Module 3

The Language and Tools of Financial Analysis

Accounting Scandals 2: Earnings Management (Smoke and mirrors)

Presenter: Paul Kofman

The Problem with Management – Agency

Corporation owners rely on executive management – assisted by a Board of Directors – furthering their interests

Principal ↔ Agent

- Annual (quarterly) reporting
- Annual General Meeting
- Indirect control (appointment, remuneration, major events)
- Direct 'control' (sell shares)

What is management's incentive?

The Problem with Management – Agency

Management's compensation package creates incentives – often linked to the firm's share price

- Meet/exceed compensation targets
- Receive bonus
- Ensure tenure
- Receive perks
- Hubris (pride)
- Track record

An alignment problem?

Earnings Management – Good or bad?

A firm with poor forecast earnings will normally have a lower share price.

Earnings management is the deliberate manipulation of (forecast) earnings to create a desired profit trajectory over time

Usually this profit path satisfies smoothing of earnings over time, by adding and removing cash to the income statement

So?

Earnings Management – Good or bad?

The U.S. securities regulator (SEC) considers earnings management *a material and intentional misrepresentation of results*

When the SEC considers the manipulation excessive, it has the ability to issue fines.

Not much that individual shareholders can do.

What happens in practice?

Significant academic evidence in 1990s that management engages in earnings management

- by manipulation of accruals with no direct cash flow consequences (e.g., under provisioning for bad debt expenses, or delaying asset write-offs)
- by manipulation of real activities to meet certain earnings targets which does affect cash flows and possibly accruals

What happens in practice?

Operational intervention

- price discounts
- acceleration of sales
- building up excess inventory to reduce reported COGS (overproduction)
- alterations in shipment schedules
- **delaying research and development (R&D) expenditures** – most common
- delaying maintenance expenditures
- etc.

It depends on the purpose!

What happens in practice?

Many accounting scandals have elements of earnings management (in addition to plain fraud often hiding debt)

Enron 2001
WorldCom 2002
Tyco 2002
Kmart 2002
Merck & Co. 2002
Parmalat 2003
Health South 2003
Freddie Mac 2003
AIG 2005

Summing up with Sarbanes-Oxley (SOX)

Public Company Accounting Reform and Investor Protection Act (2002) set new standards for all US public company boards, management and public accounting firms

- auditor independence
- corporate executive responsibility
- disclosure of conflict of interest
- enhanced financial disclosure (e.g. off balance sheet items)

New threats….

- Crowding out by non-audit, consulting services
- Competitive pressure on auditing fees
- Focus on more cost efficient means of auditing

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