This chapter defines earnings management and explains the difference between legal and illegal earnings management (commonly called “cooking the books”).

Earnings, sometimes called the “bottom line” or “net income,” are the single most important item in financial statements. They indicate the extent to which a company has engaged in value-added activities. They are a signal that helps direct resource allocation in capital markets. In fact, the theoretical value of a company’s stock is the present value of its future earnings. Increased earnings represent an increase in company value, while decreased earnings signal a decrease in that value.¹

Given the importance of earnings, it is no surprise that company management has a vital interest in how they are reported. That is why every executive needs to understand the effect of their accounting choices so they can make the best possible decisions for the company. They must, in other words, learn to manage earnings.

Earnings management may be defined as “reasonable and legal management decision making and reporting intended to achieve stable and predictable financial results.” Earnings management is not to be confused with illegal activities to manipulate financial statements and report results that do not reflect economic reality. These types of activities, popularly known as “cooking the books,” involve misrepresenting financial results.

Many executives face a lot of pressure to cross the line from earnings management to cooking the books. A 1998 survey at a conference sponsored by CFO

*Magazine* found that 78 percent of the chief financial officers (CFOs) in attendance had been asked to cast financial results in a better light, though still using generally accepted accounting principles (GAAP). Half of them complied with the request. Worse, however, 45 percent of the group attendees reported that they had been asked to *misrepresent* their company’s financial results—and 38 percent admit with complying.

The intense pressure to report better earnings was confirmed by a similar survey at a *Business Week* CFO conference. It found that 55 percent of the CFOs had been asked to misrepresent financial results, and 17 percent had complied.²

**HOW WIDESPREAD IS EARNINGS MANAGEMENT?**

Research on earnings management “suggests that this is a pervasive phenomenon: We estimate that 8-12 percent of firms with small pre-managed earnings decreases manipulate earnings to achieve earnings increases, and 30-44 percent of the firms with small pre-managed losses manage earnings to create positive earnings (emphasis added).”³ In other words, a large number of companies are using earnings management either to maintain steady earnings growth or to avoid reporting red ink.

One study estimates that operating profits for the Standard & Poor’s 500 stocks “have been inflated by at least 10 percent per year for the past two decades, thanks to a mix of one-time write-offs and other accounting tricks.”⁴ Since it is widely accepted that operating profits are highly correlated to stock prices over the long term, this means that the prices of S&P 500 stocks, some of the best companies in the world, have consistently been enhanced by earnings management techniques. The practice is indeed pervasive.

General Electric (GE) was one of America’s best-loved stocks as it achieved $10.7 billion in earnings for fiscal year 2000. It had had a 482 percent total return over the previous five-year period. GE’s chief executive, Jack Welch, was considered a management genius. He disputed the idea that the company managed earnings even using legal methods.

The facts show that GE had, through fiscal year 2000, had 100 consecutive quarters of increased earnings from continuing operations. This even surpassed Wal-Mart’s 99-quarter streak that ended in 1996.⁵ The streak is one of the reasons that in 2001 GE had the stock market’s biggest capitalization, $590 billion.

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GE’s earnings were so predictable they were almost a straight upward line. In the calendar year 2000, *The Value Line Investment Survey* gave GE its highest score of 100 for earnings predictability.⁶

How did GE do it? One undeniable explanation is the fundamental growth of its eight industrial businesses and 24 financial-services units. “We’re the best company in the world,” Dennis Dammerman, GE’s chief financial officer, declared.

But another explanation is earnings management, the orchestrated timing of gains and losses to smooth out bumps and especially avoid a decline. Among big companies, GE has long been known as “a relatively aggressive practitioner of earnings management,” to quote Martin Sankey, a CS First Boston Inc. analyst.⁷

Many people believe that this type of long-run earnings increase just does not happen by chance. Reporter Jon Birger has said, “GE has employed a number of confusing but apparently legal gimmicks to achieve its vaunted consistency. No company, not even one as well managed as GE, has 100 quarters of uninterrupted growth without resorting to some fancy accounting—or, as the mannered folks on Wall Street like to call it, earnings management.”⁸

**BY ANY OTHER NAME**

A number of phrases have been used to describe earnings management activities:

- Income smoothing
- Accounting hocus-pocus
- Financial statement management
- The numbers game
- Aggressive accounting
- Reengineering the income statement
- Juggling the books
- Creative accounting
- Financial statement manipulation
- Accounting magic
- Borrowing income from the future
- Banking income for the future
- Financial shenanigans
- Window dressing
- Accounting alchemy

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⁸Birger, “GE’s Glowing Numbers,” above, n. 5.
There is no standard, universally accepted definition for any of these terms. People use them in different ways and with different degrees of appreciation to cover a wide variety of activities, many perfectly legal. This tends to blur the distinction between entirely legal earnings management and illegally cooking the books.

**ACHIEVING EARNINGS MANAGEMENT**

The definition of earnings management that we are using describes reasonable and proper practices that are part of a well-managed business that delivers value to shareholders. Earnings management is primarily achieved by management actions that make it easier to achieve desired earnings levels through:

- Accounting choices from among GAAP.
- Operating decisions (sometimes called *economic earnings management*).

An example of a GAAP accounting choice would be whether a company should (a) be a voluntary early adopter of a new accounting standard or (b) wait two years until adoption of the new accounting standard is required of all companies.

A choice of this type occurred when the Financial Accounting Standards Board (FASB) issued a new standard for pensions (FAS No. 87) effective in 1987. Firms could choose to adopt the new standard as early as 1985. The new standard permitted companies whose pension assets exceeded their pension liabilities to count the difference as income. Not surprisingly, “Almost all of the firms that opted for an early adoption boosted their earnings by it.”

An example of a proper management operating decision would be whether or not to implement a special discount or incentive program to increase sales near the end of a quarter when revenue targets are not being met. Other examples of operating decisions would be whether to invest in new equipment or hire additional employees. Companies have to make these types of decisions constantly. Earnings management via operating decisions is sometimes called “economic earnings management” because it attempts to manage the cash flows and thus the revenues and expenses associated with operations.

There are real economic costs to this type of earnings management. For example, if you eliminate normal maintenance procedures in one period to reduce maintenance costs, you are likely to incur higher operating costs caused by the lack of maintenance in either the next or some future period. Earnings management via accounting choices similarly may result in real economic costs. For example, a company may have to pay a higher bonus in a subsequent period due to accounting earnings management. Figure 1.1 illustrates how management may manage reported earnings through either operating decisions or accounting choices:

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This book will focus on explaining earnings management via accounting choices. Earnings management though operating decisions is not discussed because it can vary so widely from industry to industry and business to business.

**BENEFITS TO SHAREHOLDERS**

A common criticism of earnings management is that it reduces transparency by obscuring the “true” earnings of the company. However, leading academics argue that both the level and patterns of earnings convey information and that even when earnings management conceals information, it can still be beneficial to shareholders. Arya, Glover, and Sunder state:

“That earnings management reduces transparency is a simplistic idea. A fundamental feature of decentralized organizations is the dispersal of information across people. Different people know different things and nobody knows everything. In such an environment, a managed earnings stream can convey more information than an unmanaged earnings stream. A smooth car ride is not only comfortable, but it also reassures the passenger about the driver’s expertise.”

**SELECTIVE MISREPRESENTATION HYPOTHESIS**

There is no doubt that the GAAP reporting rules are often arbitrary, complicated, and, occasionally potentially misleading. Some highly respected academic researchers believe this is no accident, characterizing the principles as means to

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selective financial misrepresentation. Management, shareholders, auditors, and standard setters are motivated to support GAAP, they suggest, because selective misrepresentation of economic reality benefits them in some way.

“Corporate America often wants exceptions to broad accounting principles,” Business Week has said. Consider Financial Accounting Standard 133, which dictates accounting for derivatives and hedging. To avoid “unpredictable swings in corporate earnings” the FASB “carved out exceptions for hedging deals, forward contracts or materials, insurance policies, and other special cases.” “The result: FAS 133 and its supporting documents weigh in at 800 pages— and it’s still a work in progress.”

As long ago as 1984, in a Business Week article titled “The SEC Turns up the Heat on ‘Cooked Books,’” one of the commissioners of the Securities and Exchange Commission was quoted as saying that the SEC was also concentrating enforcement on “‘cute accounting,’ the stretching and bending, rather than out-and-out breaking, of accounting rules.” Two decades later the SEC is still dealing with the same issues even though it has the legal power to set and enforce, with civil and criminal penalties, both accounting and auditing standards. In 2003, Business Week said the SEC was “writing or implementing standards that could force companies to recast their results and disclose much more information. It’s the biggest advance in public company accounting since the securities laws of the 1930s.” The two-decade delay suggests that even the SEC has had, and may still have, some motivation to support GAAP that allow a variety of representations of economic reality.

Professor Lawrence Revsine comments on this hypothesis:

“To summarize, research evidence is consistent with the notion that managers use latitude in existing financial reporting to benefit themselves. In several of these studies, this behavior simultaneously benefits shareholders. This reinforces the point that misrepresentation conveys potentially widespread benefits. Indeed, this characteristic of “shared benefits” may be crucial to the survival of selective misrepresentation.”

I do not believe that the word “misrepresentation” is appropriate to describe legal earnings management. It implies that managers know what “true” earnings are and are deliberately trying to show a different amount. In many cases managers are simply making choices that increase earnings because accounting standards permit them to do so.

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In fact, many people believe that only GAAP defines what “earnings” or “income” actually is. Thus, if management is following GAAP, earnings are not being misrepresented. Critics to this argument, however, point out that the standard setters who write the GAAP rules must have some theoretical concept of “true” earnings or income that they are attempting to measure via the GAAP rules. I believe that true earnings exist only as a theoretical concept and do not necessarily describe an amount that is not known or knowable by management. This conclusion is supported by arguments made by a current member of the FASB, which establishes GAAP, and her co-author who write:

“Earnings can be defined using the economics-based definition of earnings developed by J. Hicks in his 1939 book Value and Capital. ‘Hicksian’ income corresponds to the amount that can be consumed (that is paid out in dividends) during a period, while leaving the firm equally well off at the beginning and end of the period . . . We define earnings quality as the extent to which reported earnings faithfully represent Hicksian income . . . The construct (Hicksian income) thus allows us to consider what reported earnings would look like in the absence of reporting rules and their implementation . . . Because Hicksian income is not observable, it is not possible to quantify the differences . . . between the Hicksian earnings concept and reported earnings generated by U.S. GAAP, along with preparers’ implementation decisions.”

This previous discussion supports the argument that “true” earnings are not observable and, therefore, not a reasonable standard against which to judge management’s earnings decisions.

It is clear from the research that:

- GAAP permits many accounting choices and requires many estimations, thereby facilitating earnings management.
- Because all companies make innumerable operating and accounting choices, they must engage in some form of earnings management even if this is by default rather than active choice.
- Many parties benefit from active earnings management.

Since earnings management must be practiced, whether by active choice or by default, smart executives will learn to use the techniques discussed in this book whenever they seem appropriate.

ACCOUNTING EARNINGS MANAGEMENT

Earnings management activities may occur (1) because managers have flexibility in making accounting or operating choices or (2) because managers are trying to
convey private information to financial statement users. It is important for readers of financial statements to determine which type is being practiced and to understand its significance. Some examples:

- **Flexible accounting or operating choices.** Managers may adopt a depreciable life for a new computer chip plant that is at the high end of industry norms in order to lower depreciation expense and thus maximize reported earnings for future periods. The aim here is to manage earnings (and thus share prices) in a direction desired by current shareholders.

- **Private information.** Managers may adopt a depreciable life for a new computer chip plant that is substantially less than industry norms because anticipated technological changes make it likely that the plant will be obsolete sooner than has been the norm for the industry. The motive here is to give stakeholders information not otherwise available so they can adjust their expectations appropriately.

  Careful release of such information may lower earnings and the share price for the company, but if the information conveys significant new news to analysts and other users of financial statements, they may also adjust earnings estimates (and share prices) downward for other companies in the industry, so that the company revealing the information may actually feel some positive impact on its share prices because it is perceived as having a higher “quality of earnings.” This concept is discussed in more detail later.

**ACCOUNTING CHOICES**

Accounting choices should be made within the framework of generally accepted accounting principles. GAAP are the set of rules, practices, and conventions that describe what is acceptable financial reporting for external stakeholders. The main source of GAAP for public companies are the Financial Accounting Statements (FAS) of the FASB, although there are also several other sources.

Some people find it quite surprising that a single, normal, everyday accounting choice may be either legal or illegal. The difference between a legal and an illegal accounting choice is often merely the degree to which the choice is carried out. To better understand this, think about driving a car. Driving is inherently neither legal nor illegal. Much depends on the law in the jurisdiction in which you are driving. If the speed limit is 65 mph, for instance, and your speed is 60 mph, your driving is within the legal limits. On the other hand, if your speed is 100 mph, you are clearly driving illegally.

The problem with many accounting choices is that there is no clear posted limit beyond which a choice is obviously illegal. Thus, a perfectly routine accounting decision, such as expense estimation, may be illegal if the estimated amount is extreme but perfectly legal if it is reasonable. GAAP does not tell managers what
specifically is normal and what is extreme. It is more like a speed limit sign that just says “Don’t Drive Too Fast!”

Product warranty cost estimation is an example of an accounting decision many managers have to make. GAAP normally requires that this estimate be recorded as an expense in the same fiscal year as the revenue from the product is recorded: If you sell a hair dryer for $30 and offer a free refund or replacement if it breaks within one year from date of purchase, you should estimate this warranty cost and record it as an expense in the same fiscal year as the $30 revenue from the hair dryer. This follows a basic accounting concept of matching expenses with related revenue. If you assume that warranty cost averages $2.75 per unit sold, the items on the income statement would look something like this: 

<table>
<thead>
<tr>
<th>Revenue</th>
<th>$30.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Warranty expense</td>
<td>2.75</td>
</tr>
<tr>
<td>Income</td>
<td>$27.25</td>
</tr>
</tbody>
</table>

However, the fact that warranty costs will be $2.75 per unit is not always so clear. Assume that for the past five years, average unit warranty costs for the hair dryer have ranged from $2.50 to $2.80, with no specific pattern being apparent. A financial manager who wanted to report the highest possible current period income would be justified in using $2.50 per unit for the current year’s expense estimate even though $2.50 is the bottom of the historical range. That same manager might even be justified in using $2.25 per unit if there was evidence that improved quality control during the current fiscal year would lower future warranty costs. But what if that manager used $1.25 per unit simply because that figure for warranty expense would make it possible to achieve a desired net income target for the fiscal year? Since the $1.25 has no reasonable support, using it would be crossing the line to financial fraud—even though GAAP does not draw that clear a line.

THE FRAUD ISSUE

Financial fraud has been defined by the National Association of Certified Fraud Examiners as “the intentional, deliberate misstatement or omission of material facts, or accounting data, which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision.”

Earnings management is at the legal end of a continuum. Financial fraud is at the illegal end. Fraud clearly violates GAAP, since the FASB has said, “Accrual accounting uses accrual, deferral, and allocation procedures whose goal is to relate revenue, expenses, gains, and losses to periods to respect an entity’s performance.

during a period (emphasis added). The key concept in this definition is that GAAP-based accounting is supposed to reflect, not distort or obscure, true economic performance. GAAP may also be violated by actions that do not sink to fraud, such as “overly aggressive accounting,” because that may distort or obscure the true economic performance of a business.

Using data from our previous warranty expense estimation example, Figure 1.2 illustrates the concept of a reported earnings continuum from merely conservative to fraudulent. Figure 1.2 assumes there was evidence that quality control improvements could lower warranty costs to $2.25.

Figure 1.2. The Earnings Management—Fraud Continuum

<table>
<thead>
<tr>
<th>Conservative Accounting</th>
<th>Neutral Accounting</th>
<th>Aggressive Accounting</th>
<th>Fraudulent Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2.80</td>
<td>$2.65</td>
<td>$2.50</td>
<td>$2.25</td>
</tr>
</tbody>
</table>

As our assumptions change, the interpretation changes. Assume there was absolutely no evidence, merely management optimism, that quality control changes during the year would lower future warranty costs under the historical $2.50 to $2.80 range. Now management has no real support for estimating that product warranty costs will be $2.25 per unit. The $2.25 figure should now be considered overly aggressive and beyond the bounds of GAAP. This scenario is illustrated in Figure 1.3.

Figure 1.3. Overly Aggressive Earnings on the Continuum

<table>
<thead>
<tr>
<th>Conservative Accounting</th>
<th>Neutral Accounting</th>
<th>Aggressive Accounting</th>
<th>Overly Aggressive Accounting</th>
<th>Fraudulent Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2.80</td>
<td>$2.65</td>
<td>$2.50</td>
<td>$2.25</td>
<td>$1.25</td>
</tr>
</tbody>
</table>


It is clear from the two figures that there is no “bright line” in GAAP to tell managers what is and what is not acceptable. Management is simply expected to make choices that appropriately reflect a company’s economic performance. What is appropriate for one company may not be appropriate for another.

THE HEALTHSOUTH EXAMPLE

Richard M. Scrushy, CEO of HealthSouth Corporation, started the company with $1 million in seed capital and turned into a multibillion-dollar hospital chain. In the decade after HealthSouth Corporation went public in 1986 it posted annual double-digit profit increases. The stock price soared an average of 31 percent per year between 1987 and 1997.

Things started to get more difficult in 1997 when Congress slashed Medicare reimbursements to hospitals and when expected economies of scale for large hospital chains proved difficult to realize. Management tried to improve operating efficiency and cut costs, and the financial reports made it appear that they had succeeded in these efforts. It later appeared that the reported earnings were not accurate. 21

“Although sales rose only 3 percent in 1999 and 2000, operating earnings soared an incredible 143 percent. Now investigators say that these fantastic numbers were just that—fantasy. Fraud, not efficiency and cost-cutting, accounted for the huge discrepancy between sales and profits. Securities & Exchange Commission and Justice Department investigators have accused Scrushy, 50, of cooking his books to inflate profits by at least $1.4 billion since 1999. The government complaint describes the most brazen sort of fraud: a group of people gathering in a room and simply making up numbers. Scrushy has denied the charges, but several of his former lieutenants, such as former Chief Financial Officer William T. Owens, have pleaded guilty and are cooperating with the investigation. Scrushy, founder and CEO, was fired on March 31.” 22

INTENT TO DECEIVE

A key element in financial fraud is intent to deceive. This poses a difficult question in many possible fraud situations because managerial intent with respect to accounting choices is unobservable and often can only be inferred from management actions.

Fraud is usually carried out for personal gain. The gain may be direct, such as a higher bonus for the year, or it could be indirect, such as job security or maintaining a career path as a “high flyer.”

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22Ibid.
A wide variety of state and federal laws deal with fraud. Violators may find themselves subject to both civil (monetary damages) and criminal (jail time) penalties and may be prosecuted under more than one of these laws. Among the most stringent of these laws are the federal securities statutes starting with the 1933 and 1934 Securities and Exchange Commission Acts. These give considerable power over the financial markets and financial reporting to the SEC. That is partly why the SEC is a key player in promoting GAAP, making their use mandatory for the annual reports and financial statements of the 14,000 or so U.S. public companies.

Managers whose financial statements reflect any of the following activities may be committing fraud even if they do not think of their actions as fraud:

- Recording fictitious sales.
- Recording sales when there is a right of return and return is expected.
- Recording sales when shipping unfinished products.
- Backdating sales invoices.
- Failing to properly record expenses.
- Engaging in barter transactions where the goods or services exchanged are substantially overvalued or undervalued.
- Overvaluing assets.
- Improperly capitalizing expenses.

THE SARBANES-OXLEY ACT OF 2002

The actual incidence of reported and detected fraud in the United States is relatively low. T. J. F. Bishop notes that, in 1999, the Wall Street Journal reported only 25 new cases of alleged material fraud in financial statements. During the same period, 8,873 audits of public companies were reported. That would constitute an annual fraud rate of 0.003 percent for public companies—relatively low compared to the failure rate in other professions. However, this statistic addresses only the frequency of frauds and not their size or economic impact.

A number of spectacularly large business failures, including Enron and WorldCom, involved either suspicions or allegations of fraud. These failures created negative publicity and loss of confidence in the capital markets. The U.S. Congress responded to the apparent public outrage by passing the Sarbanes-Oxley Act of 2002 (SOA) to remedy perceived deficiencies in financial reporting. All financial executives should be familiar with the main provisions of this law. (These provisions are discussed in Chapter 5.)

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