Creative Accounting: Unethical Accounting and Financial Practices Designed To Boot Earnings and To Meet Financial Market Expectations

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Abstract

This paper discuses financial shenanigans and earnings management and what motivate managers to engage in unethical financial practices. This paper explores the role accounting standards play in the creative accounting practices by the corporate manager. The excessive financial scandals and earnings restatements in recent years has left many investors questioning whether reported earnings can ever be free of management manipulation. ***The*** *author looks at the role accounting rules and standards, auditors and external factors play in earnings management and revenue recognition****. T****he paper finds that some of the improprieties relating to earnings management stems from an outdated accounting standards, complex corporate financing arrangements, preservation of executive compensation incentives and corporate pressure to meet earnings projection. It is apparent that managers have a strong interest in the corporate bottom line and the managers can choose accounting policies from a set of policies from Generally Accepted Accounting Principles (GAAP) to meet or beat the market expectation, it is natural that the management would choose policies that will help them achieve their objectives. Statement on Auditing Standard (SAS) No 82 distinguishes fraud from error on the basis of whether the underlying action of management that results in misstatement of financial statement is intentional or unintentional. Security Exchange Commission Staff Accounting Bulletin ((SAB) No 101 provides specific guidelines for revenue recognition. Firms go as far as they can to recognize revenues that lack economic substance. International Accounting Standard Board (IASB) IFRS 15 and US Based Financial Accounting Standard Board(FASB) ASU 2014-09 published a new revenue standard. The new standard is as a result of a convergence project between the two Boards.*

1. Introduction

The role of Securities and Exchange Commission (SEC) and Financial Accounting Standard Board (FASB) and International Accounting Standard Board (IASB) is to establish the Generally Accepted Accounting Principles (GAAP)and improve standards of financial reporting for the guidance and education of the public which includes issuers of financial statements, auditors, and users of the published financial information. Transparency in financial reporting is of the essence because individuals, potential investors, creditors and regulators make investment decisions based on firms published financial reports. Recent events in the economy coupled with scandals have raised questions about transparency and disclosure practices of some firms. One of the stumbling blocks is the seemingly diverse component of the standards, interpretations and the application of the standards. FASB issues standards that are difficult to read and understand and create tendency to compromise when finding a solution to difficult accounting problem because the attempt to compromise can lead to the use of judgment. Grover (1992) states that some big corporations are taking advantage of accounting rules to improve their economic outlook these firms are taking big write-offs so that in the future they can add some of that reserve to their operating income if their initial write-off was too large. Dean (1993) postulates that corporate interest influence many of the FASB standards, along with its funding and membership. He suggests that one way to make FASB to update accounting standards and regulation is to make Securities and Exchange Commission (SEC) responsible for appointment of board members.

The publicized accounting fraud by Qwest, Enron, Worldcom, HealthSouth, Global Crossing, Adelphia, Tyco etc generated media frenzy on abuses in the application of accounting rules by corporate managers to boost earnings within the confine of the Generally Accepted Principles (GAAP). The Government Accountability Office (GAO) report expresses concern on corporate accounting improprieties that begun to surface in the late 1990's and is critical of the number of publicly held firms that restated their financial statement. The GAO reports noted that the number of firms that restated their earnings are on increase and alarming. The report also states that the publicly held companies that restated their financial statements increased by 147% from January 1997 through June 2000.

The GAO report listed four factors that caused firms to use questionable practices: 1) Corporate pressure to meet earnings projections and thus maintain stock prices during and after the market expansion of 1990's. 2) Perverse executive compensation incentives. 3) Outdated accounting and rule based standards, and 4) Complex corporate financing arrangements. The GAO postulates that based on the number of financial re-statements as of June 30, the GAO expects increase in restatement to exceed 170 percent by the end of the year. In response to earnings manipulation that goes on in corporate arena, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin No 99 (SAB 99) which declares that the principle-like qualitative standard that would govern financial statement. The Committee on Capital Market Regulation report in 2006 criticized SAB 99 as vague. They argue that the qualitative standard of financial reporting requires assessments of a wide range of factors which includes subjective motivation for financial misstatements, and is directed at the problems of manipulation the result from a rule like quantitative standard. Aggressive corporate managers could give a sudden pinch to their earnings at will to meet market expectation. The Committee on Capital Market Regulation recommends that the Securities and Exchange Commission revises its guidance on materiality for financial reporting as it was traditionally defined in terms of a-five-percent of pretax income threshold. The qualitative and quantitative standards are breeding ground and manifest a blank check for earnings management and manipulation. A sharp decline in stock prices in 2001, slight recovery in September 2001, and a prolonged drop that began 2002hits it lowest ebb is a reflection of deterioration of market price related to the numerous reports of corporate earnings management schemes

Earnings Management and Manipulation

Earnings management is an outright accounting fraud practice designed by management to record bogus, inflated, revenue, and earnings smoothing to meet earnings projections, financial market, and analyst expectations.

Earnings management has a negative impact on earnings quality and dilutes the transparency of financial reporting. The flexibility, limitations, and inconsistencies that are built into Generally Accepted Accounting Principles (GAAP) have given the managers the latitude of making accounting decisions that will drive revenue results. Earnings management practices involving restructuring costs, creative merger and acquisition accounting, and reserves are very difficult and challenging for financial accounting information users to detect. Investors judge corporate managers harshly when the firms do not meet the pre-determined earnings expectation. The stock price of the firms who did not meet the earnings expectation tend to decline, therefore, to steer stock prices higher some management engage in a variety of earnings manipulation. Stanley and Waldron (2007) earnings management is a deliberate action taken within GAAP to bring about desired earnings outcomes. They argue that GAAP is rule based, but the wide latitude flexibility that exist in its application, and many subjective judgments and assumptions must be made in determining accrual-based earnings. Brown (1999) notes that it is precisely this latitude, flexibility, use of judgment, and subjectivity in applying GAAP that allow earnings management to flourish. Pitman (2001) defined earnings management as the use of 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 judgment. The former SEC Chairman, Arthur Levitt Jr., states that earnings management is generally pursued with five accounting practices such as the big bath, restructuring charges, creative acquisition accounting, cookie jar reserves immaterial misapplications of accounting principles, and the premature recognition of revenue.

Desai (2005) states that the corporate profits are the measurement that is central to capital allocation within the economy and to a variety of economic policy decisions. He argues that investors infer a company's prospects and value from reported earnings, adjusting portfolio decisions in response to changed estimates and aggregate corporate profits are often employed to forecast overall stock market.

Under performing firms may be tempted to use questionable accounting techniques to boost earnings to meet market expectations, if undetected might mislead and confuse potential investors, creditors, and other users of financial statements. Earnings manipulation occur when management use judgment in financial reporting and structuring transactions to alter financial report to make earnings appear higher than they actually are. The underlying economic performances of the company are masked to mislead or influence contractual outcomes that depend on published financial statements. Schipper (1989), Lev (2003) classified earnings manipulations into three overlapping categories: personal gain, continuation of investors/suppliers support, and satisfying contractual agreements. He argues that in some cases managers manipulate earnings for personal gain because a large portion of executive compensation (stocks and stock options) is typically linked directly or indirectly to earnings. Healy (1985) documented an upward trend in earnings management and manipulation when pre-manipulated earnings fell within the bonus bounds of the company, and a downward trend of earnings manipulations when pre-manipulated earnings fell outside the bonus bounds, presumably to shift the “saved” earnings to future periods when they would have an impact on the bonus. Lev (2003) report that in 1990’s accounting scheme helped to inflate Xerox’s stock price so that the executives could cash in $5 million in performance based compensation and more than $30 million from stock sales. He argues that Xerox stock rose to more than $60 per share in mid 1999, the period which SEC says that the Xerox’s executive were manipulating earnings before the stock price fell to less that $4 per share in 2000. Jordan, Clark and Waldron (2007) state that one of the reasons why firms manage or manipulate earnings is to meet market expectations or forecasts by analysts. They argue that the companies that meet or exceed earnings expectations enjoy the benefit of higher stock prices and earnings per share relative to companies that do not meet earnings expectations.

Glaum, Lichtblau, and Lindeman (2004) also indicate that that management manipulates earnings to increase their own wealth through bonus schemes tie to earnings. Brown and Higgins (2001) earnings management occurs as management seeks to enhance share-price performance because of the resultant benefit accruing to them from their stock-based compensation packages. Church at el (2001) note that earnings-based bonus plans and restrictive debt covenants can create economic incentives for managers to manipulate earnings.

They argue that the objective of such behavior is to maximize the present value of bonus income and maintain compliance with debt covenants. Such behavior may involve the use of discretionary accruals and accounting changes, it may also be affected through deliberate, non-GAAP manipulations of financial data (Church, at el., 2001). Schipper (1989) states that financial statement manipulation can be divided into two separate into two separate but often blurred categories: earnings manipulation and earnings management. He argues that the distinguishing characteristic between manipulation and management is somewhat subjective but it is generally seen as a technique(s) used in preparing financial information that is either misleading or inaccurate. The difference according to Schipper in 1989 can rest in whether the technique used might fall within or outside the requirements and recommendations provided Generally Accepted Accounting Principles. Goel and Thakor (2003) earnings smoothing is a special case of earnings management involving inter-temporal smoothing of reported earnings relative to economic earnings; it attempts to make earnings less variable over time. They distinguish two types of earnings smoothing (artificial and real smoothing) and argue that real smoothing involves the changing the timing of cash flows from investments and providing promotional discount and provide financing to risky customers to boost sales. On the other hand artificial smoothing involves the use of flexibility afforded by the Generally Accepted Accounting Principal to attain desired sales level. Jackson and Pitman (2001) argue that earnings management represents purposeful intervention in the financial reporting process with the intent of obtaining personal gains.

Arthur Levitt the former chairman of SEC, states that “the practice of management of earnings should be abolished for the sake of our markets; for the sake our global economy which depends so much on the reliability of America’s financial system; for the sake of investors; and for the sake of a larger commitment not only to each other, but to ourselves A version of earnings management that has become far more common in recent years is the reporting of ‘pro form earnings’ measures. These measures are called or referred to as operating earnings; a term with no generally accepted definition. The pro forma earnings statements are calculated ignoring certain expenses such as restructuring charges, stock-options expenses or write-down of assets from continuing operations. Ross (2005) points out that the corporate executives are allowed to use judgment to determine amounts reported on accounts that greatly affect resulting financial information.

The 70-year old development GAAP has produced a set of principles, not hard-and-fast rule, which allow judgment to be exercised when measuring the effects of company events. Management believes that by ignoring these expenses, a clearer picture of the underlying profitability of the firm will emerge. Stanley and Waldron (2007) state that earnings management can be accomplished because the determination of accrual earnings under GAAP is subject to numerous estimate and judgments in accounting policy choice Statement of Financial Accounting Standards (SFAS) No 143. There is so much leeway for choosing what to exclude or include that it becomes hard for investors and analysts to interpret the numbers across firms. The lack of clearly defined standards gives management leeway to manipulate earnings. GAAP allows firms considerable discretion to manipulate earnings. David and Geoff (1991) notes that, it is precisely this subjectivity in applying GAAP that allows earning management to flourish in firms. In the late 1990's Kellogg took advantage of the flexibility in accounting rules and capitalized its restructuring charges over three years which are supposed to be treated as ordinary expense or period costs.

Jackson and Pittman (2001) argue that there is a growing concern in the investment community that certain practice of earnings management are eroding public confidence in external financial reporting and impeding efficient flow of capital in financial market. In September 28, 1998 in a Number Game Speech, the former SEC Chairman, Arthur Levitt Jr., expressed his concern that failure of corporate managers to provide meaningful and representative financial information on their financial statement erodes not only the trust between stockholders and the company, but also threatens our economy with subsequent price fluctuations. He states that too many corporate managers, auditors and analysts are participants in a game of nods and winks. Later in his speech he emphasizes concern for the American Economy, and argues that the current culture among the corporate managers, auditors, and analysts and their credibility has been called into question**. *He calls*** on independent auditors to lead the crusade to prevent deceptive accounting practices because of their in-depth knowledge of accounting and reporting matters but also have access to audit committee and the board of directors responsible for scrutinizing a company‘s decision makers. He expressed his fear of witnessing erosion in the quality of earnings, and therefore, the quality of financial reporting, and uniformly agreed accounting misrepresentations, which ensues among them, undermines the integrity and the number one position of the American financial market in the world. Levitt believes that the earnings management game negatively influence the accuracy of company's financial statements will eventually, if not addressed soon yield to the erosion of faith in capitalism as a viable solution to the efficient allocation of resources in our societies.

Leonard, Peter, and Lorraine (2004) state that a forensic audit conducted by PricewaterhouseCoopers reveals that HealthSouth Corporation's cumulative earnings were overstated from $3.8 billion to $4.6 billion.

According to the report issued January 2004 HealthSouth acknowledged that the forensic audit discovered at least another $1.3 billion in fraudulent financial report in addition to the previously estimated $2.5 billion. Predicated on the forensic findings the Securities and Exchange Commission (SEC) charged HealthSouth and its Chief Executive Officers with accounting fraud. The SEC's complaint alleged that HealthSouth had systematically overstated its earnings by at least$1.4 billion since 1999 and U.S. Justice Department used the information obtained from HealthSouth executives to uncover another $1.1 billion of overstated earnings (Leonard, Peter, and Lorraine 2004).

Following the demise of Enron and other corporations, the US accounting profession is rushing to restore confidence to the investing public. In late October 2002, FASB issued a proposal for public comments on a principles-based approach to accounting setting, this might improve the quality and transparency of financial reporting. The FASB Chairman Robert Herzsays FASB is committed to improving U.S. financial accounting standards. Chairman Robert Herz states that "Many believe that moving to a broader or more principles based accounting standards as those used in other parts of the world would facilitate better reporting in the United States" Quinn (2003).argues that Principles-based approach to accounting could reduce the comparability of financial information and leave too much room for judgment by companies and auditors. Standard of Auditing Standard (SAS) No. 82 requires auditors to specifically assess risk of material misstatement from fraud. SAS No. 82 states that the auditor has the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by error or fraud. SAS No 82 distinguishes fraud from error on the basis of whether the underlying actions of the corporate managers that result in a misstatement of financial statement is intentional or unintentional.

Accrual Based Earnings

SAB 101 provides the criteria for revenue recognition, income statement presentation and requires disclosures concerning revenues in financial statements. Revenue recognition principle requires that two criteria be satisfied before revenue is recognized. 1 The earning process is judged to be complete or virtually complete. 2. There is reasonable certainty as to the collectivity of the asset. Stated alternatively revenue can be recognized only after the earning process is virtually complete and collection from the customer is reasonably assured. Revenue recognition guidelines by nature could be controversial and strictly adhering to the criterion would violate the overriding objectives of revenue recognition principles in the period revenue generating activities of the company are performed. On May28, 2014 the Financial Accounting Standard Board (FASB) and International Accounting Standard Board (IASB) jointly adapted a converged accounting standard on Revenue Recognition. The new Revenue Recognition guidelines replaces nearly all previous US GAAP and International Financial Reporting Standard (IFRS) guidelines that require significant flexibility and changes in the way US companies recognize revenue in their financial statements. The new revenue recognition standard requires that companies across all industries use a new five step model to recognize revenue from customer contract. The new standard requires any company or business that enters into a contract with customers to transfer goods or services into a contract for the transfer of nonfinancial assets, unless the contract are within the scope of other standards. The new standard International Accounting Standard Board (IASB) IFRS 15 and US Based Financial Accounting Standard Board (FASB) ASU 2014-09 is as a result of a convergence project between the two Boards. Russell Golden, the Chairman of the FASB states that the new revenue recognition standard represent milestone that will eliminate a major source of inconsistency in the GAAP, which currently consist of numerous desperate industry-specific pieces of revenue recognition guide. In 2009 General Electric (GE) settled accounting fraud with Securities and Exchange commission in which its accounting staff worked diligently to conceal the negative impact its inability to meet predetermined earning projections would have in its financial statement. On April 4, 2009 GE settled the accounting fraud charges for allegedly misleading investors with improper hedging accounting revenue recognition scheme by accelerating revenue recognition from its locomotive and aircraft spare part business. On December 18, the SEC charged Digital Media Company and its three executives for their role in an accounting fraud that artificially inflated the company revenue and misstated its operating income to the investors. Green (2003) notes that understanding when revenues are recognized is the first step to comprehending the quality of the revenue stream. He argues that revenues of the highest quality are those that are recognized after the customer has received, accepted, and paid for the product or services without any further performance requirements or contingency. The SEC chairman, Arthur Levitt identified revenue recognition guidelines as a popular way for companies to manage earnings primarily prematurely. He argues that premature revenue recognition reduces the quality of reporting earnings, particularly, if those revenues never materialized.

Davis (1989) remarks how Memorex struck a deal in early 1970's with Independent Leasing Corporation for the sale of some computer equipment; Memorex quickly reported the sale in its nine month earnings statements of September 30. On December the president of Memorex wrote the stockholders asking them to revise theirearnings per share downwards from $1.64 to $0.97 because financing for the deal had fallen through and Memorex reported earnings of $3 million in revenue from sales that did not materialized. In the 1980's large oil companies such as Texaco and Occidental used the full-costing method to boost earnings by capitalizing the current costs(period costs) that should have been expensed**.** Qwest communications incorrectly accounted for more than $1.1 billion intransaction between 1999 and 2001 (Green 2003). Corporate executives tend to believe that by manipulating earnings and presenting fraudulent financial report to meet predetermined level of earnings would increase firm value, earnings per share, market price per share and favorable bond rating. This may have short term effect but on the long run, it will have an exact opposite effect on firm value etc. Sarbanes-Oxley Act examines the role of board of directors in constraining earnings management.(Klein 2002). Sarbanes-Oxley Act enacted provisions that deal with the rules governing corporate governance in general and the board of directors in particular that should likely constraint earnings manipulation. Sarbanes-Oxley Act reiterates the importance of ensuring that financial statements are free of material misstatements due to error or fraud. The Sarbanes -Oxley Act is the most sweeping regulatory reform since the creation of SEC in 1943.

The Act mandates the SEC to regularly and systematically review the disclosures of companies that have securities on a national securities exchange, and particularly those firms that have issued material restatements of financial results or those that have experience significant volatility in their stock price as compared to other listed companies. The Act also mandates that each periodic SEC financial statement report should be accompanied by a written statement by issuer's Chief Executive Officer and Chief Financial Officer certifying that the report fully complies with the 1934 Act and that information contained in theperiodic report "fairly presents, in all material respects, the financial condition, and results of the issuer". Public Company Accounting Oversight Board (PCAOB) notes in the alert that misstatement of revenue is a common ploy in many financial fraud cases. According to PCAOB a 2010 report of a- ten-year study by the Committee of Sponsoring Organization of the Tradeway Commission (COSCO)of Accounting and Enforcement Action by Security Exchange Commission found that 61% of347 cases involve gaming or fabricating revenue, the most common method used to improve the appearance of financial statements.

Fama and Jensen (1983) argue that separating the positions of chief executive officer and the chairman of the board would improve board monitoring and organizational performance by providing an independent check on the chief executive officer position. They further state that firms that have the same person holding these two positions are less likely to have effective monitoring which reduces the likelihood of constraining earnings manipulation. Visvanathan (2008) reports that much attention has been focused upon the role of the board of directors and audit committees, in overseeing the activities of corporate executives in particular instances of earnings manipulations. Management can significantly alter the earnings to deceive the investors and Wall Street that earnings or certain financial goals have been met. Visvanathan (2008) says that much of the attentions are focused on accrual type earning management such as aggressive revenue recognition, misstatement of inventories and accounts receivable. Spiceland, Sepe, Nelson and Tomassini (2009) state that receivables should be recorded at the present value of accounts receivable of future cash receipts using realistic discount rate or interest rate.

However, because the difference between present and future of accounts receivable often is immaterial, therefore APB 21 excludes accounts receivable from the general rule that receivable be recorded at present value (Spiceland, at el 2009). They argue that accounts receivable initially are valued at the exchange price agreed upon by the buyer and seller. Ross (2005) states that in many cases of fraud, companies try to manage their appearance by inappropriately reporting fictitious revenue and by failing to report to report expenses as they occur. The author argues that without egregious transgressions, companies can take full advantage of two types of legitimate latitude, operational freedom and reporting freedom accorded them by the Generally Accepted Accounting Principles.

The infamous Enron, a natural gas trading company, used varieties of accounting techniques such the mark –to-market, structured financing vehicles and special purpose entity. Enron employed mark to-market accounting technique to recognize revenue. Mark-to-market is defined as the act of assigning value to as asset based on its present value or current market value of future cash inflows. Enron would recognize revenue using the present value of future cash flows of long-term contracts the company signed and matched the expense and using the present value of future cost. Enron reported unrealized gains and losses in the market later on as part of earnings as they occur. Structured financing was utilized by Enron to hedge against credit risk, interest risk and liquidity risk exposures. Enron failed to report the varieties of the structured financial vehicles in its financial statements which were designed to permit Enron to recognize the financial benefits of the structured finance immediately even though the federal income tax benefits would not occur until significantly over into the future. Structured finance is a form of securities securitization in which corporations and financial institutions package assets, loans, and mortgages into a standardized securities backed by those assets, loans or mortgages which can be traded like any other securities. The corporation and financial institutions act as servicing agents for the securitized assets.

Conclusion

Firms use earnings management to inflate profits, therefore manipulates market price, boost credit rating and management financial performance. Understanding earnings management is important to the accountants and auditors because it helps in understanding of usefulness of earnings to the users of financial information.

It may also assist accountants to avoid some of the serious legal consequences that may arise if the when the firms become financially distresses Earnings management undermines earnings quality, erodes transparency in financial reporting and misleads users of financial statements. Financial shenanigans tend to breed freely in an environment in which no check and balances exist among senior managers when outside board of director slacks the skills to protect investors, and also when the auditors fail to detect signs financial misappropriations and reporting infractions. The financial reporting problems exist because the Financial Accounting Reporting Standard Board (FASB) have not kept up with changing business arena and the standard allow for use of judgment. The reporting problems can be classified as recognition or measurement problems.

Companies who fail to meet market expectations are penalized by the market. They see their stock price drop precipitously. They are victims of market reaction for not meeting expectation. Some of the accounting improprieties related to earnings management are not perpetrated by the corporate managers alone, in-house accountants, Chief Financial Officers and Independent Auditors played vital roles in earnings management. The actions of Wall Street official also contributed to the problem by lobbying for the Private Security Act of 1995. The act that made it more difficult to sue executives and auditors for fraud. Financial market tend to disregard big non-operating charges by the management thereby creating an avenue for mangers to take big charges and in the circumstance manipulates earnings. To combat earnings management practices schemes, the Management and the Board of Directors should investigate if the expectation about the firm from the financial market, and the analyst are realistic.

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