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Case #2 - Group Case Analysis

Excel link: [Case 2 - Mesa Verde.xlsx](https://1drv.ms/x/s!AvqGL7zAjJF9gP9KXOgySlCDXwRp_Q?e=pJx1Ry)

1. What are two reasons managers engage in earnings management?

Earnings explained in a simple manner is the net income(bottom line), or profitability of a company. Earnings management is the use of accounting techniques by companies to deliberately and intentionally manipulate their financial reports in usually a positive manner. This makes it a vital reason for a company’s management to engage in earnings management in order to exploit benefits for their company. There are numerous reasons why managers engage in earnings management, but we will discuss only two reasons why managers do it.

One reason why managers engage in earnings management is the desire to influence the stock price of their firm. In most cases, the price of a stock reflects a company’s financial well-being. The price of a stock heavily relies on historical and future earnings. Typically, consistent growth or a steady earnings allow investors to invest and further increase the company’s spending power and even expand their operations. Generally, if a company’s net profit plummets, the stock price of that company will result in a decrease. This sets the stage for managers to use earnings management to the best of their ability to convey their firm in a positive manner. For instance, managers have an earnings benchmark to hit, and if the managers achieve their goals they are usually compensated for with bonuses. Illia Dischev mentions this in his article “The Misrepresentation of Earnings”(8). The rewards are too great not to use legal accounting practices that offer extreme pleasant benefits.

The second reason why managers engage in earnings management is the fear of, “adverse career consequences if they report poor performance”(Dischev, 8). Reports of poor performance usually means that the senior managers made poor decisions that caused the poor performance in most cases, or at least shareholders would think that. Some managers believe reporting poor financial performances will critically affect their career by exposing them to the public in a negative light. Managers will be afraid of being fired, or even being elected for a similar position in their near future. So, managers tend to stress on this point, by using earnings management strategies to capitalize on any benefits and stay in a positive light for the public.

2. In your group’s opinion, is earnings management a negative thing? Why or why not?

Provide your group’s opinion on earnings management. And WHY you feel that way.

While earnings management may initially seem like a negative practice that encourages weaseling around financial reporting standards, the practice is much more of a gray area. Forms of it are legally allowed as long as all losses and gains are realized and the information presented is accurate, with variance allowed in the timing of recognizing such transactions. However, regardless of whether any one firm chooses to participate in earnings management, various studies have shown a multitude of firms in every industry engage in this tactic. This means that if the majority of these firms are using the flexibility in reporting earnings allowed under GAAP and not illegally misrepresenting reported financial information, a firm that does not engage in earnings management will be at a disadvantage. Thus every manager faces internal and external pressure to make their firm’s financial statements appear as solid as is legally possible.

It is also difficult to discern what qualifies as a distinct accounting choice to change represented earnings, rather than simply a choice for the good of the firm that most complies with GAAP. For this reason our group believes that earnings management is not a negative practice. Earnings management is allowed partially because not allowing it would be almost impossible to regulate when the amount of accounting decisions in all different industries that can be made is factored in. This statement is even more applicable if both definitions of earnings management are weighed in, as earnings management can apply to the accounting selection of timing specific transactions or it can apply to the economic decision making to represent operating assets in a specific light that will affect future cash flows.

Finally, the idea of managing earnings being akin to “a smooth car ride” (Mckee) is an idea our group agrees with from the reading. When firms take time to present their earnings in the brightest legal light possible, it allows for earnings to look smoother from year to year for investors to make the most educated decision possible. It could even be argued that a lack of this annual consistency in a firm’s reported earnings may signal to investors that even with U.S. GAAP flexibility in reporting earnings, this firm is still struggling to appear afloat.

3. Choose two stakeholders and think of it from their perspective. Is earnings management a negative thing to them?

One stakeholder that is impacted by earnings management is investors. From the perspective of an investor, earnings management can be both a positive and a negative thing. If an investor owns stock of a company that participates in earnings management, it may benefit the investor if the companies’ earnings management results in an increase in the stock price. However, if an investor wants to buy more shares of the company, or their first stock of the company, earnings management could be seen as a negative thing, because the investor may feel that the price they want to buy it at is inflated due to earnings management. This would result in the stock, in the opinion of the investor, to not be worth the current price in terms of how well the company is performing. All in all, we think that earnings management can be seen as both positive and negative from the perspective of an investor, depending on how they are affected by a company’s earnings management.

Another stakeholder that is affected by earnings management is a company’s competitors. From a competitor’s perspective, earnings management can be seen as negative because it gives them a less accurate understanding of their competitor’s performance, and having this information is key for any company looking to stay toe-to-toe with their competitors. Companies also understand that earnings management is a common thing to do, so they are able to use earnings management to their advantage in order to increase their stock price, which could make competitors think that earnings management is also a positive thing. So we believe that for a competitor, their belief on whether earnings management is a positive or negative thing depends on their situation.

References

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