OVERVIEW OF EARNINGS MANAGEMENT

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What is Earnings Management?

- **Definition**
  - ***Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers***
    - **Paul Healy and James Wahlen (1999)**
- **Means, Motive, and Opportunity**
  - **Motive**
    - **Why do managers feel the need to manipulate earnings?**
  - **Means**
    - **What changes do managers make to manipulate earnings?**
  - **Opportunity**
    - **When are managers able to get away with earnings management?**

Earnings Management Example

- Reported Earnings = Unmanaged Earnings + Managed Earnings
- Unmanaged earnings are expected to be $10,000
  - This number includes Bad Debt Expense of $1,000
  - Bad Debt Expense is based on a good faith estimate that 1% of credit sales ($100,000) will not be collected given the customer base and the economy
- The manager wants Reported Earnings to be $10,500
  - We will discuss reasons why on the next slide
- The manager creates Managed Earnings of $500
  - Manager intentionally changes bad debt estimate to 0.5% so that Bad Debt Expense is only $500
  - Lower expense means positive Managed Earnings of $500
- Now, Reported Earnings will be $10,500
  - $10,500 Reported = $10,000 Unmanaged + $500 Managed

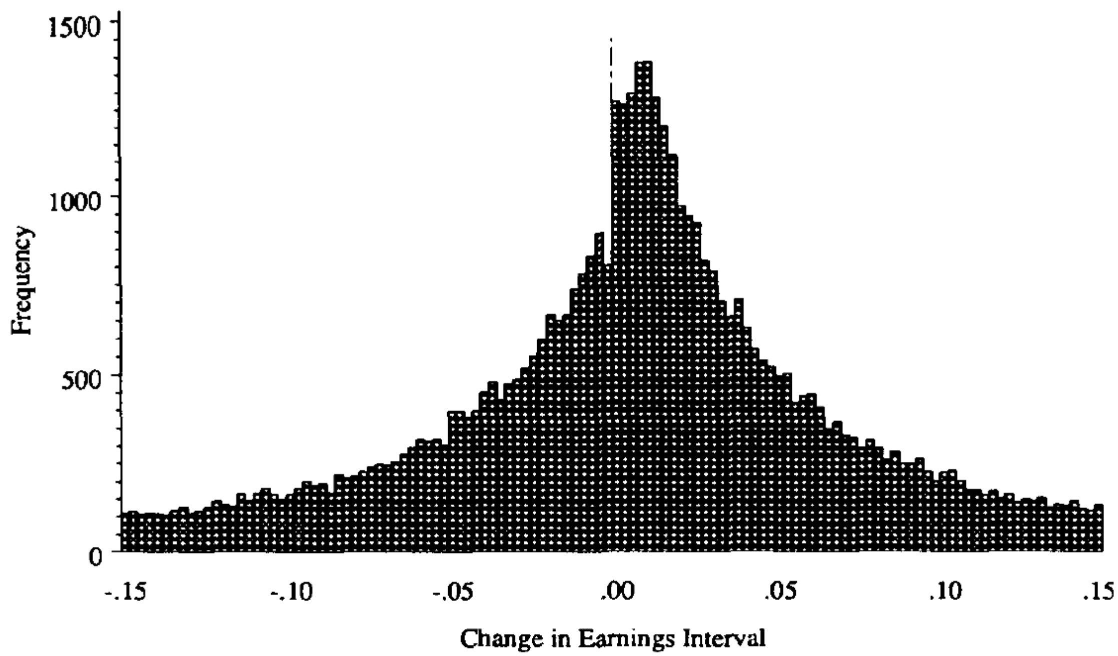
- Note: This ignores tax expense to make the math easier

Motive for Earnings Management

- For managers to have a motive for earnings management, the following two conditions must hold:
  - Unmanaged Earnings are expected to be different than some target
    - Unmanaged earnings could be “too low” or “too high”
    - Target could based on stakeholder expectations or a contractual requirement
  - Managers would get some benefit from using Managed Earnings to make Reported Earnings “look better” than Unmanaged Earnings
    - Some stakeholder would react less positively (or more negatively) to Unmanaged Earnings than to Reported Earnings that have been “managed”
- Common earnings targets
  - Earnings for same quarter last year
  - Security analysts’ forecasts of earnings
  - Contractual target (loan covenant, bonus compensation)

Meeting Last Year’s Earnings Target

- **There’s a discontinuity around zero change in earnings**
  - **More small positive, fewer small negative, than expected**
    - **David Burghstahler and Ilia Dichev (1997)**



What are Sources of Earnings Management Motives?

- **Capital markets (stock prices and valuation)**
  - Investors, analysts
    - Earnings affect stock prices directly through Price-Earnings-multiple valuations and indirectly through the use of earnings to forecast future cash flows
- **Product and labor markets**
  - Customers, Competitors, Suppliers, Employees
    - Stakeholders use earnings as key measure of firm performance and financial health
- **Contracts**
  - Lenders, Board of Directors (Executive Compensation)
    - Contracts often explicitly use earnings to determine rewards (bonuses) or penalties (covenant violations)
- **Regulators**
  - Industry Regulators, Justice Department, Congress
    - Regulators use earnings to detect monopoly activity and to trigger bail-out actions

Means: How Can Managers Manipulate Earnings?

- **Accrual-based earnings management**
  - **Aggressive revenue or expense recognition policies**
  - **Changes in accounting choices or estimates (e.g., bad debt expense, capitalize vs. expense costs)**
- **Real earnings management**
  - **Changes in operational decisions (e.g., delay R&D expense, overproduce inventory)**

Opportunity: When Can Managers Pull It Off?

- **For managers to have the opportunity for earnings management, the following two conditions must hold:**
  - **The expected benefits of earnings management are greater than the expected costs of earnings management**
    - **What are potential litigation and reputation costs of getting caught?**
    - **Is "borrowing" earnings from the future costly?**
  - **Stakeholders are not able to "see through" the earnings management and back out Unmanaged Earnings**
    - **If you and I can spot earnings management, why can't the stakeholders spot it?**
    - **Manager could obfuscate in disclosures, investors have limited attention and fixate on reported numbers, stakeholders don't want to jeopardize relationship with managers by questioning behavior**

Conclusions

- **All earnings manipulation is context-specific**
  - **There will be no “universal” tool that will allow you spot manipulated financial statements**
- **Detecting manipulation of financial statements requires a consideration of**
  - **Motive: What are managers incentives this period to manipulate?**
  - **Means: What items on the financial statements look unusual and, thus, may have been used to manipulate?**
  - **Opportunity: What are the factors that would allow managers to get away with earnings management?**

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