Earnings Management: An Academic Primer

By Manuel A. Rodriguez

Our financial reporting system is under siege as never before. Corporations are under intense pressure from shareholders to meet or exceed earnings targets. Globalization continues to relentlessly compress profit margins. The response from many companies has been dramatic: radically reduce expenses by slashing services, wages and benefits, raise prices whenever possible, and employ accounting gimmicks and sleight-of-hand to manipulate earnings whenever these measures fall short.

These gimmicks, some quite elaborate, have resulted in a string of accounting failures and corporate scandals. Accounting failures have become rampant and more pervasive, undermining the credibility of the accounting profession and the inherent reliability of the financial reporting model as an evaluative tool in shaping investor confidence and awareness.

The financial statements, which include both quantitative and qualitative information, purport to transmit the financial data of an entity or group of entities into a prescribed format that stakeholders of that entity can use as a means of evaluating the financial health and viability of that entity. Financial statements must be able to accurately and faithfully convey the economic substance of a transaction, over a period of time, and as of a given date.

Financial information presented in these statements must be capable of accurate comparison to financial statements of other entities. These other entities may or may not be within the same industry as the target company, and the financial statements must convey the economic substance of the transaction rather than merely the economic form of it.

This substance-over-form doctrine has been widely accepted as the prevailing standard in evaluating the nature of a transaction. Transparency and comparability have been the goalposts toward which the accounting profession and the SEC have driven. Comparability between financial statements ensures that creditors and investors will make meaningful investing decisions based on financial statements that faithfully convey the underlying economic position of the entity. Lack of comparability ensures that the financial statements and any assessments derived from them are meaningless and will convey fiction rather than truth.

Creative accounting and earnings management occur when organizations are tempted to manipulate earnings through the creative application of accounting principles, or through flagrant abuse in the application of those principles. Earnings management is a by-product of the perceived need to inflate earnings to meet or exceed Wall Street expectations, which are created as a result of consensus opinions by the hundreds of analysts on Wall Street.

Failure to achieve or reach these expectations can create powerful downward pulls on company stock valuations and affect both shareholder value and employee compensation through the devaluation or worthlessness of stock option incentives. Powerful incentives to reach elusive earnings expectations can create serious conflicts of interest among corporate executives eager to meet these expectations.

Several academic theories have developed to both explain and regulate creative accounting and earnings management. Former SEC Chairman Arthur Levitt Jr. championed the most pervasive and widely accepted of these theories in 1998 in his speech to the New York State Society of Certified Public Accountants. In essence, this speech served as the bellwether for the SEC's efforts to enforce and prosecute those individuals and organizations it felt were engaging in widespread and pervasive earnings management.

In it, Levitt characterized the process of earnings management as a game among market participants and one that would have serious repercussions and adverse consequences for America's financial reporting system. The method of achieving earnings management involves the use of accounting techniques created primarily to allow and encourage companies to be flexible in the recording of their transactions in order to facilitate the goal of Generally Accepted Accounting Principles, that of ensuring substance over form in the recognition of an accounting transaction whenever possible.

Earnings management occurs when this flexibility is exploited in an effort to conceal financial volatility. To this end, Levitt identified a series of methods and techniques that are commonly used to manipulate earnings. These methods include the manipulation of reserve accounts (i.e., “big bath” restructuring charges and “cookie jar” reserves), manipulation of materiality within the audit process, improper revenue recognition, and creative acquisition accounting.

The SEC's response to the methods of manipulating earnings has been to encourage stricter compliance with existing accounting rules, greater enforcement, policing efforts by the SEC, and widespread cultural change of the corporate ethos, which encourages such behavior. Levitt outlined a proposal whose common theme was hyper-technical reliance and adherence to the established standards and a call for greater specificity within those standards.

Levitt's clarion call for a change in corporate culture failed to acknowledge the powerful countervailing forces poised to undermine the credibility and transparency of the financial reporting model. Corporate, shareholder, and auditor interests remain conflicted with the ideals of financial credibility and integrity. The unceasing demands of Wall Street ultimately dictate the financial reporting climate adopted by the subject companies.

The pressure to accommodate is relentless and causes the subtle yet perverse degradation of accounting standards that ultimately leads to outright fraud. An alternative theory of corporate governance holds that Levitt's proposed solutions simply compounded the problems, rather than correcting them. These theorists argue that increasing compliance with the growing volume of rules and statutes has ironically rendered financial statements incomprehensible to the very consumers they purport to protect – the investing public.

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