Financial Accounting Theory
Seventh Edition
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Chapter 11
Earnings Management
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Earnings Management

- Patterns of earnings management
- Motivations for earnings management
- Good earnings management
- Implications for accounting
- Bad earnings management
What Is Earnings Management?

- Earnings management is the choice by a manager of accounting policies (accruals), or real actions, that affect earnings so as to achieve some specific reported earnings objective
  - Real actions to manage earnings include, for example, cutting or increasing R&D and advertising; manufacturing for stock
  - Accrual-based earnings management includes, for example, managing the allowance for bad debts, changing amortization policy

>> Continued
What Is Earnings Management? (continued)

• Here, we concentrate primarily on the role of accruals in earnings management
  – Note the “iron law” of accruals reversal: if accruals increase earnings this period, their reversal lowers earnings in future periods

• Two types of accruals
  • Non-discretionary: management has little discretion to control amounts
  • Discretionary: management has discretion to control amounts
  • To discover role of accruals in earnings management, accountant needs to separate these two types
    • Jones model usually used for this separation
11.2 Patterns of Earnings Management

- Bath
- Income minimization
- Income maximization
- Income smooth
11.3 Evidence of Earnings Management for Bonus Purposes

- A contractual motivation
  - Bonus plan hypothesis: to manage cash bonus
    - Evidence: [Healy (1985)]
      - Confined to bonuses based on net income
      - Recall concepts of bogey and cap
      - Evidence of upward earnings management when net income between bogey and cap
    - Measuring discretionary accruals
      - Healy used total accruals as proxy
      - Now usually based on Jones model

» Continued
11.4 Other Earnings Management Motivations

- Other contractual motivations
  - To avoid violation of debt covenants
    - Evidence: Dichev & Skinner (2002), text Section 8.5
      - They report evidence of earnings management to maintain debt covenant ratios well above contracted values (covenant slack)
  - To avoid political costs
    - Evidence: Jones (1991), text Section 11.3
      - designed the Jones model to separate discretionary and non-discretionary accruals. Reports firms used income-reducing discretionary accruals to bolster their case for tariff protection

>> Continued
Other Earnings Management Motivations
(continued)

• To meet investors’ earnings expectations
  – Strong negative share price reaction if expectations not met
  – Damage to manager reputation if expectations not met
    • Evidence: e.g., Jackson & Liu (2010), found evidence of management of bad debt allowances to avoid missing market’s earnings expectations
Other Earnings Management Motivations
(continued)

• Initial public offerings
  – To increase proceeds of new share issues
    • Cohen & Zarowin (2010) find evidence of use of income-increasing discretionary accruals in years of SEOs.
      – They also report use of real earnings management techniques to increase reported net income
      – They report declining ROA for 3 years following SEO, driven in part by accrual reversal
    • Dechow, Ge, Larson & Sloan (2011) (Section 11.6). A sample of firms charged by SEC with financial statement misstatements were actively raising additional capital
11.5 The Good Side of Earnings Management

• Investor-based arguments for good earnings management
  – To credibly communicate inside information to investors
    • Blocked communication may inhibit direct disclosure of earnings expectations
    • Discretionary accrual management as a way to credibly reveal management’s inside information about earnings expectations
      – Manager foolish to report more earnings than is expected to persist
      – So, manage reported earnings to an amount management expects will persist, thereby revealing inside information about future profitability

>> Continued
The Good Side of Earnings Management
(continued)

• Contract-based arguments
  – To give firm some flexibility in the face of rigid, incomplete contracts
    • Bonus contracts based on net income
      – New accounting standards may lower net income and/or increase volatility.
        May adversely affect manager effort
    • Debt covenant contracts
      – New accounting standards may increase probability of debt covenant violation
  – Contract violation is costly, earnings management may be low-cost way to work around
The Good Side of Earnings Management
(Continued)

• Theoretical models supporting good earnings management
  – Demski & Sappington (1987a & b)
    • To unblock inside information

» Continued
The Good Side of Earnings Management
(continued)

• Empirical evidence of good earnings management
    • Greater use of income smoothing (their measure of accruals-based earnings management) positively associated with share returns. Suggests that investors value earnings management that smooths out non-persistent items.
  – Other studies
    • Bowen, Rajgopal, & Venkatachalam (2008)
    • Liu, Ryan, & Whalen (1997)
    • Das, Shroff, & Zhang (2009)
    • Cready, Lopez & Sisneros (2012) (Section 11.6)
    • Jayaraman (2008) (mixed results)
    • Francis, LaFond, Olsson, & Schipper (2005) (mixed results)
Earnings Management at General Electric

• Text, problems 11.8 & 11.9
• Earnings management devices used by GE 1993-2007
  – Assumed rate of return on pension funds
  – Restructuring charges
  – Acquisitions, sales of divisions
  – Conservative accounting practices
    • Sales of leased aircraft
  – Allocation of goodwill on purchase of subsidiaries
• Earnings management devices used in harmony to report steadily increasing earnings
  – See next slide
### Earnings Management at General Electric (continued)

- **GE Reported Net Income (Millions)**
  - 2008: $17,235
  - 2007: 22,208
  - 2006: 20,700
  - 2005: 16,353
  - 2004: 16,593
  - 2003: 15,002
  - 2002: 14,118
  - 2001: $13,684
  - 2000: 12,735
  - 1999: 10,717
  - 1998: 9,296
  - 1997: 8,203
  - 1996: 7,280
  - 1995: 6,573
  - 1994: 4,726
  - 1993: 4,315

» Continued
Earnings Management at General Electric  
(continued)

• Note argument that even under securities market efficiency, GE is so large and complex that even analysts cannot prepare accurate earnings forecasts
  – Management has best inside information about expected persistent earnings
  – Direct communication blocked
  – Creates role for earnings management to reveal management’s expected persistent earnings

• Is this good or bad (i.e., opportunistic) earnings management?
Earnings Management at General Electric

(continued)

• Theory in Practice 11.2
  – GE reports lower earnings for quarter ended March 31, 2008
  – Share price falls by 13%
  – Why did share price fall?
11.6 The Bad Side of Earnings Management

- Contracting Perspective
  - Healy (1985) (Section 11.3, Slide 11.6)
    - Reports evidence of management use of accruals to maximize their cash bonuses
    - Is this good or bad earnings management?
The Bad Side of Earnings Management (continued)

- Financial Reporting Perspective
  - Hanna (1999)
    - Investors and analysts look to core earnings, ignoring provisions for extraordinary and non-recurring items
    - Implies manager not penalized for non-core provisions, such as writedowns, provisions for restructuring
    - But current non-core provisions increase core earnings in future years, through lower amortization and absorption of future costs
The Bad Side of Earnings Management (continued)

- Hanna (continued)
  - As a result, managers tempted to “overdose” on non-core provisions, thereby putting earnings “in the bank”
    - also called cookie jar accounting
- Note securities market reaction
  - Elliott & Hanna (1996) found evidence that investors use frequency of such provisions as proxy for their misuse—they found lower ERC when greater frequency
  - Would full disclosure in income statement of effect on net income of past writedowns provide useful information to investors?

>> Continued
The Bad Side of Earnings Management (continued)

• More recent studies of bad earnings management
  • Leuz, Nanda & Wysocki (2003)
    • Countries with poor investor protection experience more earnings management
  • McInnis & Collins (2011)
    • Increase in accrual quality (i.e., less bad earnings management) following availability of cash flow forecasts

>> Continued
The Bad Side of Earnings Management (continued)

• Recent examples of bad earnings management
  • Groupon Inc., Theory in Practice 11.1
    • Extreme income maximization
      • Capitalize marketing costs
      • Emphasize pro-forma income
  • Olympus Corp., Theory in Practice 11.3
    • Elaborate scheme to avoid huge writedown of investments, by transferring loss to purchased goodwill

>> Continued
The Bad Side of Earnings Management (continued)

- **Standard setters response to bad earnings management**
  - IAS 37
    - Before recording a provision, payments must be probable and capable of reliable estimation
    - Provision must be valued at fair value
    - No excess provision as a result of uncertainty
    - Provisions must be used only to absorb costs for which provision originally set up
  - ASC 420-10-25
    - No provision until liability incurred
  - Do these solve problem of abuse of provisions?
    - Management controls timing
    - Fair values require estimation

>> Continued
The Bad Side of Earnings Management (continued)

• Do managers accept securities market efficiency?
  – Perhaps
    • Poor disclosure enables earnings management even if markets are efficient
  – Perhaps not
    • Theory and evidence that securities markets may not be fully efficient supports a “no” answer
    • Evidence that efficiency not accepted
      – Pro-forma earnings
        » Doyle, Lundholm, & Soliman (2003), Heflin & Hsu (2008)
      – Managing same-quarter earnings of previous year
        » Schrand and Walther (2000)

>> Continued
The Bad Side of Earnings Management (continued)

• Analyzing Managers’ Speech to Detect Bad Earnings Management

  • Cognitive dissonance
    • Arises when persons behave contrary to their opinion of themselves—e.g., a misleading statement produces a guilty feeling
    • An individual will react by trying to reduce his/her dissonance
      • Will try to change his/her beliefs
      • Will back off somewhat from the dissonance-creating statement
    • Sophisticated computer programs can detect these reactions

• Hobson, Mayhew & Venkatachalam (2012)
  • Analyzed managers’ speech during earnings announcements, obtaining a cognitive dissonance score for each manager
  • Found that higher dissonance score associated with future earnings revisions
Earnings Management at Sunbeam Corp.

- See Problem 11.10 text
- Devices used by Sunbeam to manage earnings upwards
  - See next slide
- Note loss reported 1st Q. 1998
  - Illustrates “iron law” of accrual reversal
- Where was auditor?
# Earnings Management at Sunbeam Corp.

<table>
<thead>
<tr>
<th>Sunbeam Corp, 1997</th>
<th>Estimated Discretionary Accruals</th>
<th>Effect on 1997 Net Income ($ million)</th>
<th>(Net of tax)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>Inventory written down to zero in 1996, sold at 50¢ on the dollar in 1997</td>
<td>$ 36.5</td>
<td>$15</td>
<td></td>
</tr>
<tr>
<td>Decline in prepaid expense from $40.4 in 1996 to $17.2 in 1997</td>
<td>25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decrease in other current liabilities ($18.1) and other long-term liabilities ($19), attributed mainly to reduction in product warranty provisions.</td>
<td>6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduction in 1997 amortization, due to 1996 writedown of property, plant and equipment, and trademark</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capitalization of product development, advertising, etc. into property, plant and equipment in 1997</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decrease in allowance for doubtful accounts from $23.4 to $8.4 during 1997</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing for stock in 1997, evidenced by 40% increase in inventories, thereby absorbing manufacturing overhead of about “Early buy&quot; and “bill and hold” sales of $50: estimated profit from early revenue recognition</td>
<td>8</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>105.5</td>
<td>$15</td>
<td></td>
</tr>
<tr>
<td>Less total of Decrease column</td>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income-increasing discretionary accruals</td>
<td>$ 90.5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The Bad Side of Earnings Management (continued)

• Can accountants reduce bad earnings management?
  – Yes, if full disclosure of
    • Revenue recognition policies
    • Unusual, non-recurring and extraordinary events
      – Enables investors to better evaluate earnings persistence
    • Effect of previous writeoffs on current core earnings
      – Hanna (1999)
11.7 Conclusions

- Earnings management can be good if used responsibly
- Full disclosure helps to control bad earnings management