Muhasebe Enstitüsü Dergisi
MED -Journal of Accounting Institute

Earnings Management: A Review of Selected Cases

Belverd E. Needles, Jr.[1]*, Marian Powers[2], Y. Bora Senyigit[3]

[1] *DePaul University, School of Accountancy, USA*
[2] *Northwestern University, Kellogg Graduate School of Management, USA*
[3] *King's College, McGowan School of Business, USA*

ABSTRACT

The past decade has been characterized as a period of financial crisis. A number of high-profile cases have highlighted the role of financial reporting and the issues surrounding earnings management. The flood of these so-called 'accounting scandals' and the alarming increase in accounting revisions and restatements has drawn the attention around the globe of accounting researchers and the popular press alike. Among the questions that need explanation are: 1) 'What is earnings management or mismanagement?' 2) 'What is the role of judgment in ethical financial reporting?' and 3) 'What are the difficulties of identifying earnings management?'. In order to answer these research questions,this paper reviews a literature on the topic and then identifies and places on an earnings management continuum some of the major cases globally over the last decade.

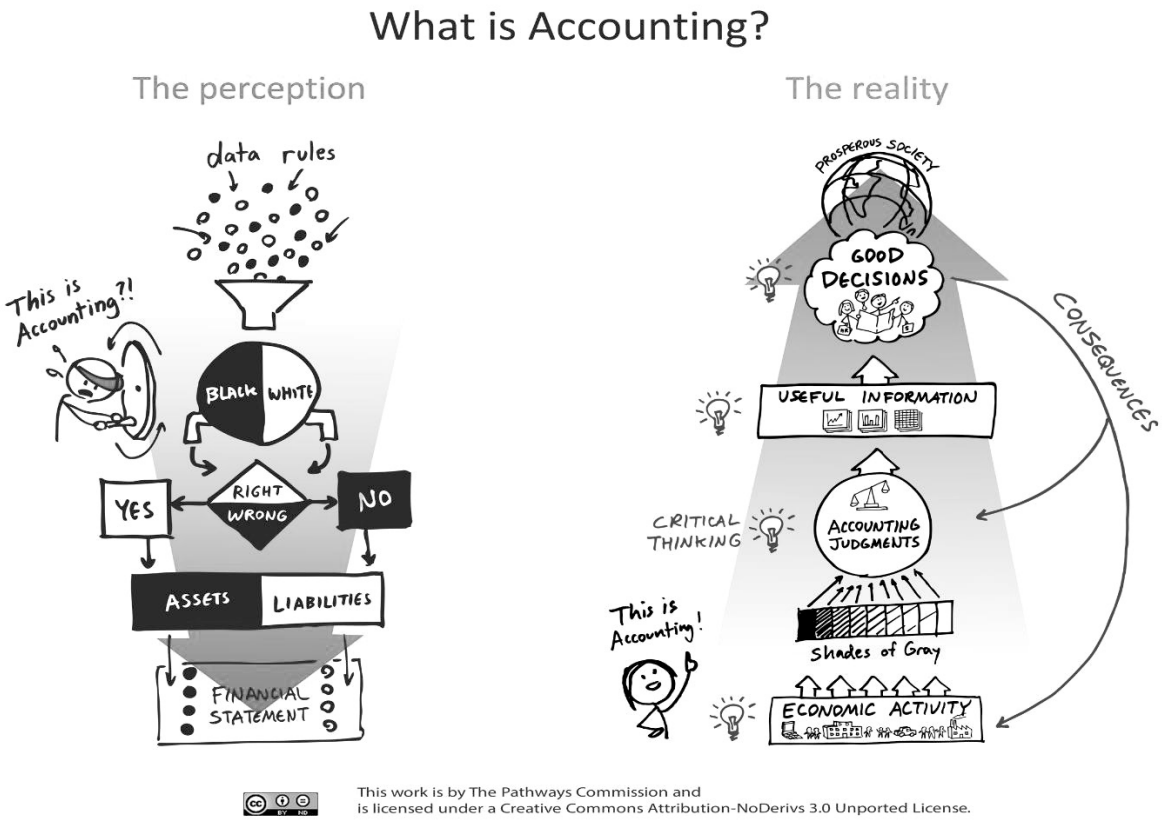
Keywords: Earnings management, Judgement, ethical financial reporting

1. Introduction

The objective of financial reporting is defined as "to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity" in the International Accounting Standards Board's (IASB) Conceptual Framework for Financial Reporting (IASB, 2010). In order to create useful information that can help financial statement users make better decisions, accounting judgments and estimates require critical thinking are necessary. The Pathways Commission on Accounting Higher Education, which was established jointly by the American Institute of Certified Public Accountants (AICPA) and the American Accounting Association (AAA), created the Vision Model diagram depicted on the right-hand side of Figure 1 to show the reality of 'What is Accounting?' to students in their first course in accounting. The 'Reality of Accounting' (the Vision Model) shows professional accountants making complex accounting judgments that affect and are affected by economic activity and contribute to a prosperous society. However, the 'Public Perception of Accounting' depicted on the left hand-side of Figure 1 shows professional accountants focus on recording financial transactions and preparing financial statements using black and white accounting rules.

* Corresponding author (Needles Jr, Belverd E.)
E-mail: bneedles@depaul.edu

Figure 1: The Pathways Commission's Vision Model



Source: The Vision Model at www.PathwaysCommission.org.

Since the application of financial reporting standards requires considerable judgment, it creates opportunities for earnings management as well. Although financial statement audit provides confidence that those judgments are reasonable, there are many cases that audit firms could not detect material misstatements or fraud. This is because it is difficult to determine whether there is a tolerable amount of earnings management (Barth, 2018). The reminder of the paper presents, in order, a definition of earnings management, discussion of interrelations among judgment, estimates, and earnings management, the difficulty of identifying earnings management, selected earnings management case examples, and conclusion.

2. Earnings Management

'Earnings management' typically focuses on the artificial increase (or decrease) of revenues, profits, or earnings per share figures through aggressive accounting tactics. The actual situation is, however, more complex. Consider these example definitions of earnings management:

- "Purposeful intervention in the external financial reporting process with the intent of obtaining some private gain."
- "Use of 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 judgments."

- "An intentional structuring of reporting or production/investment decisions around the bottom line impact." (emphasis added)

These definitions illustrate that earnings management is a complex process that involves the accounting judgment that underlies not only the income statement but also the other financial statements and related disclosures. It also involves the 'structuring' of business decisions. Healy and Wahlen (1999) more closely address this complexity by 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 a company or to influence contractual outcomes that depend on reported accounting numbers.

Earnings management seems to have short-term benefits for management and boards of directors. Recent research of more than twenty years of SEC accounting manipulation cases shows that CEOs with equity holdings often influence short-term financial results by pressuring CFOs, who do not hold as much equity and do not get involved for immediate financial benefit, to set aside their role as a watchdog of financial reporting quality (Feng et al., 2011). Turner and Vann (2010) have shown that "independent directors of firms that exhibit earnings management benefited significantly greater cumulative percentage increases in the market value of stock and stock options owned either actually or beneficially than did independent directors on the audit committees of companies presenting no evidence of earnings management."

Consider the following business decisions by a company seeking to meet its debt covenant requirements:

- The company sells its receivables without recourse
- The company sells its receivables with recourse
- The company sells its receivables with a side agreement to buy them back within thirty days

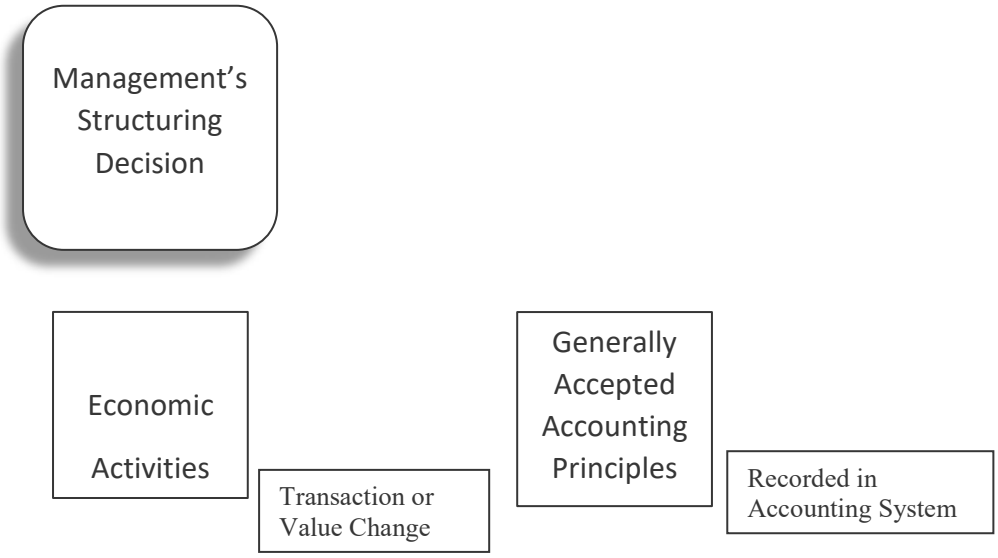
Also, consider the following accounting decisions:

- The company records the sale of receivables with the resulting gain or loss
- The company records the sale of receivables and makes an optimistic estimate of the probability of recourse
- The company records the sale of receivables and makes a pessimistic estimate of the probability of recourse
- The company records the sale of receivables and indicates in the footnote disclosures the requirement to re-buy
- The company records the sale of receivables and does not indicate in the footnote disclosures the requirement to re-buy

As may be seen in Figure 2 (McKee, 2005), every item in the financial statements is the result of the complex interaction of these two decisions by management: A business structuring decision -A financial reporting decision

Financial statements are affected first by business structuring decisions that engage the business in economic activities. These decisions result in transactions or changes in value that must then be recorded in accordance with generally accepted accounting principles (GAAP). Because GAAP offers both alternative financial

Figure 2: Business Structuring Decisions versus Financial Reporting Decisions



reporting treatments and relies on judgment, various accounting decisions must be made to record the transactions in the accounting system from which the financial statements and related disclosures are prepared.

Management can structure its decisions to such a way as to determine subsequent GAAP treatment by, for example, how they:

- Time transactions to result in favorable timing of revenue or expense recognition
- Write contracts, such as for lease agreements and pension agreements

GAAP requires managers to make numerous financial reporting judgments that have an impact on reported earnings. Examples of these financial reporting judgments that could subtly shade earnings in one direction or another include:

- Long-term construction contracts require estimates of progress toward completion and costs to complete. Managers could use optimistic estimates of progress toward completion to inflate earnings.
- Depreciation computations require estimates of useful lives and salvage values. Managers could use optimistic estimates of the life and salvage value of depreciable assets, reducing depreciation expense.
- Accounts receivable must be stated at net realizable value. Managers could use optimistic estimates of collectability to overstate earnings.
- Costs must be classified as product costs or period costs. By classifying some borderline costs as product rather than period costs, managers can reduce expenses during times of inventory growth.
- Gains on asset dispositions may be fully recognized in the period of sale. Managers could time the sale of appreciated assets such as marketable securities and fixed assets to bolster earnings.
- Software development companies must estimate the point at which technological feasibility is reached for software products and capitalize software development costs after that point. Managers could accelerate this date to avoid immediately expensing some software development costs.

- Anticipated costs of satisfying warranty obligations must be accrued and matched to revenues. By making optimistic estimates of product warranty costs, managers could reduce current expenses.
- Ordinary repairs are expensed as incurred, while major repairs are capitalized. By treating ordinary repairs as major repairs, managers could bolster current earnings.
- Inventories must be stated at the lower of cost or market. Managers could use optimistic market values, resulting in reduced inventory write-downs (Jackson and Pitman, 2001).

Most frequently, these examples that represent accounting accruals (estimates)—adjustments to operating cash flows in calculating net income—are the means for achieving a rational allocation of costs to expense but could also be used to achieve a desired earnings figure. Some argue that earnings management within reasonable bounds can be beneficial for a company and even value adding (Yaping, 2006). By their nature, accruals involve estimation, require subjective judgments, and are difficult for auditors to objectively verify before their realization. Although auditors are likely to scrutinize financial statement accounts involving managers' subjective judgments, it is nonetheless unlikely that they could fully counteract deliberate, pervasive efforts to shade accruals in one direction or another. Auditors develop a range of reasonable values for an account but rarely insist upon an exact estimate within that range. Nonetheless, auditors, financial executives, and regulators must understand the motivations for earnings management in order to counteract it effectively.

In a study of 347 cases of fraudulent financial reporting over the last decade, the Committee of Sponsoring Organizations (COSO) identified numerous motivations for falsifying the financial reports (Beasley et al., 2010, p. 14), including to:

- Meet external earnings expectations of analysts and others
- Meet internally set financial targets or make the company look better
- Conceal the company's deteriorating financial condition
- Increase the stock price
- Bolster financial position for pending equity or debt financing
- Increase management compensation through achievement of bonus targets and through enhanced stock appreciation
- Cover up assets misappropriated for personal gain

Overly aggressive earnings management is a form of fraud and differs from reporting error. Management, wishing to show earnings at a certain level or following a certain pattern, seeks loopholes in financial reporting standards that allow them to adjust the numbers as far as is practicable to achieve their desired aim or to satisfy projections by financial analysts. These adjustments amount to fraudulent financial reporting when they fall 'outside the bounds of acceptable accounting practice.' The special COSO report also identified the most common financial fraud techniques among the 347 fraud companies to include (Beasley et al., 2010, p. 17):*

- Improper revenue recognition (recording fictitious revenues or recording revenues prematurely) 61%
- Overstatement of assets (excluding accounts receivable) 51%
- Understatement of expenses/liabilities 14%
- Insider trading also cited 24%
- Disguised use of related party transactions 18%
- Other miscellaneous techniques (acquisition, joint ventures, etc.) 20%

* *Totals more than 100% because of multiple abuses*

Earnings management is seen as a pressing issue in current accounting practice. It is relatively easy for an auditor to detect error, but earnings management can involve sophisticated fraud that is covert. The requirement for management to assert that the accounts have been prepared properly offers no protection where those managers have already entered into conscious deceit and fraud. Auditors need to distinguish fraud from error by identifying the presence of intention. Part of the difficulty lies in the accepted recognition that there is no such thing as a single 'right' earnings figure and that the line between acceptable and unacceptable financial reporting may be difficult to determine as will be illustrated in the following section.

3. Judgment, Estimates and Earnings Management

Accounting choices, both structural and judgmental, should be made within the framework of GAAP. Most people understand that GAAP are the set of rules, practices, and conventions that describe what is acceptable financial reporting for external stakeholders, but they may find it surprising that a single, normal, everyday accounting choice may be either ethical or unethical. The difference between an ethical and an unethical accounting choice is often merely the degree to which the choice is carried out. The problem with many accounting judgments is that there is no clear limit beyond which a choice is obviously unethical. Thus, a perfect routine accounting decision, such as expense estimation, may be illegal if the estimated amount is extreme but perfectly ethical if it is reasonable. GAAP does not tell managers what specifically is normal and what is extreme. It is more like a speed limit sign that simply says, 'Don't Drive Too Fast!'

Uncollectible accounts estimation is a prime example of an accounting decision many managers have to make. Since a company extends credit as an incentive for customers to buy, estimated losses from those who do not pay are considered a cost of the current period even though it will not be known until future periods, which customers will not pay, and what the amount of non-payment will be. GAAP requires that an estimate of uncollectible accounts be recorded as an expense in the same fiscal year as the revenue from the product is recorded. This follows a basic accrual accounting concept of matching expenses with related revenue.

Even small changes in estimates can have important effects on reported earnings. To illustrate, assume that a company has operating income of $100,000 before the estimate of uncollectible accounts. Also, assume management estimates uncollectible accounts to be $6,000, or 2% of net sales of $300,000. The income statement would look like this:

Revenue	$100,000
Less: Estimated uncollectible accounts expense	6,000
Net	$ 94,000

However, the fact that uncollectible accounts will be $6,000 is not always so clear. Assume that for the past five years, average uncollectible accounts costs on the same level of sales have ranged from $4,000 to $8,000 (1.33% to 3.67% of net sales) with no specific pattern being apparent. A financial manager who wanted to report the highest possible current period income would be justified in using the $4,000 amount for the current year's expense estimate even though $4,000 is the bottom of the historical range. That same manager might use $8,000 to be conservative in a year when the economy is weak.

The same manager might even be justified in using $3,000 if there was evidence that improved customer credit investigation and improved economy during the current fiscal year would be expected to lower future losses from uncollectible accounts. But what if that manager used an estimate of $1,000 simply because that figure would make it possible to achieve a desired net income target for the fiscal year? Or on the other end of the spectrum, management might choose the highly conservative estimate of $11,000 because the company for

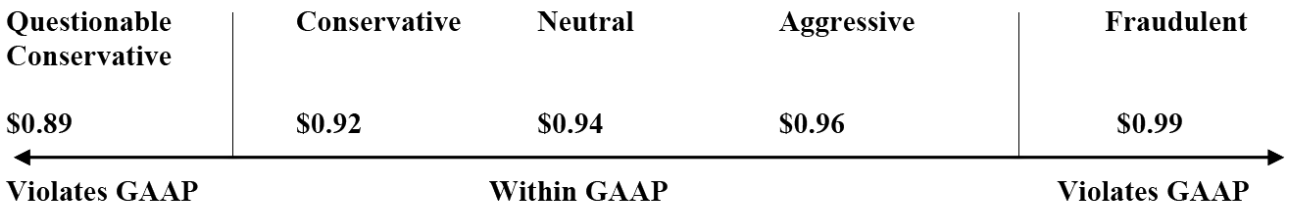
whatever reason (perhaps to avoid taxes or to appear unattractive to a take over) did not want to show higher income. Since the $1,000 or $11,000 have no reasonable support, using it would be crossing the ethical line to possible financial fraud even though GAAP does not draw a clear line of the ethical use of judgment or the unethical use.

As may be seen in Figure 3 as adapted from Dechow and Skinner (2000), the concept of a reporting earnings continuum may range from questionable conservative to conservative to neutral to aggressive to fraudulent. The question becomes as to where to draw the lines. Should they be wide latitude as in Figure 3a or more narrow as in Figure 3b? The answer does make a difference. In this one example of a rather modest difference in estimate from $1,000 to $11,000 (.33% to 3.67% of net sales), it makes a difference of $.10 per share ($.99–-$.89) or approximately 10% of earnings per share (EPS). Given that EPS is the most commonly quoted performance measure for companies and that when companies miss analysts' earnings estimates by $.01, 75 percent of the time it is by more than the estimate. Finally, consider that the estimate of uncollectible accounts is only one of dozens of estimates made by management in preparing the financial statements.

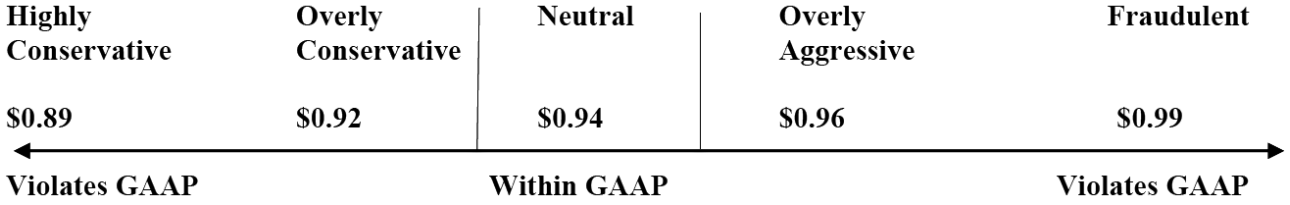
It is clear from Figure 3 that there is no 'bright line' in GAAP to tell managers what is and is not acceptable. It is also clear that while this illustration shows the magnified effect of just one judgment, we have seen earlier that management is presented with numerous structural and estimate decisions that can impact reported earnings. Management is simply expected to make choices that appropriately reflect a company's economic performance. What is appropriate for one company may not be appropriate for another.

Figure 3: Where Do You Draw the Line?

3a: The Earnings Management Continuum of Ethical Financial Reporting



3b: Overly Aggressive Earnings on the Continuum



4. The Difficulty of Identifying Earnings Management

A common criticism of earnings management is that it reduces transparency by obscuring the 'true' earnings of the company. However, leading academics argue that both the level and patterns of earnings convey information and that even when earnings management conceals information, it can still be beneficial to shareholders. Arya, Glover, and Sunder (2003) state: "That earnings management reduces transparency is a simplistic idea. A fundamental feature of decentralization organizations is the dispersal of information across people. Different people know different things and nobody knows everything. In such an environment, a managed earnings stream can convey more information than an unmanaged earnings stream."

Aggressive and deceptive accounting focuses on the quantity of earnings as opposed to the quality of earnings. Studies of the financial press has shown that the most common measure of a company's success is earnings per share and, further, the earnings per share is the most common measure of executive performance in executive compensation (Needles et al. 2008).

Bergstresser and Philippon (2006) have provided evidence that the use of discretionary accruals to manipulate reported earnings is more pronounced at firms where the CEO's potential total compensation is more closely tied to the value of stock and option holdings. In addition, during years of high accruals, CEOs exercise unusually large numbers of options, and CEOs and other insiders sell large quantities of shares. It, nevertheless, is true that firms subject to fraud investigations are severely penalized when SEC investigations for fraud result (Christensen et al., 2010).

Earnings management can be difficult to identify except in retrospect. Thus, in spite of a large body of research purporting to identify aspects of earnings management, the research may be criticized as insufficiently useful to standard setters (Healy and Wahlen, 1999). Because prior studies necessarily focus on those areas that have resulted in SEC enforcement actions or for which empirical tests, particularly of accruals, are most powerful, little is known about earnings management with respect to many accounts. Also, relatively little research has examined factors that limit earnings management. For example, because prior studies focus on post-audit financial statements, they cannot separate managers' *attempts* to manage earnings and auditors' decisions to *waive* adjustment of earnings-management attempts. Durtschi and Easton (2005) assert that researchers and teachers cannot rely on the shapes of earnings distributions from prior research as evidence of earnings management until alternative, much more likely, explanations for the shapes are ruled out. Durtschi and Easton state that in spite of the popularity of the notion that the shapes of the earnings distributions are evidence of earnings management, they cannot be relied upon because (1) supporting evidence that this is so is sparse, perhaps even nonexistent and (2) alternative explanations for the shapes of the distributions are often very evident. Durtschi and Easton's research shows that the discontinuity observed in prior studies may be due to deflation rather than the properties of earnings per se. To explore this possibility, they provided evidence of significant pricing differences between firms reporting positive earnings and firms reporting losses. The basic premise (and, often, the maintained hypothesis) in the growing literature that focuses on the discontinuity in the distribution of deflated earnings at zero is that the discontinuity is evidence of earnings management to avoid losses. Their evidence suggests that the differential pricing of small losses and small profits, which leads to a relatively larger deflator for profits than for losses, coupled with sample selection bias, may induce the discontinuity. Similarly, the discontinuity at zero in the frequency distribution of change in net income deflated by beginning-of-period market capitalization is not evident in the distribution of change in earnings per share. This is not surprising in view of the high correlation between earnings per share and change in earnings per share.

In subsequent research, Durtschi and Easton (2009) provided three sets of evidence that these discontinuities are likely caused by factors other than earnings management. They provided the following:

- A detailed analysis of the severe effects of sample selection in a recent study; this study erroneously concludes that the shape of an earnings distribution is evidence of earnings management
- A simple explanation for the shape of the earnings distribution that is most often cited as evidence of earnings management; the relation between earnings and prices differs with the magnitude and the sign of earnings
- Further examples that support the main point of their paper; evidence beyond the mere shape of a distribution must be brought to bear before researchers can draw conclusions regarding the presence/absence of earnings management

  Regulators tend to regard earnings management as harmful and in need of immediate remedial action. The SEC is always against any type of earnings manipulation. This will remain the case, as Dechow & Skinner (2000) speculate, even if financial statements and related disclosures included sufficient detail to allow investors to adjust for earnings management. The SEC's explanation to this is its mandate to ensure that stock exchange is fair to buyers. However, it is the SEC's job to work for the best interests of every lawful and rational market participant. Market participants include not only buyers but also sellers. Being within legitimate constraints, earnings management is beyond criticism; hence, it should not be identified as a target of regulators' enforcement actions. Achilles cannot blame others for taking advantage of his heel because people are opportunistic. For the same reason, it gives no cause for criticism if managers take advantage of the inadequacies of accounting standards and exploit their ability to manage reported earnings, and it is inappropriate to say that taking advantage of the inadequacies is to subvert the intent of the standards. It is the standard makers who should be held responsible. The quality of financial statements is an indirect indicator of the quality of accounting standards. If the inadequacies of standards cannot be eliminated, one must learn to live with earnings management. Zero earnings manipulation is impossible as long as compensation schemes, tax payments, debt contracts, stock offerings, labor negotiations, and regulatory monitoring are not independent of accounting data. It is also impossible when there are information asymmetries, accounting flexibility and management's reporting discretions. Instead, efforts should be made to improve antifraud programs. Useful mechanisms for this purpose include internal controls, audits' checks, regulatory bodies' monitoring, and financial analysts' scrutiny. In addition, accounting policymakers and standard-setters need to examine how the current standards can allow abusive manipulation of accounting numbers and to strive to reduce the subjectivity or ambiguity in accounting standards thereby enabling the standards to cope with business innovations. The less subjectivity and ambiguity that accounting standards have, the less potential of earnings manipulation. The ambiguity in accounting standards might lead to substantial disagreement as to what is within versus outside the bounds of acceptable reporting.

Moreover, standard setters need to keep pace with the accelerating changes in business practices so as to prevent accounting recognition from lagging economic events and to minimize the opportunities for creative accounting practices. Some companies, however, blatantly ignore GAAP in reporting earnings, requiring the SEC to step in. For example, in support of a $20 billion initial public offering, startup Groupon highlighted in its regulatory filings a concept of earnings not seen before in accounting literature: 'Adjusted Consolidated Segment Operating Income' (CSOI). Under this concept, the company stripped out marketing expenses, acquisition-related costs, stock compensation, interest expense, and tax payments (Cyran et al., 2011). Groupon said it generated $81.6 million in earnings in the first quarter of 2011, when if only marketing costs are deducted, the company had a loss of $98 million. After questions from the SEC about its unusual concept of earnings, Groupon said in an amended return to the SEC, that CSOI, "should not be considered as a measure of discretionary cash available to us to invest in the growth of our business or as a valuation metric" (Raice and Wingfield, 2011).

Promising ways of addressing the issues of identifying earnings management is to define the quality of earnings as the size of dividends in relation to earnings and cash flow from operations that underlies earnings. In the first case, Tong and Miao (2011) find that, 'dividend paying status is indicative of firms' earnings quality.' In the second case, Needles, Frigo, and Powers (2006) have shown that companies that are able to perform at a consistently high level are able to generate from one to three times cash flow to earnings. This measure, called the cash flow yield, is measured by dividing net income by cash flow from operations. A cash flow yield below 1.0, and especially a negative cash flow yield, is an indicator of low or very low quality earnings. This lowering of the quality of earnings occurs most often due to accruals that increase earnings but produce no cash flows, as illustrated by the Enron case.

In its 2001 annual report, Enron's management asserted: "We are laser focused on earnings per share" (Enron Corporation, 2002). In fact, Enron's cash flow yield went below 1.0 thirteen quarters before its bankruptcy in October 2001. The measure went negative almost two years before its bankruptcy. In its last quarter Enron (AccountingMalpractice) hid almost $25 billion in liabilities, as follows (in billions):

Reported debt per 3rd qtr 10Q	$13.0
Actual debt per 3rd qtr	38.0
Amount hidden	$25.0
Where hidden (in billions):	
Unconsolidated affiliates	$10.7
Commodity transfer w/ fin. inst.	4.8
Share trusts	3.4
Minority interest financings	1.7
FAS 140 transactions	2.1
Structured assets	1.5
Leases	.6
Equity forward contracts	.3
Amount hidden	$25.1*

**Difference due to rounding.*

5. Selected Earnings Management Case Examples

This section identifies and places on the earnings management continuum some of the major cases globally over the last decade.

5.1. The Microsoft Case

Following the anti-trust investigation by the U.S. attorney general, Microsoft failed to recognize revenue as earned. This is perhaps an example of unacceptable highly conservative earnings management showing that not all earnings management practices involve overstatements. The Securities and Exchange Commission (SEC) alleged that Microsoft's accounting practices from July 1994 through June 1998 caused its income to be substantially misstated. Microsoft failed to accurately report its financial results, causing overstatements of income in some quarters and understatements of income during other quarters. The SEC said that Microsoft enhanced its financial results by setting aside artificially large reserves to reduce revenues, with the idea of reversing that procedure to record the revenues in less profitable times. The reserves totaled between $200 million and $900 million during the period in question. The SEC criticized the use of such so-called 'cookie-jar' reserves, which can give investors an inaccurate picture of the company's current financial performance. Under a settlement with the Securities and Exchange Commission, Microsoft has agreed to refrain from accounting violations to settle federal regulators' allegations that it misrepresented its financial performance.

Under the settlement, Microsoft neither admitted nor denied wrongdoing and no fine was imposed (USA Today, 2002).

5.2. The Time Warner Case

Based on management's analysis of sales returns and allowances and uncollectible accounts, Time Warner established reserves of $2,253 billion and $2,229 billion at December 31, 2009 and 2008, respectively. These estimates represent about 30 percent of gross accounts receivable in both years. Management explains that this is an "area of judgment affecting reported revenues and net income" and is based on analysis of "vendor sell-off of product, historical return trends, current economic conditions, and changes in customer demand" (Times Warner Inc., 2010). This is perhaps an example of conservative to neutral earnings management.

5.3. The Southwest Airlines Case

Following the 9/11 crisis, Southwest Airlines changed the estimated lives of its airplanes from 22 years to 27 years under the reasoning that improved maintenance methods enabled the company to get more useful years out of the aircraft. This change in accounting estimate, which does not require a consistency disclosure in the auditor's report, had the effect of enabling Southwest to continue to show year-to-year earnings growth. The change of estimate and its effect were disclosed in a note to the financial statements. This is perhaps an example of acceptable neutral to aggressive (not overly aggressive) earnings management (Southwest Airlines Inc., 2003).

5.4. AT&T Inc. and Verizon Communications Cases

Some companies, including AT&T Inc. and Verizon Communications Inc., are changing their accounting for pension plans in 2010 by shifting to market-to-market accounting. In the market meltdown from the financial crisis in 2008–2009, these companies incurred very large losses: $23 billion for AT&T and $12 billion for Verizon. Rather than recognize these losses on their income statements in 2008–2009 the companies elected in accordance with current U.S. standards to amortize them over future years (Rapoport 2011). Now, in the 2010 financial statements, these companies are electing to change their accounting for pension funds to mark-to-market accounting in line with international standards and to restate prior years financial statements. The effect of this change is that the large losses in 2008–2009 will never be reflected in the current year's financial statements, and 2010 earnings will be much better than they would have been. The companies justify the change as making the financials more transparent for investors in current and future years by reflecting changes in the market value of pension assets and obligations. An AT&T spokesman says it improves accounting clarity so "everyone can understand where the gains and losses that get recognized in our income statement at the end of each year are tied to real economic events." And a Verizon spokesman says the new approach "actually is a preferable accounting method and one that aligns with the fair value accounting concepts and current [IASB] proposal" (Burr, 2011). This is perhaps an example of acceptable aggressive earnings management.

5.5. The Dell Case

The Securities and Exchange Commission accused Dell of misleading investors by using money the company received from the chip maker Intel to pad its quarterly earnings statements. Company executives, according to the SEC, relied on the payments from Intel to meet or surpass Wall Street's expectations. Intel paid Dell in the form of rebates as part of an agreement to ensure that Dell would not use computer chips made by Advanced Micro Devices (AMD) in its personal computers and computer servers, according to the civil charges. Those rebates are the subject of federal and state antitrust inquiries of Intel. When Dell eventually picked AMD as a second supplier, Intel cut the rebates and Dell's financial performance suffered, the complaint said. The SEC said in its charges that "investors were not aware of the extent of period to project financial results that the company wished it had achieved but could not," said Christopher Conte, associate director of the SEC's

enforcement division, in a statement announcing the settlement. “Dell was only able to meet Wall Street targets consistently during this period by breaking the rules.” Without the Intel payments, Dell would have missed the consensus estimate for earnings per share published by Wall Street analysts who followed the company in every quarter during its fiscal years from 2002 through 2006. The exclusivity payments constituted a steadily growing part of what Dell reported as its operating earnings, from 10 percent in fiscal 2003 to 38 percent in fiscal 2006, then jumping to 76 percent in the first quarter of fiscal 2007, the SEC said. In settlement, Dell, several former executives, and its founder, Michael S. Dell, agreed to pay more than $100 million in penalties to settle charges of disclosure accounting fraud filed by the Securities and Exchange Commission (Wyatt, 2010).

5.6. The Satyam Computer Services Case

Satyam Computer Services, which was once ranked among the top three IT firms in India, boasted in early 2008 that the company had mastered U.S. GAAP accounting. “We can say with confidence that we carry out U.S. GAAP accounting as perfectly as any other global corporation …We have to comply with Sarbanes–Oxley (SOX) requirements well ahead of time” (Reason, 2009). On the morning of Jan. 7, 2009, Ramalingam Raju, the chairman of troubled Indian IT outsourcing company Satyam Computer Services, sent a startling letter to his board and the Securities & Exchange Board of India. Raju acknowledged his culpability in hiding news that he had inflated the amount of cash on the balance sheet of India’s fourth-largest IT company by nearly $1 billion, incurred a liability of $253 million on funds arranged by him personally, and overstated Satyam’s September 2008 quarterly revenues by 76% and profits by 97%. After submitting his resignation, Raju ended his letter by apologizing for his inability to close what began as a “marginal gap between operating profits and the one reflected in the books of accounts” but which later grew unmanageable (Kripalani, 2009). Satyam was charged with fraud and was later bought by Mahindra & Mahindra Inc. Satyam has come to be known as the ‘Enron of India.’ This is a case that clearly qualifies as deceptive accounting: unethical and fraudulent.

Thus, earnings management occurs on a continuum, from savvy transaction timing, to aggressive accounting, to deceptive accounting. Savvy transaction timing is usually called ‘income smoothing,’ and its purpose is to make a smooth trend in earnings over time; investors like to see a continual upward growth in earnings. One method is called the ‘cookie-jar reserves.’ Management recognizes estimated expenses in a year when revenues are high, so fewer expenses are recognized in a quarter when earnings are lower. Another way to accomplish this goal is to defer revenues for ‘tougher times.’ Another technique used is called ‘the big bath.’ A company accelerates expenses and losses in a year with already poor results so that future income looks better and smoother (Silver, 2009).

6. Conclusion

In this paper, we discuss the earnings management continuum of ethical financial reporting, highlighting the difficulty of identifying cases of earnings management and provide the major cases globally over the last decade. It is clear from the extensive literature on earnings management and the experience of the past decade that reform is needed in defining the boundaries of acceptable accounting flexibility, and the balance between principles-based standards and rules-based standards needs to be better understood.

The need for better understanding of judgment is reinforced by the efforts of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to bring U.S. GAAP and International Financial Reporting Standards (IFRS) closer together through more principle-based standards. The lack of decisive guidelines for principles-based standards may create inconsistencies in the application of standards across companies and countries. Contrarily, rules-based standards can be seen as deficiently flexible

to accommodate a topic such as fair value, which often requires considerable judgments gained through experience, with limited market data.

References

AccountingMalpractice.com

Arya, A., Glover, J., & Sunder, S. (2003). Are unmanaged earnings always better for shareholders? *Accounting Horizons*, Supplement 2003, 111–112.

Barth, M. E. (2018). The future of financial reporting: Insights from research. *Abacus*, 54(1), 66-78.

Beasley, M. S., Carcello, J. V., Hermanson, D. R., & Neal, T. L. (2010). *Fraudulent financial reporting 1998–2007: An analysis of U.S. public companies*. Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Bergstresser, D. & Philippon, D. (2006). CEO Incentives and Earnings Management. *Journal of Financial Economics* 80, 511–529.

Burr, B. (2011). Mark-to-market accounting helps companies shift pension plan losses. *Pensions and Investments,* February 21, 2011.

Christensen, T., Paik, D., & Williams, C. (2010). Market efficiency and investor reactions to SEC fraud investigations. *Journal of Forensic & Investigative Accounting,* Special Issue, *2*(3).

Cyran, R., Currie, A., & Cox, R. (2011). Fuzzy accounting enriches Groupon. *NYTimes.com,* June 12. Available at: http://www.nytimes.com/2011/06/13/business/13views.html

Dechow, P. M. & Skinner, D. J. (2000). Earnings management: Reconciling the views of accounting academics, practitioners, and regulators. *Accounting Horizons, 14*(2), 239.\

Durtschi, C. & Easton, P. (2005). Earnings management? The shapes of the frequency distributions of earnings metrics are not evidence *ipso facto*. *Journal of Accounting Research*, *43*(4), 57–59.

Durtschi, C. & Easton, P.. (2009). Earnings management? Erroneous inferences based on earnings frequency distributions. *Journal of Accounting Research*, *47*(5), 1249–1281.

Enron Corporation. (2002). *2001 Annual Report*. Houston, TX.

Feng, M., Ge, W., Luo, S., & Shevlin, T. (2011). The role of CFOs in material accounting manipulations—the Executive Summary. *The Conference Board*, May 2011.

Healy, P. M. & Wahlen, J. M. (1999). A review of the earnings management literature and its implications for standard setting. *Accounting Horizons, 13*(4), 365–383.

International Accounting Standards Board (IASB) (2010), The Conceptual Framework for Financial Reporting 2010, London: IASB.

Jackson, S. B. & Pitman, M. K. (2001). Auditors and earnings management. *The CPA Journal,* July 2001. Available at: http://www.nysscpa.org/cpajournal/2001/0700/features/f073801.htm.

Kripalani, M. (2009). India's Madoff? Satyam scandal rocks outsourcing industry. [Electronic version]. *Business Week,*. January 2009. Available at: http://www.businessweek.com/globalbiz/content/jan2009/gb2009017_807784.htm.

McKee, T. E. (2005). *Earnings management: An executive perspective*. Mason, OH: Thomson/South-Western.

Needles Jr., B. E., Frigo, M., & Powers, M. (2006). Strategy and integrated financial ratio performance measures: Further evidence of the financial performance scorecard and high-performance companies. In *Studies in Financial and Managerial Accounting,* ed. Mark Epstein and J.-F. Manzoni, Vol. 16. London: JAI Elsevier Science Ltd.

Needles Jr., B. E., Powers, M., & Frigo, M. (2008). Performance measurement and executive compensation: Practices of high performance companies. In *Studies in Financial and Managerial Accounting,* ed. M. Epstein and J.-F. Manzoni, Vol. 18. London: JAI Elsevier Science Ltd.

Raice, S., & Wingfield, N. (2011). Groupon's accounting lingo gets scrutiny. *The WSJ.com,* July 25. Available at: http://online.wsj.com/article/SB10001424053111903635604576472531846174782.html

Rapoport, M. (2011). Rewriting pension history. *Wall Street Journal,* March 9.

Reason, T. (2009). Pro-Forma distraction at Satyam. *CFO Magazine,* January 20, 2009. Available at: http://www.cfo.com/article.cfm/1296444/c_13047759?f=insidecfoeurope.

Silver, B. (2009). Manipulating earnings: From legal techniques to outright fraud. *financialstatements.suite101.com,* September 2009.

Available at: http://financialstatements.suite101.com/article.cfm/spotting_earnings_management.

Southwest Airlines Inc. (2003). *2002 Annual Report*. Dallas, TX.

The Commission on Accounting Higher Education: Pathways to a Profession. Available at:www.PathwaysCommission.org

Time Warner Inc. (2010). *Time Warner Annual Report, 2009*. New York, NY.

Tong, Y. H. & Miao. B. (2011) Are dividends associated with the quality of earnings? *Accounting Horizons, 25*(1), 183.

Turner, J. & Vann, C. (2010). Audit committee independence and earnings management: How independent are independent directors? *Journal of Forensic & Investigative Accounting,* Special Issue, *2*(3).

USA Today. (2002). Microsoft settles accounting charges with SEC. *USA Today (*June 3).

Wyatt, E. (2010). Dell to pay $100 million settlement. *The New York Times*, July 22. Available at: http://www.nytimes.com/2010/07/23/business/23dell.html.

Yaping, N. (2006). A different perspective of earnings management. *Canadian Social Science*, *2*, No. 4, 53