lists and other highlighting of key items, words, and phrases will not only aid the reader in getting your message, it will also help to ensure that the grader will catch all of the most important points that you are trying to get across. Frequently, if the question is worth say five points, the grader will be looking for five key items, words, or phrases from a list of 10 or 15 they have in front of them. If you have five, but they are buried within a lot of excess verbiage, they may not be spotted and you may only get three or four points instead of the full five you deserve.

Possible solution: The fact that the client's records contain intentional errors may be indicative that the client (if a public company) has violated securities laws by failing to maintain accounting records that accurately and fairly reflect in reasonable detail the transactions of the company. This would be considered an illegal act and would require, among other things, the auditor to communicate with the audit committee of the client board of directors.

The following represent important considerations in formulating a response to this situation:

- An inconsequential misstatement should be viewed differently than those that are more significant.
- The clarity of authoritative accounting guidance with respect to the misstatement (i.e., if clear and authoritative guidance exists, the misstatement should be corrected).
- The manner in which the misstatement arose (in this case, a misstatement—even though immaterial—that is part of an ongoing earnings management initiative sanctioned by management is likely not acceptable).
- Intentional misstatements are more important than unintentional misstatements (such as clerical errors) since an intentional error reflects on the integrity and reliability of management and employees of the client company.
- Immaterial misstatements may be material if they allow the client to avoid violation of a contractual agreement such as a debt covenant.
- Does an immaterial misstatement affect the trend in earnings?
- Does the immaterial misstatement allow the company to meet financial analysts' expectations for the company?
- Does the immaterial misstatement result in meeting the threshold for management bonuses where the bonus compensation is based on earnings?

The fact that the departure from GAAP, in this case, is intentional should alert the auditor to look for motivations for the client to make such a departure. The honesty and integrity of the client must be considered. Although immaterial, the misstatements should be closely reviewed to see if they are motivated by any of the above mentioned factors or other factors that the auditor might identify.

Glossary

Note that Appendix C in the rear portion of the textbook contains a comprehensive glossary for all of the terms used in the textbook. That is the place to turn to if you need to look up a word but don't know which chapter(s) it appeared in. The glossary below is identical with one major exception: It contains only those terms used in Chapter 6. This abbreviated glossary can prove quite useful when reviewing a chapter, when studying for a quiz for a particular chapter, or when studying for an exam which covers only a few chapters including this one. Use it in those instances instead of wading through the 19 pages of comprehensive glossary in the textbook trying to pick out just those words that were used in this chapter.

big bath The concept that a company expecting to have a series of hits to earnings in future years is better off trying to recognize all of the bad news in one year, leaving future years unencumbered by continuing losses.

cost of capital The cost a company bears to obtain external financing.

cost of debt financing The after-tax interest cost associated with borrowing external financing.

cost of equity financing The expected return (both as dividends and as an increase in the market value of the investment) necessary to induce investors to provide equity capital.

earnings management continuum A continuum that describes earnings management ranging from savvy timing of transactions to outright fraud; in most companies, if practiced at all, does not extend beyond savvy transaction timing.

GAAP Oval Represents the flexibility a manager has, within GAAP, to report one earnings number from among many possibilities based on different methods and assumptions.

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.

internal earnings target An important tool in motivating managers to increase sales efforts, control costs, and use resources more efficiently.

pro forma earnings number The regular GAAP earnings number with some revenues, expenses, gains, or losses excluded because companies claim that the GAAP results do not fairly reflect the company's performance.

weighted-average cost of capital The average of the cost of debt and equity financing, weighted by the proportion of each type of financing.

window dressing Practice of companies to boost their reported earnings when the companies enter phases in which it is critical that reported earnings look good.