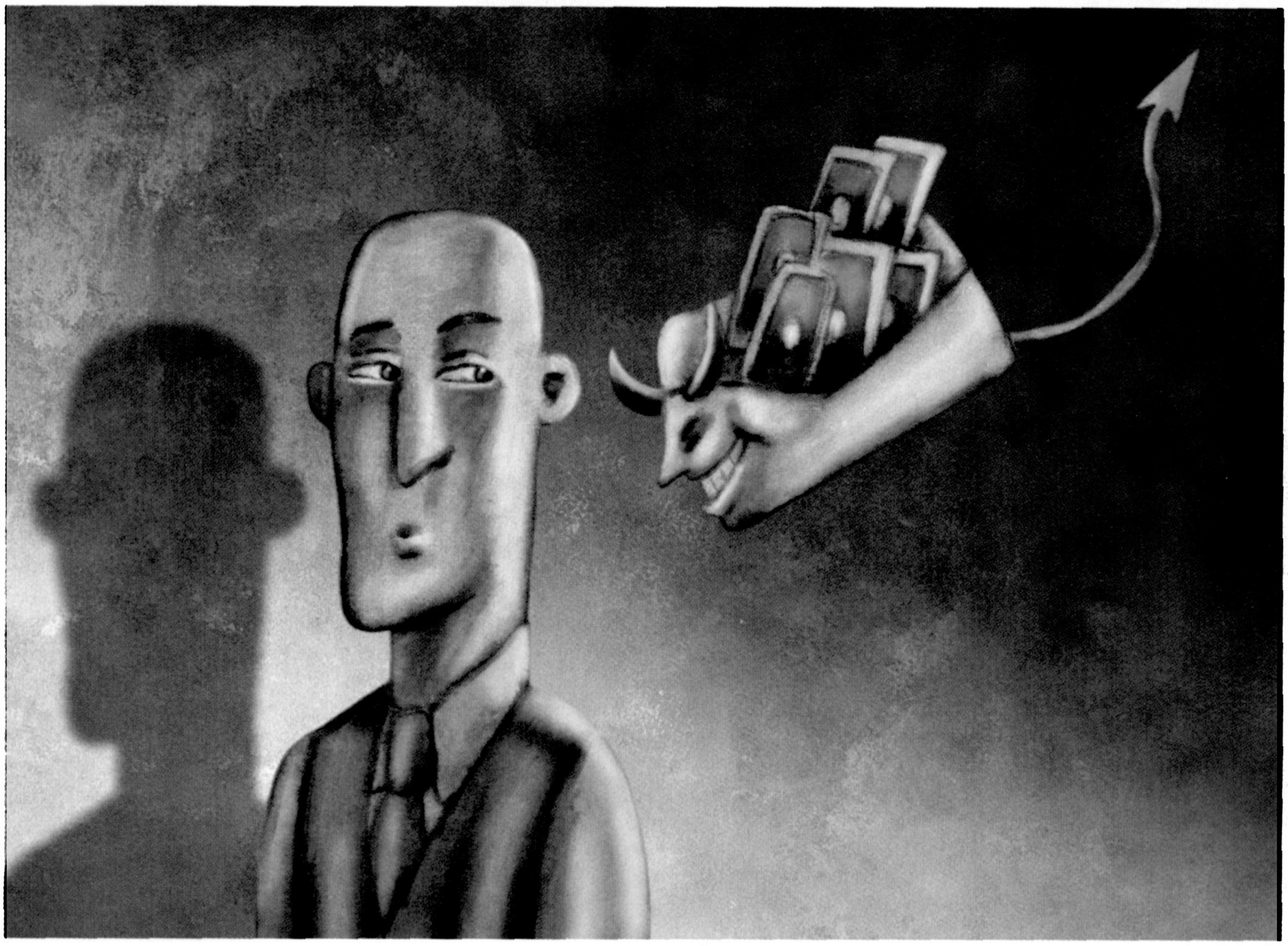

Earnings Management and Its Implications

Educating the Accounting Profession

By Michael D. Akers, Don E. Giacomino, and Jodi L. Bellovary

In the wake of continuing, highly publicized financial frauds and failures, the accounting profession has placed renewed emphasis on issues related to earnings management and earnings quality. The SEC and the public are demanding greater assurance about the quality of earnings. Staff Accounting Bulletin (SAB) 101, *Revenue Recognition in Financial Statements*, which was issued in December 1999 in response to the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report, illustrates the importance of earnings to the SEC.

In the August 1990 *Management Accounting*, William J. Bruns, Jr., and Kenneth A. Merchant reported the results of their survey of the readership of the *Harvard Business Review* (*HBR*). That survey described 13 earnings-management situations that the authors had directly or indirectly observed, and asked *HBR* readers to rate the acceptability of those practices. Characterizing the results as "frightening," they observed the following:

> It seems that if a practice is not explicitly prohibited or is only a slight deviation from rules, it is an ethical practice regardless of who might be affected either by the practice or the information that flows from it. This means that anyone who uses information on short-term earnings is vulnerable to misinterpretation, manipulation, or deliberate deception.

We have no doubt that short-term earnings are being managed in many, if not all companies. Some of these earnings-management practices can be properly labeled as immoral and unethical.

Prior to the Bruns and Merchant study, researchers and accounting professionals paid little attention to the morality of short-term earnings management. Despite the increased research in this area during the past five years, there appears to be little evidence that the accounting profession is educating accountants about earnings management. Therefore, the authors decided to conduct a study to determine the extent to which public accounting organizations have addressed the issue of earnings management through training and continuing education.

Where management does not try to manipulate earnings, there is a positive effect on earnings quality. The earnings data is more reliable because management is not influencing or manipulating earnings by changing accounting methods, recognizing one-time items, or deferring expenses or accelerating revenues to bring about desired short-term earnings results. The absence of earnings management does not, however, guarantee high earnings quality. This is true because some information or events that affect future earnings may not (and cannot) be disclosed in the financial statements. Thus, the concept of earnings management is related to the concept of earnings quality. The authors' definition of earnings management is as follows:

> Earnings management is recognized as attempts by management to influence or manipulate reported earnings by using specific accounting methods (or changing methods), recognizing one-time nonrecurring items, deferring or accelerating expense or revenue transactions, or using other methods designed to influence short-term earnings.

The SEC and the public are demanding greater assurance about the quality of earnings. The first step is to use a definition of earnings quality that meets the objectives of FASB. One major objective of the FASB Conceptual Framework is to assist investors and creditors in making investing and lending decisions. The Conceptual Framework refers not only to the reliability (or truthfulness) of financial statements, but also to the relevance and predictive value of information presented in financial statements. The authors' definition of earnings quality takes into consideration those two characteristics of earnings:

> Earnings quality is a measure of the ability of reported earnings to reflect the firm's true earnings and to help predict future earnings.

Is the accounting profession responding to the practice of short-term earnings management through greater education? The authors identified existing educational and training efforts by accounting firms, as well as those offered by state and national accounting organizations. The authors also conducted a survey of the top 100 accounting firms to determine the extent to which these firms provide formal training on earnings management, and discuss the implications for academia and the accounting profession.

Education/Training Effort

On the academic side of the profession, the American Accounting Association (the primary academic accounting group) made the quality of earnings its main theme at its 2002 annual meeting. In turn, academic journals have invited and published recent research on earnings management. Except for the study by Bruns and Merchant more than 15 years ago, there is little evidence of studies that focus on earnings management through 2000. Since then, however, several studies have examined ethics and financial statement fraud. Recently, many universities, some with assistance from the Association of Certified Fraud Examiners, have begun to offer courses on fraud examination. See www.larry-adams.com/university_fraud_courses.htm for a listing of fraud examination courses and degrees offered by various universities.

Two national public accounting firms (including a Big Four firm) were contacted by the authors to determine the extent of training on earnings management for their employees. Neither firm provides training to its employees on earnings management. One firm indicated that earnings management would fall under the topic of professional skepticism.

Next, the authors reviewed the continuing education courses offered by each of the state CPA societies (including Washington, D.C.) and the AICPA. Of the 52 organizations, 34 do not offer courses that focus on earnings management. The other 18 offer only eight courses that have some relevance to earnings management topics. Three of those courses focus on revenue recognition, three cover ethics in a broad form, one covers disclosures, and one forensic accounting. Only the revenue recognition courses emphasize earnings management, and only two of the courses are covered by more than two organizations.

Exhibit 1 identifies the state societies that offer courses related to earnings management. The titles and descriptions of those courses are as follows:

"Deceptive Accounting and Revenue Recognition Techniques—Recognizing the Warning Signs" (offered by eight organizations). This program emphasizes revenue recognition and discusses other GAAP requirements and how they were violated or grossly misrepresented by companies and their outside CPAs. More than 40 high-profile cases are reviewed, including Parmalat, WorldCom, and Waste Management. Emphasis is on how this relates to privately held companies.

"Disclosure—The Key to Financial Statements" (offered by New Jersey). This program reviews the "bread and butter" disclosures and helps participants keep current on new reporting trends and requirements. Special emphasis is given to related-party transactions, changes to loans and trade receivables, goodwill and intangibles, guarantees and discontinued operations, impairments, and cash flow disclosures. This program does not discuss SEC requirements. Also covered are common disclosure deficiencies noted in practice and in peer reviews; related-party transactions; and recent changes in buy-sell agreements, guarantees, variable interest entities, leases, contingencies, risks and uncertainties, accounting policies, liabilities (debt violations impact classification), deferred taxes, and income statement presentation; and changes in discontinued operations, other categories of earnings, and cash flow statements.

"Ethics in Today's Environment for Louisiana CPAs" (offered by Louisiana). This course provides case studies drawn from actual litigation and administrative proceedings involving CPAs in public practice and industry. It takes a proactive, risk-avoidance stance by pointing out common pitfalls and presenting alternative courses of action. The course explores ethical issues in the context of proceedings that were resolved both in favor of and against accounting and auditing professionals.

The course uses real-world accounting and auditing cases that deal with management integrity and professional responsibilities in relation to key business topics such as off–balance sheet financing, related-party transactions, revenue recognition, materiality, loan and lease loss reserves, restructuring charges, and independence. The course identifies pitfalls faced by every financial professional and attempts to effect a heightened sensitivity for the types of ethical dilemmas one might face.

"Forensic Accounting: Fraudulent Reporting and Concealed Assets" (offered by two organizations). This course focuses on identifying common forensic techniques to recognize fraud schemes and scams. Participants learn to sharpen their forensic skills through the use of analytical tools, and learn to follow cash flows and uncover accounting schemes. This course's objectives are to learn common forensic techniques to recognize schemes and scams and detect fraud through the use of analytical tools and other techniques.

"Fraud: 2005 Hot Topics" (offered by two organizations). This course is an update on the environment in which people commit fraud, theft, or embezzlement, or enter into kickback and corruption schemes. It covers the newest techniques and regulatory requirements, including audit standards and Statements on Standards for Accounting and Review Services (SSARS). Topics include: 1) how new state-level rules and regulations apply to firms, small and midsize businesses, and government entities and nonprofits, including new independence rules for nonattest work; 2) the four ways employees cheat on their travel and entertainment (T&E) reports; 3) current cases against CPA firms and companies—who's winning and who's losing; 4) why principled managers bend company rules; 5) seven industries under assault for fraud; 6) most-recent guidance on audits of privately held companies; 7) recognizing when "adjusting" the numbers becomes fraud, and learning to spot little numbers that are material; and 8) how the AICPA and the FBI are working together to stop fraud.

"Real World Business Ethics: How Will You React?" (offered by eight organizations). This course provides case studies drawn from litigation and administrative proceedings involving CPAs in public practice and industry. The course identifies common pitfalls, and presents alternative courses of action. It also explores ethical issues in the context of actual proceedings that were resolved both in favor of and against accounting and auditing professionals. The course uses real-world accounting and auditing cases that deal with management integrity and professional responsibilities in relation to topics such as off–balance sheet financing, related-party transactions, revenue recognition, materiality, loan and lease loss reserves, restructuring charges, and independence.

EXHIBIT 1
Earnings Management CPE Offered By CPA Societies

Course Title	AICPA	Ala.	Ariz.	Ark.	Conn.	Del.	Fla.	Ga.	La.	Minn.	Mo.	N.H.	N.J.	N.C.	Pa.	R.I.	S.C.	Tenn.
Deceptive Accounting and Revenue Recognition—Recognizing the Warning Signs			X		X	X	X		X				X	X			X	
Disclosure—The Key to Financial Statements												X						
Ethics in Today's Environment for Louisiana CPAs									X									
Forensic Accounting: Fraudulent Reporting and Concealed Assets	X																	X
Fraud: 2005 Hot Topics												X				X		
Real World Business Ethics: How Will You React?	X	X		X				X		X	X				X			X
Revenue Recognition: Guidance, Implementation, and Fraud Concerns	X																	
Revenue Recognition in Today's Business Climate	X			X													X	

"Revenue Recognition: Guidance, Implementation, and Fraud Concerns" (offered by the AICPA). In its October 2002 "Report on Financial Statement Restatement," the General Accounting Office (GAO) concluded that almost 38% of the 919 announced restatements between 1997 and June 2002 involved revenue recognition and that revenue recognition was the primary reason for restatements each year. Moreover, more than 50% of the immediate market losses following restatements were attributable to revenue recognition–related restatements and approximately 50% of the SEC's enforcement cases involved revenue recognition issues.

This course provides an overview of the relevant accounting literature and the information needed to implement the authoritative guidance. The course covers techniques for examining bill-and-hold sales, consignment sales, and refund rights, and shows proper presentation of revenue as gross or net on the statement of operations. The course considers revenue recognition of nonmonetary and "round-trip" transactions that have drawn the attention of the SEC. Finally, the course covers multiple-element arrangements, when entities bundle products, or products with services, to provide more complete solutions to their customers, another area in which FASB's Emerging Issues Task Force (EITF) has provided guidance.

This course's objectives are to: 1) identify situations where aggressive revenue-recognition issues may exist, including recognizing revenue prematurely, recognizing revenue that may not be earned, reporting sales to fictitious or nonexistent customers, sales to related parties, and nonmonetary exchanges; and 2) identify the differences between aggressive accounting and financial fraud and the point at which aggressive accounting practices become fraudulent.

"Revenue Recognition in Today's Business Climate" (offered by three organizations). Revenue-recognition guidance exists throughout the accounting literature, accounting and audit guides, and audit risk alerts for specific industries, as well as SAB 104. Yet there is no one comprehensive source. This course reviews the current literature, looks at the implications of premature recognition and unique revenue-recognition issues of specialized industries, and examines current FASB projects and the impact they will have on financial statements.

The course's objectives are to: 1) understand the implications of faulty revenue-recognition; 2) make appropriate revenue recognition decisions; 3) deal with unique revenue-recognition issues in specialized industries; and 4) increase awareness of revenue-recognition developments in the profession, such as activities of FASB and the IASB.

Most accounting firms do not address the topic of earnings management, directly or indirectly, with training courses.

Survey of the Top 100 Accounting Firms

Notwithstanding the grave threat that abusive earnings-management practices pose to the reliability and accuracy of financial statements, the accounting profession may be reluctant to address this issue. Therefore, to evaluate how, if at all, the profession has responded to the dangers posed by earnings management, the authors surveyed the top 100 accounting firms (from *Accounting Today*, "Top 100 Firms, 2005 Merger Marathon"). The results suggest that most accounting firms do not address the topic of earnings management, directly or indirectly, with training courses.

The survey was directed toward abusive earnings-management practices and defined earnings management as "[the] misapplication of generally accepted accounting principles to actively manipulate earnings towards a predetermined target for purposes of creating an altered impression of business performance." It sought to collect data on whether the top accounting firms address abusive earnings management through training or education and asked whether firms have training courses specifically focusing on earnings management. If not, the survey asked whether firms handled this topic as part of other training courses.

The results indicate that accounting firms are doing little to address earnings management. Of the 100 accounting firms surveyed, 17 responded. Of these, only three reported having training courses specifically addressing earnings management. Five firms reported that earnings management was addressed within the context of other training courses, but did not devote a specific course. Nine firms, more than half of the respondents, reported not providing any training courses that address earnings management. Less than 20% of responding firms claimed to have training classes principally designed to educate employees about earnings management. About 30% of responding firms tangentially address this issue as part of other training courses but do not devote a specific course to the subject. More surprisingly, over 50% of responding firms do not address the topic of earnings management in any training, directly or indirectly. See *Exhibit 2* for a breakdown of responses.

Exhibit 3 provides descriptions of other courses that directly or indirectly address earnings management. Three firms reported having training classes designed to address earnings management. Only one of these courses, "The Recording of Income," is narrowly tailored to earnings management and seems to adequately address the subject. The course discusses how revenue and income are recorded across various industries and how these figures can be manipulated. It is directed toward junior staff, seniors, managers, and partners, and utilizes small group dis-

EXHIBIT 2
Training Programs Among Responding Firms

Responding Firms with Training Courses ...		
Designed to specifically address earnings management	3	18%
Address earnings management as part of other course(s)	5	29%
Earnings management not addressed	9	53%
Total	**17**	**100%**

cussions to share practical experience on earnings management. The other two courses are primarily directed toward asset allocation and financial planning, rather than educating employees on earnings management and identifying potential abuses.

Five firms reported providing training that indirectly educates employees with regard to earnings management. Two of these firms covered earnings management in annual review or annual update courses. One firm addressed the topic in ethics and financial reporting classes by using material obtained from continuing education vendors. The remaining two firms identified earnings management as a topic to be aware of.

Based on responses to this survey, it appears that very few of the top 100 accounting firms are training their employees in identifying earnings management abuses. These results are further evidence that accounting firms are not doing enough to address this problem, and support former SEC Chairman Arthur Levitt's call for a cultural change among corporate management, Wall Street, and accounting firms.

Implications for Academia and the Accounting Profession

While there is evidence that accounting educators are attempting to make accounting students aware of abusive earnings-management practices, further efforts are needed by state societies and public accounting firms to better equip CPAs with the tools necessary to identify earnings-management techniques. Education could help to reduce the expectations gap between auditors and financial statement users. Robinson-Backmon and Finney (*Research on Accounting Ethics* 1999, 5: 77-93) found that most firms that fraudulently misstated earnings through earnings management had employed Big Five public accounting firms as their auditors. Business and professional publications could educate their readers by publishing articles on how to detect and deter earnings management schemes.

Some researchers argue that auditors are in the best position to assess a firm's earnings quality because of their familiarity with GAAP, the client's controls, and its business practices. Consequently, researchers have proposed that auditors prepare a "quality of earnings report" on the income statement.

Little is being done by the profession to educate CPAs about earnings management, despite the SEC's efforts to crack down on this type of abuse. The public accounting profession needs to take a proactive approach. Auditors can't be expected to identify these schemes without training on how they are perpetrated. ❑

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EXHIBIT 3
Courses by Level of Participant

Course	Description	Level of Participant: Staff	Senior	Manager	Partner
Asset Allocation	Discusses asset allocation: how it's important and how it relates to personal finance	x	x	x	x
Recording of Income	Discusses the ways various industries record revenue and how it can be manipulated. Lecture and discussion components, with inter-firm sharing of knowledge and experience.	x	x	x	x
Personal Financial Planning	Helps seniors learn strategies for effective financial management and provides guidance on financial recordkeeping.		x		
Running the Firm as a Business	Training course for new managers that teaches proactive management on issues such as earnings management.	x	x	x	x
Annual Quality Update	No description provided.	x	x	x	x
Course title not provided	Auditing course that addresses manipulation of earnings as something to look for and point out to clients as inappropriate.	x			
Annual Accounting and Auditing Update Course; SEC Update Course	No description provided.	x	x	x	x
Ethics; Financial Reporting	Uses various handouts that are provided by continuing education vendors.	x	x	x	x