Feature Article

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The Challenge of Earnings Management: A Valuator's Perspective

Every business day is filled with moral decisions—matters of right and wrong. People in business are frequently torn between reducing cost, maximizing profits, self-interest, and social responsibility. As valuation practitioners, most of us are far removed from the likes of Enron, Tyco, WorldCom, Global Crossing, Lucent, Xerox, and so forth. We are not, however, removed from questionable accounting practices and inappropriate management behavior. As valuation practitioners, we rely heavily on representations made by both management and outside accounting firms. "Enrongate[1]" has put us on notice to look beyond the numbers in search for economic reality. This article introduces the concept of economic reality and discusses the meaning and challenge of earnings management.

Economic Reality

Accordingly to Dr. Paul Krugman,[2] an economist at MIT, "perception creates economic reality." To valuation practitioners, economic reality is the true essence of a company's financial condition and its earnings power. The Internal Revenue Service, a major contributor of valuation theory, employs various common law doctrines[3] (substance over form, economic substance, sham transaction, business purpose, and step transaction) to reveal the true essence of a transaction—economic reality. According to Jay Soled, writing in the Boston College Law Review,[4] the courts "prefer giving greater weight to the substance of a transaction over its form (in the search for economic reality) because the latter may be easily manipulated (managed) or used in self-serving fashions."

The very nature of our accounting environment makes the search for economic reality a daunting task. As valuators, our search starts with an understanding of generally accepted accounting principles (GAAP) and the application of GAAP by the company being valued. GAAP proposes the use of accrual accounting. The objective of accrual accounting is presented by the FASB in Statement of Financial Accounting Concept No. 6 (FASB, 1985):

> Accrual accounting uses accrual, deferral, and allocation procedures whose goal is to relate revenues, expenses, gains, and losses to periods to reflect an entity's performance during a period instead of merely listing its cash receipts and outlays. Thus, recognition of revenues, expenses, gains, and losses and the related increments or decrements in assets and liabilities—including the matching of costs and revenues, allocation, and amortization—is the essence of using accrual accounting to measure performance of entities.

In summary, the objective of accrual accounting is to help us measure the economic performance of a business over a period of time. By design, GAAP provides for flexibility in accounting, allowing management to make judgments and estimates. The problem is that management's use of judgment also creates opportunities for "earnings management," in which managers choose reporting methods and estimates that do not accurately reflect economic reality.[5]

What is Earnings Management?

Representative definitions of earnings management from the academic literature include the following:

> "…a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say, merely facilitating the neutral operation of the process)." Schipper (1989)[6]

> "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers." Healy and Wahlen (1999).[5]

In practice, earnings management includes a wide variety of legitimate and illegitimate actions by management that affects earnings. Legitimate earnings management includes reasonable and proper practices that are part of operating a well-managed business and delivering value to shareholders, while illegitimate earnings management is intervening to hide real operating performance by creating artificial accounting entries or stretching estimates beyond a point of reasonableness.[7]

Professors Dechow and Skinner[8] distinguish between earnings management decisions that are fraudulent and those that comprise aggressive, but acceptable, ways in which managers can exercise their accounting discretion. Table 1 is an adaptation of their presentation.

The Securities and Exchange Commission, oddly enough, does not explicitly define earnings management. In September 1998, SEC Chairman Arthur Levitt spoke at NYU Center for Law and Business where he addressed his concerns about earnings management, describing it as "accounting hocus-pocus." Chairman Levitt expressed his fear "that we are witnessing an erosion in the quality of earnings, and, therefore, the quality of financial reporting. Managing may be giving way to manipulation; integrity may be losing out to illusion." In November 1998, Chairman Levitt spoke to the Financial Executives Institute where he addressed his concerns about earnings management, describing it as "perverted accounting practices where managers cut corners and where earnings reports reflect the desires of management rather than the underlying financial performance of the company." In August 2002, Robert Bayless (currently with the SEC's Division of Enforcement) spoke at the American Accounting Association's 2002 Annual Meeting where he stated that the SEC's focus was on management's intent to deceive—including "within-GAAP choices that are used to obscure true economic performance."

Is Earnings Management Pervasive?

In a nutshell—yes! Numerous studies have documented the prevalence and motivations for earnings management by publicly traded companies. Professors Healy and Wahel present a comprehensive review of the relevant literature. These studies are supported by a survey of Fortune 500 CFOs conducted by *CFO Magazine* in October of 1998, which concluded that 78 percent of CFOs had been asked to use accounting rules to manage earnings.[9]

Does this mean that only publicly traded companies manage earnings? No! Any seasoned valuator (or practicing CPA) can attest that *all closely held businesses manage earnings* in some form or fashion—employing many of the same strategies and techniques commonly used by publicly traded companies (discussed below). Importantly, closely held companies are not subject to the same rigor or scope of examination as publicly traded companies—no SEC filings and enforcement, no public reporting, little or no board oversight, no financial news scrutiny, no stock analysts, and so forth—and therein no creditability checks or watchdogs.

Table 1. Earnings Management Decision Grid

CLASSIFICATION	ACCOUNTING CHOICES WITHIN GAAP
Conservative	Overly aggressive recognition of provisions or reserves Overvaluation of acquired in-process R&D in purchase acquisitions Overstatement of restructuring charges and asset write-offs
Neutral	Earnings that result from a neutral operation of the process
Aggressive	Understatement of the provisions for bad debts Drawing down provisions or reserves in an overly aggressive manner
	ACCOUNTING CHOICES THAT VIOLATE GAAP
Fraudulent	Recording sales before they are realized Recording fictitious sales Backdating sales invoices Overstating inventory by recording fictitious inventory

Source: Adapted from Dechow and Skinner

Earnings Management Techniques—Publicly Traded Companies

Recent accounting scandals have identified four commonly employed earnings management techniques (strategies or schemes) used by publicly traded companies: (1) off balance sheet accounting, (2) accelerating revenue, (3) delaying expenses, and (4) accelerating expenses.

Off balance sheet accounting refers to methods employed by a company to remove assets and liabilities from its balance sheet. There are generally four ways to remove (or impair) assets and liabilities from a company's balance sheet: (1) special purpose entities (SPE), (2) asset impairment, (3) spinoffs, and (4) synthetic leases. Enron, for example, employed the use of SPEs to hide debt totaling over $1 billion. Adelphia Communication's off balance sheet accounting involved the use of company assets to secure $3.1 billion in payments to the Rigas family (its founders). WorldCom employed a similar scheme when making $400 million in off balance sheet loans to its founder, Bernard Ebbers. A spin-off is simply another way to establish a SPE—a subsidiary into a separate publicity traded entity. A synthetic lease is employed to improve a company's financial performance ratios by keeping assets and liabilities off the books.

Accelerating revenue is simply the process of recording revenue in one period while delaying recognition of related costs (delaying expenses) for later periods. AOL, for example, inflated its sales by booking barter deals and ads it sold on behalf of others and "round-trip" deals with advertisers and suppliers. Bristol-Myers inflated its 2001 revenue by $1.5 billion by "channel stuffing" or forcing wholesalers to accept more than they could sell (subject to return) just to get it off their books. Global Crossing and Qwest engaged in network capacity "swaps" with other carriers to inflate their revenue. A final example is Merck, which recorded $12.4 billion in consumer-to-pharmacy co-payments that they never expected to collect.

Delaying expenses serves to boost current earnings. The recent WorldCom scandal demonstrates how desperate (or creative) companies are. WorldCom, the second largest long-distance phone company in the U.S., overstated its cash flow from operations by booking $3.8 billion in operating expenses as capital expenses. Another delaying expense strategy, employed by both Qwest and WorldCom, is the improper treatment (timing) of long-term contracts.

Accelerating expense strategies, commonly referred to as the "big bath," generally sacrifice current earnings to improve or boost future earnings. For example, a company might "front-load" expenses in a current period to reduce expenses in a latter period. The most recent example of this is AOL Time Warner's announcement that it will take a $60 billion write-down of impaired assets. Other accelerating expense areas include nonrecurring items, goodwill impairment, in-process R&D charge-offs, and other income.

Earnings Management Techniques—Closely Held Companies

Although the order of magnitude may be less, closely held companies commonly employ many of the same strategies used by publicly traded companies. The challenge of earnings management and closely held companies is frequently compounded (or muddied) by other fundamental problems, including, but not limited to, a consistent method of accounting and a comprehensive set of books and records. The challenge of earnings management may again be compounded by the purpose of the valuation. For example, if the purpose is adversarial or litigation-related (divorce, shareholder action, business damages, etc.), the respondent might present skewed data, incomplete data, or a pessimistic view of the business, its prospects, and risks.

Normalizing for Earnings Management

A fundamental step in the valuation process is the collection and analysis of a company's historical financial statements. Historical data analysis helps the valuator develop a business profile—positive and negative trends, strengths and weaknesses, investment attributes, quality of management, risks, and other factors that might impact the company's future performance or identify asset impairment. Simply stated, historical financial information serves as a foundation from which valuators develop their opinions. To enhance the quality, comparability, and predictive value of the financial reporting being examined, valuators must normalize the data to more closely reflect economic reality. We normalize (or adjust) the balance sheet to reflect a company's true economic condition—market value—of both booked and unbooked assets and liabilities—tangible, intangible, and contingent. We normalize a company's income statement to reflect its true economic performance or earnings power. The normalization process should result in transparency allowing insight (absent distortions) into what can reasonably be expected in the future. The normalization process is made more complicated by earnings management.

As presented by Professors Dechow and Skinner (see decision grid above), earnings management covers a wide variety of actions from complete legitimacy at one extreme to fraud at the other. Understanding such, the valuation practitioner must make a credibility determination regarding the financial data and related representations. Is a certified audit report more creditable than a tax return? Consideration must also be given to the motivation(s) for earnings management.

Concluding Comments and Observations

This article attempts to contribute to the valuation literature by using recent accounting scandals to identify various strategies (techniques) employed by publicly traded firms to manage earnings. No one disputes that companies (large and small) manage earnings or that current accounting practices—GAAP—misrepresent economic reality. As valuation practitioners, we must be cautious, even skeptical, in our reliance on representations made by both management and outside accounting firms. Scope limitations aside, the challenge of earnings management is real and must be considered.

[1] *Term coined by Richard Wayman, a writer with Forbes Magazine (Re:* ***Accounting Red Flags****, Feb 27, 2000).*

[2] *West, Andrew,* ***The Economic Spin Doctors: Perception Creates Economic Reality****, Capitalism Magazine, http://www.capitalismmagazine.com/1999/june/west*

[3] *Patton, Stewart (2002)* ***Treasury Regulation §301.6111-2T and The Economic Substance Doctrine****, Houston Law Review, Summer.*

[4] *Soled, Jay (2001).* ***Use of Judicial Doctrines in Resolving Transfer Tax Controversies****, Boston College Law Review*

[5] *Healy, Paul and Wahlen, James (1999).* ***A Review of Earnings Management Literature and Its Implications for Standard Setting****, Accounting Horizons.*

[6] *Schipper, K. (1989).* ***Commentary on Earnings Management****, Accounting Horizons.*

[7] *Parfet, William (2000, Dec.).* ***Accounting Subjectivity and Earnings Management****: A Preparer Perspective. Accounting Horizons.*

[8] *Dechow, Patricia and Skinner, Douglas (2000).* ***Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulator****s, Accounting Horizons.*

[9] *Barr, Stephen (1999).* ***Misreporting Results****, CFO Magazine, Retrieved 12/28/01 from the World Wide Web: http://www.cfo.com*

[10] *Pratt, Shannon; Reilly, Robert and Schweihs, Robert (1993).* ***Valuing Small Businesses and Professional Practices****, 2nd Ed.*