

2 POPULAR EARNINGS MANAGEMENT TECHNIQUES

This chapter briefly surveys a wide variety of popular legal earnings management techniques discussed in detail in later chapters.

The most successful and widely used earnings management techniques can be classified into twelve categories. This chapter briefly overviews and lists some of the most common techniques within each category. More detail on these techniques, including the underlying concepts, GAAP requirements, illustrative numeric examples, and actual company cases containing accounting applications are to be found in later chapters.

“COOKIE JAR RESERVE” TECHNIQUES

A normal feature of GAAP-based accrual accounting is that management must estimate and record obligations that will be paid in the future as a result of events or transactions in the current fiscal year. Since the future events cannot be known with certainty at the time of estimation, there is often substantial uncertainty surrounding the estimation process. In other words, there is no *right* answer. There is only a range of reasonably possible answers. From this range, GAAP insists that management select a single estimate. The selection process provides an opportunity for earnings management.

When management selects an estimation from the high end of the range of reasonably possible expenses, the effect is to record more expense in the current fiscal period than would be recorded if a lower estimate had been selected. Recording more expense in the current fiscal period may make it possible to record less in a future fiscal period. Thus management creates a “cookie jar reserve” [also called “financial slack”] that they can tap into later to get an earnings boost.

Of course, if in the future expenses actually turn out to be at the high end of the estimation range, the cookie jar will be empty. There will then be no earnings boost. However, if future expenses actually turn out to be in the middle or low end of the estimation range, the over accrual from the previous period may be taken into earnings.

Common areas where cookie jar reserves are created are in:

- Estimating sales returns and allowances.
- Estimating bad debt write-offs.
- Estimating inventory write-downs.
- Estimating warranty costs.
- Estimating pension expenses.
- Terminating pension plans.
- Estimating percentage of completion for long-term contracts.

“BIG BATH” TECHNIQUES

A somewhat rare occurrence for many companies is when, to remain competitive, they must substantially restructure or eliminate operations or subsidiaries. When this happens, GAAP permits management to record an estimated charge against earnings [a loss] for the cost of implementing the change. This estimated loss is usually reported as a nonrecurring charge against income, which means that it is not reported in regular operating earnings.

Charging a large loss against current earnings typically has a negative impact on the current stock price because it is associated with bad news about the company's competitiveness. However, if the charge and related operational changes are viewed as positive, the stock price may strongly rebound very quickly.

“Big bath” techniques are used in the belief that if you must report bad news, i.e., a loss from substantial restructuring, it is better to report it all at once and get it out of the way. Accordingly, since many such charges are based on estimates, it is better to estimate losses on the high side to avoid possible earnings surprises later, as would happen if you selected middle or low-side estimates only to find out in a later period that the expenses had come in on the high side.

Common circumstances where the big bath approach may be applied are in:

- Operations restructuring.
- Troubled debt restructuring.
- Asset impairment and write-down.
- Operations disposal.

“BIG BET ON THE FUTURE” TECHNIQUES

A company that acquires another company may be said to have made a “big bet on the future.” This bet may even be a sure thing in terms of increasing reported earn-

ings of the acquiring company if the acquisition is properly planned. Current GAAP requires that acquisitions be recorded under the “Purchase” method of accounting. Big bet techniques include:

- **Writing off in-process research and development costs for the company acquired.** This technique allows a substantial portion of the purchase price to be written off against current earnings in the acquisition year, protecting future earnings from these charges. This means that future earnings will be higher than they would have been otherwise.
- **Integrating the earnings of the acquired company into corporate consolidated earnings.** Current earnings of an acquired company may be consolidated with parent company earnings—providing an automatic earnings boost if the subsidiary was purchased on favorable terms.

The big bet techniques basically permit a company to buy a guaranteed boost in current or future earnings by acquiring another company.

“FLUSHING” THE INVESTMENT PORTFOLIO

Companies often buy stock in other companies either to invest excess funds or to achieve some type of strategic alliance. GAAP presumes that investments of less than 20 percent of the stock of another company are passive investments and therefore the investing company need not include a share of the investee’s net income in its financial statements, as it must do for higher ownership percentages. There are detailed rules on how to report passive investments.

GAAP requires that these investments be classified into one of two portfolio categories, each with a different accounting treatment:

1. **“Trading” securities.** Any changes in the market value of these securities during a fiscal period, or actual gains or losses from sales, are reported in operating income.
2. **“Available-for-sale” securities.** Any change in market value during a fiscal period is reported in “other comprehensive income components” at the bottom of the income statement, *not* in operating income. When these securities are sold, however, any gain or loss is reported in operating income.

The GAAP requirements for investments offer an opportunity for earnings management through the following techniques:

- **Timing sales of securities that have gained value.** When additional earnings are needed, sell a portfolio security that has an unrealized gain. The gain will be reported in operating earnings.
- **Timing sales of securities that have lost value.** When it seems useful to report lower earnings, sell a security that has an unrealized loss. The loss will be reported in operating earnings.

- **Change of holding intent.** Management can decide to change its intent with respect to a security and reclassify it from the trading security portfolio to the available-for-sale portfolio, or vice versa. This would have the effect of moving any unrealized gain or loss on the security to or from the income statement.
- **Write-down of “impaired” securities.** Securities that have an apparent long-term decline in fair market value can be written down to the reduced value regardless of their portfolio classification.

Bonds that are bought to generate short-run trading gains are also classified as “trading” securities and are treated the same as stock investments in the “trading” category. Bond investments held for the longer term are classified in a different portfolio category called “held to maturity.”

“THROW OUT” A PROBLEM CHILD

When earnings are dragged down by an underperforming subsidiary, and the drag is projected to increase in future periods, the “problem child” subsidiary may be “thrown out” to get rid of the drag through one of the following techniques involving accounting entity changes:

- **Sell the subsidiary.** When a subsidiary is sold, a gain or loss is reported in the current period income statement. If reporting a large loss on sale is undesirable, a spin-off should be considered.
- **Create a special-purpose entity (SPE) for financial assets.** One highly technical alternative available under GAAP is to transfer financial assets to a qualifying SPE. Such assets are deemed to have been sold and are removed from the balance sheet, with the transferor recording a gain or loss on the sale of the assets. A qualifying SPE is not consolidated with the transferor’s financial statements. New accounting standards now call these entities “variable interest entities,” VIE’s.
- **Spin off the subsidiary.** In a spin-off, shares in the subsidiary are distributed to or exchanged with current shareholders, thus making them, not the company, owners of the problem child. No gain or loss is normally reported on a spin-off, and the negative effects of the subsidiary are removed from all financial statements because GAAP requires that prior period financial statements be restated to reflect only the results of the remaining company.
- **Exchange the stock in an “equity” method subsidiary.** It is possible to “swap” the stock in an equity method subsidiary without having any recordable gain or loss. This technique is discussed later in this chapter under Sale/Leaseback and Asset Exchange Techniques.

CHANGE GAAP

Once a company chooses the accounting principles it will use, they are rarely changed. Companies that do change have to take care that the stock market does not view the change as lowering the quality of earnings, because that may undermine the stock price. However, under the following circumstances accounting principles can be changed without affecting the stock price negatively:

- ***Volunteering for a new accounting standard.*** Periodically the FASB adopts new accounting standards, and usually there is an adoption window of two to three years during which the companies can adopt the standard at any time. Voluntary early adoption can provide an opportunity to manage earnings.
- ***Improved revenue recognition rules.*** Many industries have several alternative revenue recognition rules. Some of these are perceived as reflecting economic reality better. Timely adoption of a “better” revenue recognition rule provides an opportunity to manage earnings.
- ***Improved expense recognition rule.*** For companies that record certain expenses on a cash basis, a timely change to an accrual-based rule can provide an opportunity to manage earnings. Such a change may coincide with a change in corporate policies concerning the item. For example, if a company primarily compensated its executives with cash, recording these expenses when paid, a change to a deferred compensation plan could provide an opportunity to record the expense on an accrual basis and lower earnings in the year of adoption.

Another possibility is to simply change an expense recognition rule because the new rule better matches expenses with related revenues. For example, a company might be using accelerated depreciation but decide to switch to a straight-line method because it believes straight-line depreciation better reflects the annual cost of using the asset. Straight-line depreciation results in lower initial charges, so the effect of this change would be to boost net income.

AMORTIZATION, DEPRECIATION, AND DEPLETION

The cost of long-term operating assets used or consumed is normally written off as an expense over the periods expected to be benefited. It can be expensed in three ways:

1. Amortization expense, for intangible assets such as goodwill, patents, copyrights, and trademarks.
2. Depreciation expense, for tangible assets such as buildings, machinery, and equipment.

3. Depletion expense, for natural resources that are being harvested or extracted, such as timber, coal, oil, natural gas.

Writing off long-term assets requires a variety of judgments, many of which offer an opportunity to manage earnings:

- **Selecting the write-off method.** Management has to decide what method to use to write-off newly acquired long-term operating assets. Some methods result in greater expense in the current period than others.
- **Selecting the write-off period.** Management must often estimate the “useful” life of a long-term asset, which can be substantially shorter than its actual physical life.
- **Estimating salvage value.** Some long-term assets retain substantial value at the end of their estimated useful lives. This value must be estimated in order to record the correct annual expense amount. The value may be realized 10, 15, or even 30 years in the future, so there can be a range of reasonable estimates.
- **Change to nonoperating use.** If a long-term asset is changed from operating to nonoperating use, it will no longer be necessary to record depreciation or amortization expense. This is permissible when a company ceases to use an asset for operating purposes.

SALE/LEASEBACK AND ASSET EXCHANGE™ TECHNIQUES

Timely disposition of long-term productive assets carried at historical cost in the balance sheet can result in the recording of unrealized gains or losses. Two methods to accomplish this are:

1. **Outright sale.** A company can sell a long-term asset that has unrealized gains or losses in a year when the sale will best enhance the financial statement. For example, suppose a building the corporation owns is carried in the balance sheet at \$30 million but is really worth \$50 million. If the building is sold, the \$20 million gain will boost current period earnings. (Of course, this does not take into account the operational and tax considerations.)
2. **Sale/Leaseback.** It is not unusual for one company to sell an asset to another and immediately lease it back. GAAP has detailed rules about whether a lease qualifies as a *capital lease* (equivalent to retaining ownership) or an *operating lease* (equivalent to merely renting the property). Losses occurring in a sale/leaseback transaction are recognized immediately on the seller’s books. Gains, however, are amortized into income, over the life of the asset if it is a capital lease or in proportion to the rental payments if it is an operating lease.

A sale/leaseback transaction offers an opportunity for managing earnings by recording the gains or losses. It also offers the opportunity to manage earnings by transforming a nondepreciable asset like land into a lease expense deduction. For example, suppose a company is recording \$2 million per year of depreciation on a building it owns. Even though the land under the building is worth \$100 million, GAAP allows no deduction for the use of land. If the building and land were subject to a sale/leaseback transaction which was an operating lease, the lease payments would be higher than the depreciation expense had been because the lessor, the new owner, would have to recover the cost of the land as well as the building. An annual lease payment of \$5 million would thus reflect the value of both the building and the land. The \$5 million lease payment would be recorded as an annual expense, providing the opportunity to lower net income by an additional \$3 million beyond the previous \$2 million annual depreciation deduction.

It is also possible to dispose of long-term productive assets *without* recording any gain or loss. This can be done by:

- **Exchange of similar productive assets.** Paragraph 21(b) of Accounting Principle Board Opinion (APB) 29 allows an exception to the general rule of recording a gain or loss on disposal of long-term assets when similar productive assets are exchanged. For example, Company A has a \$10 million refinery in one part of the country that it swaps with Company B for a refinery of similar capacity in another part of the country so as to better align its production with its customers. Properly structured, the swap would not result in any gain or loss.

Stock in a company can also be considered a productive asset if the investment is accounted for under the equity method, which is generally used for stock ownerships percentages in the range of 20 percent to 50 percent. This means that certain subsidiaries may be disposed of with no gain or loss recorded.

OPERATING VERSUS NON-OPERATING INCOME

There are two basic categories of earnings: (1) operating and (2) non-operating. Operating or “core” earnings are those that are expected to continue into the future. Nonrecurring events or earnings are not expected to affect future earnings, so they are recorded as non-operating. Financial analysts typically project growth rates for core earnings, and then discount these earnings back to the present to estimate the value of a stock. GAAP facilitates this forecasting of core earnings by separating the reporting of operating and nonoperating items in the income statement.

Possible income statement categories for reporting unusual items that are not considered part of normal operating income include:

- Special or unusual charges.
- Discontinued operations.
- Extraordinary gains and losses.
- Cumulative effect of change in accounting principles.

Items in the first category are reported as a component of income from continuing operations, but the other three items are not. There are a number of gray areas in classifying some items so it is possible to manage earnings when making decisions about items falling into those areas. For example, disposition of a major manufacturing plant could possibly be classified as either a special or unusual charges or as a discontinued operations. What classification is more accurate may depend on executive judgment about factors that are discussed in the detailed GAAP requirements for reporting discontinued operations items.

EARLY RETIREMENT OF DEBT

Long-term corporate debts, such as bonds, are typically recorded at amortized book value. When they are retired early, the cash payment required may be substantially different from book value, generating an accounting gain or loss. GAAP requires this gain or loss to be reported as an extraordinary item at the bottom of the income statement even though it may not meet the normal criteria for such a classification. Executives can manage earnings by selecting the fiscal period in which they retire debt early.

Rather interestingly, GAAP also requires the reporting of an extraordinary gain or loss for early debt retirement accomplished by either debt-for-debt swaps (new bonds for old bonds) or debt-for-equity swaps (stock for outstanding bonds), even though no actual cash is actually exchanged. Debt-for-equity swaps are used to both smooth income and to relax potentially binding sinking-fund constraints in the cheapest feasible manner.”¹

Some early debt retirements are *not* recorded as extraordinary items. These exceptions to the general rule are explained in Chapter 18.

USE OF DERIVATIVES

Derivatives are financial instruments or contracts whose value is either derived from another asset (e.g., stock, bond, or commodity) or related to a market-determined indicator (e.g., a stock market index). Derivatives can be used to protect against some types of business risk, such as:

- Interest rate changes.

¹ Hand, J. R. M. “Did Firms Undertake Debt-Equity Swaps For An Accounting Paper Profit or True Financial Gain?” *The Accounting Review*, Vol. LXIV No. 4, October, 1989, pp. 587-623.

- Commodity price changes.
- The weather.
- Oil price changes.
- Changes in foreign currency exchange rates.

Some of the varied types of derivatives are:

- Financial forwards (futures).
- Options.
- Swaps.²

The FASB concluded in 1998 that derivatives should be reported as assets and liabilities in the balance sheet and measured at fair value. Gains and losses from derivative transactions are generally recognized immediately in regular income unless they are cash flow hedges that are recorded in equity as part of comprehensive income.

Derivatives offer many opportunities to manage earnings. For example, suppose a company had a large issue of bonds outstanding at a fixed interest rate. The company could enter into an interest rate swap that would effectively convert the fixed rate bonds into variable rate bonds. When the interest rate increases, the company would then record an increase in interest expense for the bonds, and a decrease if the rate has decreased. Since when the company enters into the swap is up to the company, the timing option provides an opportunity to manage earnings.

SHRINK THE SHIP

Companies that repurchase their own shares do not have to report any gain or loss on their income statement because no income is recognized on the transaction. The reason is that, under GAAP, the company and its stock owners are considered to be one and the same. Income is only earned through equity transactions *outside* the firm, not with those involving the firm's owners.

If no gain or loss is reported on stock buybacks, how can they be used for earnings management? The answer is that although a stock buyback does not affect earnings, it *does* affect earnings per share, a widely used earnings surrogate. To briefly illustrate: Assume a company has 100,000 shares of stock outstanding and earned net income of \$300,000 during the current fiscal year (see Table 2.1). The reported earning per share figure would be \$3.00 (\$300,000/100,000 shares). If management projects that net income will remain at \$300,000 for the following fiscal year, it recognizes that this means earnings per share will be flat, rather than the average 10 percent average growth rate experienced for earnings and earnings per

² Kieso, D. E., J. J. Weygandt, and T. D. Warfield. 2001. *Intermediate Accounting*. New York: John Wiley and Sons, p. 952.

share over the last decade. If the company buys back 9,100 shares at the beginning of the next fiscal year, earnings per share for that year will \$3.30—a 10 percent growth rate, even though net income remains the same.

Table 2.1. Earnings Management through Stock Repurchase

	Current Year	Next Year
Earnings		
Earnings	\$300,000	\$300,000
Rate of earnings growth	10%	0%
Earnings per share		
Shares before and after buyback	100,000	90,900
Earnings per share	\$3.00	\$3.30
Rate of growth in earnings per share	10%	10%

