Financial Accounting
MGCR 211
Last Session

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Housekeeping

- Solutions to In-Class Quiz 8 will be updated on MyCourses
- Final Exam Review Sessions
  - Please check MyCourses
- Office Hours (for this final week…)
  - Tues: 12 PM ~ 4 PM, 5:30 PM onwards
  - Thu: 1 ~ 9 PM
  - Wed: (will be in Bronf.) by appointment
  - Fri: 5:30 PM ~ 10 PM
- Final exam on Monday, Dec. 9th, 9 AM to 12 PM
  - Building: GYM, Room: Fieldhouse, Row: 12 ~ 19
  - Bring your calculators and dictionary (if needed)
  - Write your section (or correct day / time of the class)

What's left?

- Do the course evals (if you care about your GPA….)! (https://www.mcgill.ca/mercury/)
- Prep. for final exam…
- Final Exam ☺
- Grading ☹
- Final Grade?
- GOOD LUCK!!!

Objectives for today – Earnings Management

- Earnings management
  - motivations and evidence
  - pros and cons
  - some examples
  - regulators and accountants
  - other terms
- In-Class Quiz 8…
- Last remark on final exam, final grades, and Q&A

What is Earnings Management?

- EM occurs when managers use judgement and alter financial reports either to mislead some stakeholders or to influence contractual outcomes that depend on reported accounting numbers

- EM is the choice by a manager on accounting policies (accruals) or real actions that affect earnings so as to achieve some specific reported earnings objective
  - Real actions: cutting or increasing R&D and advertising, abnormal manufacturing for stock
  - Accrual-based earnings management: managing the AFDA or changing depreciation policy

What is Earnings Management?

- Shifting of Revenues and/or Expenses from one period to the next or vice versa

Revenues

    &   Current Period / Next Period

Expenses

- If accruals increase earnings this period, their reversal lowers earnings in future period

- Two types of accruals

  - Non-discretionary (e.g. normal accruals): management has little discretion to control amounts

  - Discretionary (e.g. abnormal accruals): management has discretion to control amounts

Reference) Abnormal Accruals

Not in the exam…

Extreme accruals are low quality because it is less persistent.

$$Accruals \equiv f(X_t)$$

X = normal accruals reflect fundamental performance
f = abnormal accruals are induced by accounting rules or earnings management

$$Acc_t = \alpha + \beta_1 \Delta Rev_t + \beta_2 PPE_t + \varepsilon_t$$

$$Acc_t = \alpha + \beta_1 (\Delta Rev_t - \underline{\Delta Rec_t}) + \beta_2 PPE_t + \varepsilon_t$$

exclude possible manipulation

$$DisAcc_t - \underline{Matched\ firm's\ DisAcc_t}$$

match with same industry, closest ROA

$$\Delta WC = \alpha + \beta_1 CFO_{t-1} + \beta_2 CFO_t + \beta_3 CFO_{t+1} + \varepsilon_t$$

Abnormal accruals are less persistent?

1. **Positive but lower than non-discretionary accruals**
   Xie 2001, Dechow and Dichev 2002, Doyle et al. 2007a, Richardson et al. 2005
2. **Investors recognize but not fully incorporate into price**
   Defond and Park 2001, Xie 2001
3. **Mixed evidence from determinants and consequences**
   Bowen et al. 2008, Xie 2001

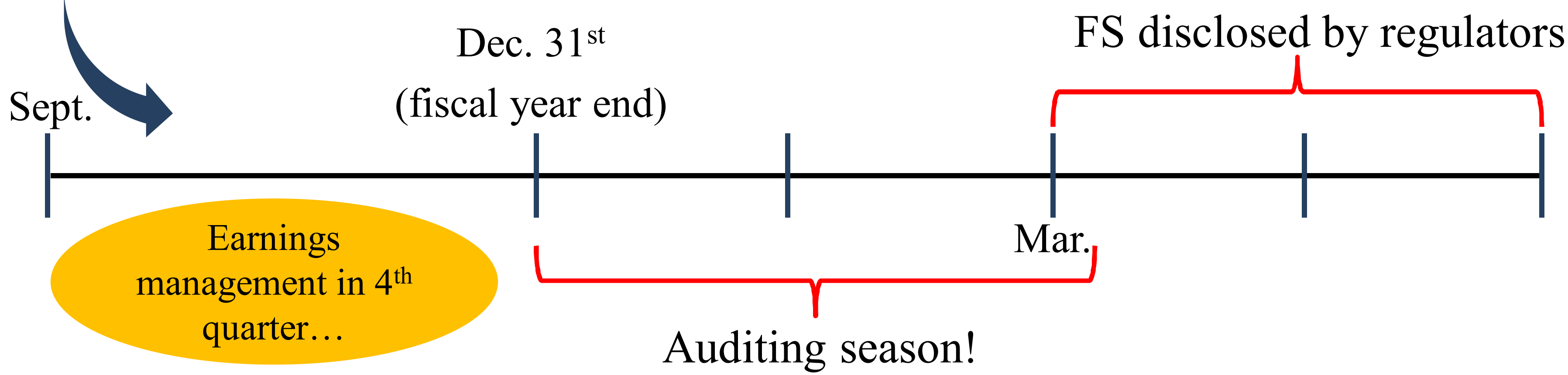
$$TCA_t = \alpha + \beta_1 CFO_{t-1} + \beta_2 CFO_t + \beta_3 CFO_{t+1} + \beta_4 \Delta Rev_t + \beta_5 PPE_t + \varepsilon_t$$

Quality of accrual system to capture fundamental performance (both short-term and long-term)

$$\sigma(\varepsilon_j)_t = \lambda_{0,j} + \underbrace{\lambda_{1,j} Size_{j,t} + \lambda_{2,j}\sigma(CFO)_{j,t} + \lambda_{3,j}\sigma(Sales)_{j,t} + \lambda_{4,j} OperCycle_{j,t} + \lambda_{5,j} NegEarn_{j,t}}_{\text{Firm characteristics that determine normal level of accruals}} + v_{j,t}$$

Patterns of Earnings Management (1)

- Last minute (chance) EM - 4th quarter!
  - Mandatory disclosure: all the accounting classes
  - Analyst forecasts and reports
  - Voluntary disclosure (by management)



Patterns of Earnings Management (2)

- Big Bath

- Income minimization
- Income maximization
- Income smoothing

Evidence of Earnings Management – Contract based Motivation

- To maximize cash bonus
  - Upward earnings management when net income between bogey and cap
- To avoid violation of debt covenants
  - Evidence of earnings management to maintain debt covenant ratios well above contracted values (covenant slack)
- To avoid political costs
  - Firms use income-reducing discretionary accruals to bolster their case for tariff protection, lower taxes, qualify for grants, subsidies and bail-outs

Evidence of Earnings Management – Expectation based Motivation

- To meet investors' earnings expectations

  - Strong negative share price reaction if expectations not met

  - Damage to manager reputation if expectations not met

    (i.e. Management of bad debt allowances)

- To increase proceeds of new share issues (IPO)

  - Use of income-increasing discretionary accruals in years leading to planned IPO.

  - Usually followed by declining ROA for 3 years following IPO, driven in part by accrual reversal

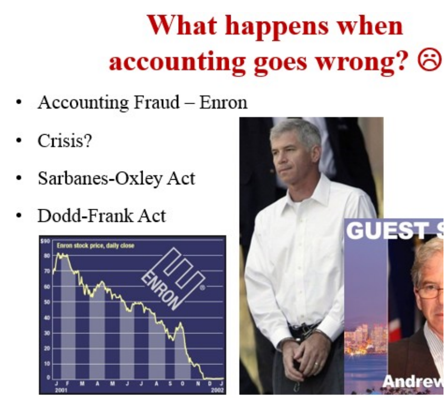
Good Side of Earnings Management

- To credibly communicate inside information to investors
  - Discretionary accrual management as a way to credibly reveal management's inside information about earnings expectations
- Bonus contracts based on net income
  - May also adversely affect manager effort
- Debt covenant contracts
  - Contract violation is costly, earnings management may be low-cost way to work around

Bad Side of Earnings Management

- Recent examples of bad earnings management
  - Groupon Inc.
    - Extreme income maximization
      - Capitalize marketing costs
      - Emphasize pro-forma income
  - Olympus Corp.
    - Elaborate scheme to avoid huge write-down of investments, by transferring loss to purchased goodwill

- Countries with poor investor protection experience more earnings management



Response from Regulators

- Standard setters response to bad earnings management
  - Ex. IAS 37 (IFRS)
    - Before recording a provision, payments must be probable and capable of reliable estimation
    - Provision must be valued at fair value
    - No excess provision as a result of uncertainty
    - Provisions must be used only to absorb costs for which provision originally set up
    - No provision until liability incurred

Role of Accountants

- Can accountants help reduce bad earnings management?
  - Yes, if full disclosure of
    - Revenue recognition policies
    - Unusual, non-recurring and extraordinary events
    - Effect of previous write-offs on current core earnings
- Earnings management can be good if used responsibly
- Full disclosure helps to control bad earnings management and enables investors to better evaluate earnings persistence