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The Naughty List or the Nice List? Earnings Management in the Days of Corporate Watchdog Lists

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Institute of Management Accountants
10 Paragon Drive, Suite 1
Montvale, NJ, 07645
www.imanet.org/thought_leadership

About the Authors

Erin L. Hamilton, Ph.D., CPA, is an assistant professor of accounting and EY Faculty Fellow at the University of Nevada, Las Vegas. She received her Ph.D. in business administration from the University of South Carolina and her master of science in accounting and bachelor of business administration in accounting from Kent State University. She is a Certified Public Accountant in Ohio.

Rina M. Hirsch, Ph.D., CPA, is an assistant professor of accounting at Hofstra University. She received her Ph.D. in business administration from the University of South Florida, master of accountancy from Florida Atlantic University, and bachelor of commerce in accounting from Concordia University. She is a Certified Public Accountant in Florida.

Uday S. Murthy, Ph.D., is the director of the Lynn Pippenger School of Accountancy and Quinn Eminent Scholar at the University of South Florida. He received his Ph.D. from Indiana University, master of business administration from Drexel University, and bachelor of commerce from the University of Poona. He is a chartered accountant in India.

Jason T. Rasso, Ph.D., CFE, is an assistant professor of accounting at the University of South Carolina. He received his Ph.D. in business administration from the University of South Florida and master of accountancy, BSBA in accounting, and BSBA in management from the University of West Florida. He is a Certified Fraud Examiner.

Introduction

Earnings management is the act of manipulating company earnings (such as through the use of aggressive accounting techniques) in an attempt to achieve a personal or companywide goal. It's something that likely occurs on a relatively frequent basis at many publicly traded companies; however, views differ quite considerably regarding the ethicality of such behavior. While some may view the intentional manipulation of company earnings as akin to fraudulent financial reporting, others believe that using the discretion allowed within U.S. Generally Accepted Accounting Principles (GAAP) to achieve earnings goals is simply part of doing business and appeasing shareholders.

Public perceptions of earnings management are particularly important in today's environment, given that the public now has access to various technologies that can be used to assess the aggressiveness of a company's accounting choices. Given the increasing ability to detect earnings management, today's managers must consider how their accounting decisions may be perceived by the public. To this end, we set out to understand how the possibility of being included on a corporate watch list (i.e., a public list that identifies companies engaged in more aggressive accounting practices) influences managers' decisions to engage in earnings management. We distributed a survey to managers of publicly traded companies who have considerable financial reporting experience. We found that:

- Managers engage in more aggressive (income-increasing) earnings management when they believe such behavior will not be revealed publicly.
- The prospect of being included on a corporate watch list changes managers' accounting choices. When managers fear inclusion on a watch list, they are *less* likely to engage in aggressive (income-*increasing*) earnings management and *more* likely to engage in conservative (income-*decreasing*) earnings management.
- Managers generally view earnings management as unethical (particularly income-increasing earnings management), but frequently engage in such behavior despite these beliefs.
- Managers give considerable thought as to how their aggressive accounting choices might be perceived by others (such as investors, regulators, and auditors).

Taken together, these observations suggest that managers are less likely to engage in aggressive earnings management if they believe such behavior may cause their company to be placed on a corporate watch list. The reduction in earnings management is something that could theoretically improve earnings quality (particularly from a stakeholder perspective), but may also reduce managers' willingness to use accounting discretion for functional purposes like signaling private information. On the positive side, making more conservative accounting decisions increases a company's chances of being placed on a list of trustworthy companies, which could result in a public perception that the firm is ethical and honest in its accounting choices. In the following sections, we provide detailed results from our survey as well as suggestions regarding the types of accounting practices that managers should avoid if they don't want their companies to be "flagged" publicly for engaging in aggressive accounting behavior.

Earnings Management Strategies and Ethicality

Earnings management can take many forms, but it's typically divided into two broad categories:

1. Accruals-based earnings management, where the discretion allowed within GAAP is used to manipulate company earnings, and
2. Real earnings management, which involves making operational or financing decisions to achieve certain earnings outcomes, even though these decisions may harm company operations.

There are various reasons why a corporate manager may choose to engage in earnings management. Some of these reasons are more justifiable than others. In fact, it may sometimes seem that manipulating company earnings is the "appropriate" or "ethical" thing to do given the circumstances. For instance, imagine being the CFO of a company that has struggled over the past few years to meet analysts' earnings forecasts and to pay hardworking employees the bonuses they deserve. It appears that this year your company's earnings are on track to meet or exceed analysts' forecasts and trigger employee bonuses. At the last minute, though, an important sale falls through. As the CFO, you know that failing to meet analysts' expectations will harm shareholder value, while failing to pay employee bonuses once again will harm employee morale. In such a scenario, many managers would argue that the ethical thing to do would be to find a way to boost company earnings. After all, isn't it the job of management to protect the interests of shareholders and company employees? Perhaps there's an accounting standard that could be interpreted a bit more aggressively to accelerate the recognition of revenue, or the sale of outdated equipment that is currently in process could be delayed until next year to avoid the loss that would occur.

Regardless of the approach used (see Table 1 for examples of various earnings management techniques), it's clear that individuals have very different views regarding the ethicality of earnings management. Many parties have weighed in on this debate. Regulators have cautioned companies against engaging in earnings management, arguing that such practices are unethical as they skew a company's "true earnings" and mislead the investing public. Others view the discretion inherent in reported earnings as a valuable tool that can be used by managers to incorporate their private information and company-specific circumstances into accounting transactions, thus making financial statements more informative for users. Still others have argued that earnings management falls along a continuum with less egregious and more justifiable methods at one end of the spectrum (for example, interpreting an accounting standard in a more aggressive manner) and outright fraud at the other, with many activities falling somewhere in between.

Table 1: Earnings Management Techniques
Accruals-based Earnings Management
• Manipulate the timing of revenues and expenses (for example, recognize revenue before goods are shipped or defer expense recognition)
• Inappropriately capitalize expenses (for example, interest on construction projects or repair and maintenance expense)
• Create "cookie jar reserves" (for example, over-accrue the allowance for bad debt in a "good year" and then reduce the reserve and corresponding expense in future periods to boost income)
• "Big bath phenomenon" (i.e., take actions to further reduce earnings in a "bad year" to achieve higher earnings in subsequent periods)
• Interpret accounting standards more aggressively than is warranted to accelerate revenues and/or defer expenses
• Decide when to adopt a new accounting standard (i.e., early adoption vs. waiting until adoption is required) based on its earnings effects
• Use discretion in accounting estimates to achieve higher earnings in certain periods (for example, through the choice of depreciation method, salvage value, or useful life)
• Classify items based on their earnings effects (for example, reclassify a trading security as available-for-sale to prevent an unrealized loss from being reported in net income)
Real Earnings Management
• Incentivize customers to purchase more product at year-end than they otherwise would (for example, by cutting prices or offering sales discounts or more lenient credit terms)
• Decide when to purchase or sell assets based on the earnings effects that will result (for example, to avoid recording depreciation on a new machine, avoid a loss on the sale of an investment, or achieve a gain on sale)
• Delay hiring employees to avoid recording various employee-related expenses in the current period
• Reduce or postpone research and development activities, advertising expenses, or discretionary selling, general, and administrative (SG&A) expenses purely to boost income
• Increase production to build up excess inventory and reduce cost of goods sold (COGS) by spreading fixed costs over a larger number of units, thus reducing the cost per unit

Given the frequency with which earnings management seems to occur in corporate America, company stakeholders may actually *expect* managers to engage in such behavior. In a 2013 survey, CFOs estimated that approximately 20% of firms manage earnings in a given period and that the typical size of these manipulations is approximately 10% of reported earnings.[1] If the perception is that "everyone else is doing it," then managers may feel they

[1] Ilia D. Dichev, John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal, "Earnings Quality: Evidence from the Field," May 7, 2013, http://dx.doi.org/10.2139/ssrn.2103384.

are at a disadvantage if they choose not to engage in such behavior. Given that earnings management resides in a gray area of the ethics continuum, we need to gain insights into the practice of earnings management, specifically understanding when managers would choose to engage in earnings management and when they would not.

Earnings Management When No One Is Watching

For many years, company stakeholders have only had a limited ability to gauge the extent of earnings management taking place within companies. Managers have been relatively free to engage in earnings management without having to worry about the practice being publicized. After all, it's easier to act in a manner you may feel is unethical if no one can call you out on your behavior.

A commonly used benchmark of whether an action is right or wrong is to answer the question, "Would you want this action publicized in the news?" If not, then don't do it. We conducted a survey to put this benchmark to the test and gain insights into the practice of earnings management.[2] One hundred twenty-two managers of publicly traded companies, with an average of 8.2 years of experience making financial reporting decisions, completed our survey. The survey put the managers in charge of a hypothetical company preparing to issue its quarterly financial statements and gave them the ability to engage in earnings management. Some of the managers were told that their company's unaltered earnings per share was set to beat analyst expectations, while others found that the earnings per share would fall below analyst expectations. To perhaps no one's surprise, approximately 90% of the managers who were told that their company was about to report earnings that would miss analysts' forecasts chose to engage in income-increasing earnings management (see Figure 1). Approximately 64% of the managers *beating* analyst expectations decided to increase earnings even without an explicit incentive to do so (see Figure 2).

[2] See the Appendix for additional information about survey procedures and participant demographics.

Figure 1: Earnings Management Decisions When *Missing* Analysts' Forecasts and Actions Not Publicized

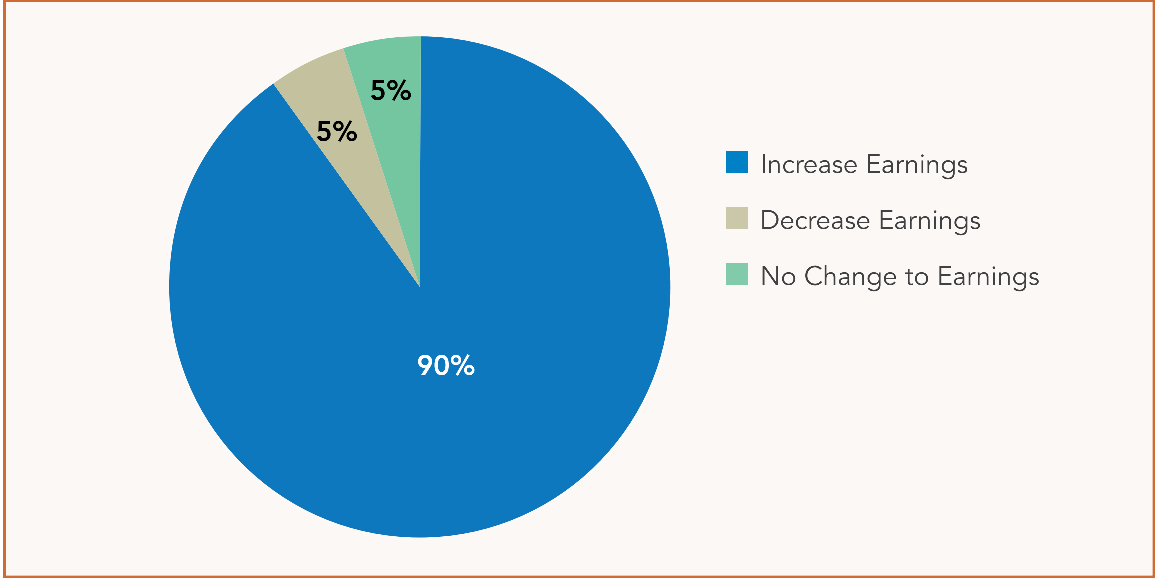
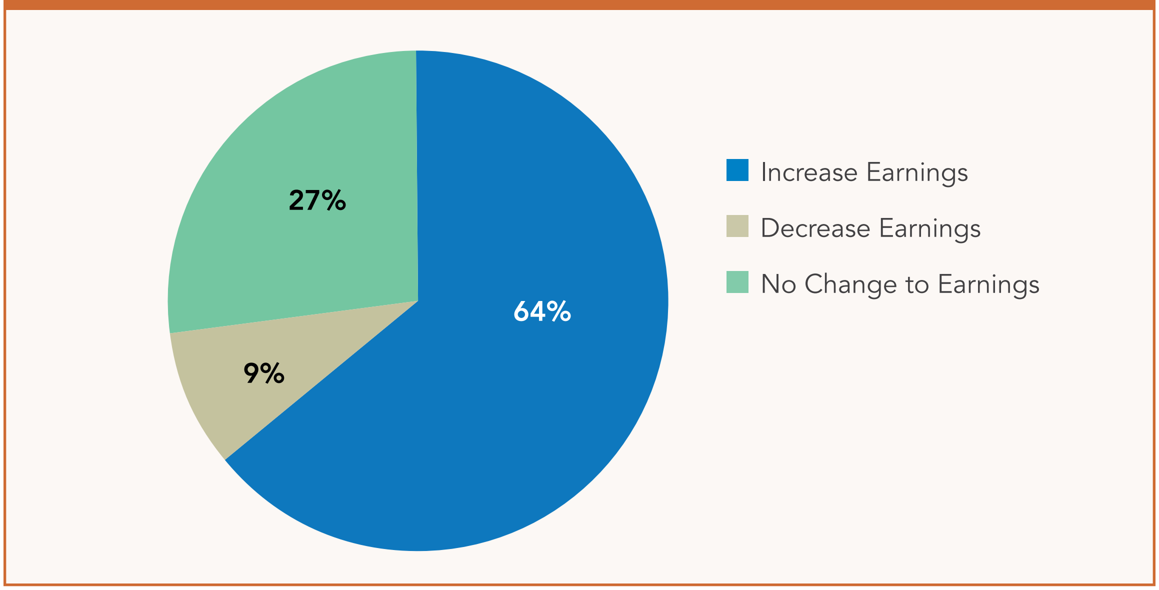
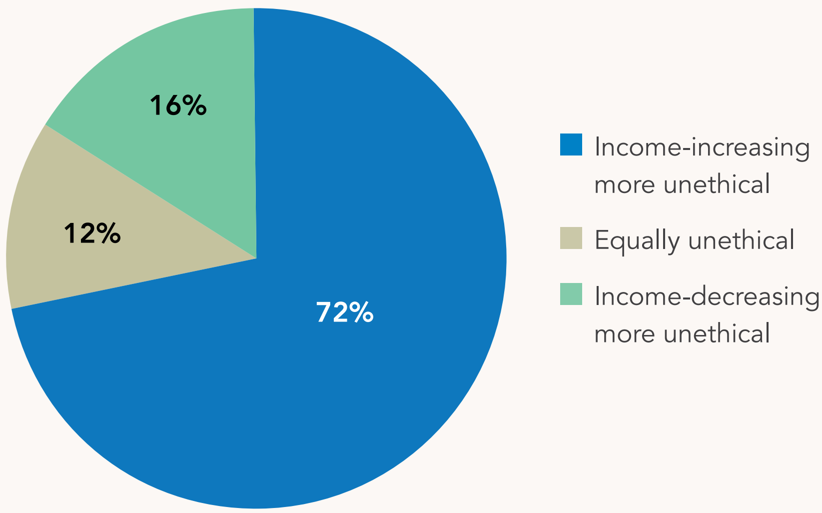


Figure 2: Earnings Management Decisions When *Beating* Analysts' Forecasts and Actions Not Publicized



Thus, a high proportion of managers chose to engage in earnings management. It would seem they either do not view earnings management as unethical or are able to justify this behavior despite perceiving it as unethical. To clarify this point, we asked the managers to rate the ethicality of earnings management on a scale ranging from 1 to 8, where 1 = not morally right and 8 = morally right. The average response to this question was a 2.8, suggesting that managers generally view earnings management to be relatively unethical. Furthermore, managers predominantly expressed the belief that income-increasing earnings management is more unethical than income-decreasing earnings management, as illustrated in Figure 3.

Figure 3: The Perceived Ethicality of Income-Increasing and Income-Decreasing Earnings Management



The results of the survey so far suggest that, despite perceiving earnings management as relatively unethical, the majority of managers will engage in some amount of earnings management when they believe that their actions will not be observed. What happens, then, when managers do believe that their accounting choices will be revealed to the public?

Earnings Management When the Public Is Watching: Inclusion on a Watch List

In recent years, the ability of company stakeholders to gauge the extent to which companies employ aggressive accounting practices has increased. New technologies, such as online investment tools, now make it possible for investors, creditors, regulators, and others to obtain information regarding the aggressiveness of a company's accounting choices and compare the accounting practices of one company to others in the same industry. For example, Audit Analytics, an independent research firm, developed the Accounting Quality + Risk Matrix, an online investment tool that can be used to screen companies for "indicators of potential earnings management and other accounting quality issues." Another commercially available investment tool is the Accounting and Governance Risk (AGR) score, which was originally developed by GMI Ratings and is now offered by MSCI Inc.[3] The AGR score is a summary

[3] GMI Ratings was acquired by MSCI Inc. in 2014. MSCI subsequently renamed GMI Ratings' AGR score the "Accounting Risk Metric." Further details are available at www.msci.com/esg-ratings.

measure that reflects the risk associated with a company's financial reporting and corporate governance practices. AGR scores have been used to compile watch lists of companies with the most aggressive accounting practices, for example, the *Forbes* Corporate Risk List and GMI Ratings' "Risk 50 List," as well as lists of companies that are the most conservative or trustworthy, such as the *Forbes* list of "The 100 Most Trustworthy Companies in America."

To better understand how AGR scores are determined and what kind of information these scores provide, we obtained a white paper by GMI Ratings (before it was acquired by MSCI) that describes how AGR scores are used to classify companies into one of four possible categories based on their level of accounting aggressiveness: very aggressive, aggressive, average, and conservative.[4] Companies move from very aggressive to conservative as their AGR scores increase, with AGR scores ranging from 1 to 100. According to the paper, approximately 10% of all companies are classified as very aggressive, 25% are aggressive, 50% are average, and 15% are conservative.

All of the metrics used in calculating an AGR score come from publicly available information, such as company financial statements. The metrics are classified into two broad categories: governance risks and accounting risks. Governance risks include risks associated with corporate governance (such as late filings, class action lawsuits, and officer changes) and high-risk events (such as divestitures, mergers and acquisitions, and restructuring). Accounting risks consist of risks associated with revenue recognition (for example, ratios such as accounts receivable over sales, operating revenues over operating expenses, and unusual income over revenues), expense recognition (such as ratios like cost of goods sold over revenues, inventory over cost of goods sold, and accounts payable over operating expenses), and asset-liability valuation (such as asset turnover, cash ratio, and working capital over assets). Approximately 55 metrics are used to determine a company's AGR score, and about two-thirds to three-quarters of these metrics are strictly accounting ratios.[5]

Regulators have also started using analytical tools to identify companies most likely to be engaged in aggressive accounting practices. One example of this is the Accounting Quality Model (AQM) from the U.S. Securities & Exchange Commission (SEC). To identify companies most likely to be engaged in earnings management, the tool screens for companies with large discretionary accruals and those whose accounting practices don't align with those of their industry peers. The SEC intends to use this tool to identify high-risk companies that may warrant further investigation.

Given the increasing ability of company stakeholders to detect earnings management through the use of technology and published watch lists that identify risky companies, today's

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[4] GMI Ratings, "The GMI Ratings AGR Model: Measuring Accounting and Governance Risk in Public Corporations," 2013. This white paper was originally retrieved from www3.gmiratings.com/wp-content/uploads/2013/11/gmiratings_AGR3.0Whitepaper_102013.pdf. This link is no longer active, and the information in the white paper is not available on MSCI's website. While we can't be certain if the same metrics are used today, we have no reason to believe these inputs have changed.

[5] The 2017 *Forbes* list of "The 100 Most Trustworthy Companies in America" can be found at www.forbes.com/sites/karstenstrauss/2017/04/07/the-100-most-trustworthy-companies-in-america-2017/#517b649b4b17.

managers must consider how their accounting decisions may be perceived by stakeholders and the general public. To investigate whether managers behave differently in this type of environment, we put some of the managers in our survey into a situation where aggressive, income-increasing earnings management would place their companies on a watch list and put them at risk of an SEC investigation. Similar to the first scenario, we gave some of these managers an incentive to engage in earnings management by telling them that their companies' earnings currently do *not* meet analysts' expectations for the period, while others were told their earnings exceeded analysts' expectations.

Recall that when managers believed their earnings management behavior would not be observed by the public, approximately 90% chose to engage in income-increasing earnings management in an effort to meet or beat analysts' earnings forecasts. In contrast, we find that when managers are told their aggressive (income-increasing) earnings management behavior will cause their company to be included on a watch list of aggressive companies, only 47% of managers decided to engage in such behavior (see Figure 4). This significant 43% difference suggests that the fear of having their aggressive accounting behavior observed by stakeholders decreases the managers' desire to engage in earnings management.

To further explore the extent to which managers would go to avoid being placed on a watch list, we also gave the managers in our survey the ability to engage in income-*decreasing* earnings management to reduce the chance that their company would be placed on the watch list. Our reasoning was that accounting decisions that decrease earnings should be viewed as more conservative and, thus, would be much less likely to be flagged as aggressive. Of the managers who believed their company was at risk of being placed on the watch list and at risk of *missing* analysts' earnings expectations, 37% chose to engage in income-*decreasing* earnings management even though this would further decrease their company's earnings (i.e., the analyst forecast would be missed by a larger amount). These managers appeared to fear the consequences of being included on a publicly available watch list more than they feared the consequences of missing analyst expectations.

Furthermore, when managers in our study were told that their company was *beating* analyst expectations but it appeared the company would be placed on a watch list, approximately 71% chose to engage in income-decreasing earnings management in an effort to appear less aggressive (which is much higher than the 9% who made this decision when there was no risk of being included on a watch list). Interestingly, the desire to avoid inclusion on a watch list led to one-third of the managers in this environment to decrease their earnings so much that they no longer met analyst expectations (see Figure 5). In general, there is a drastic reduction in aggressive (i.e., income-increasing) earnings management behavior and an increase in conservative (i.e., income-decreasing) earnings management behavior when managers fear their actions will be publicized.

Figure 4: Earnings Management Decisions When *Missing* Analysts' Forecasts and Actions Publicized (via Inclusion on a Watch List)

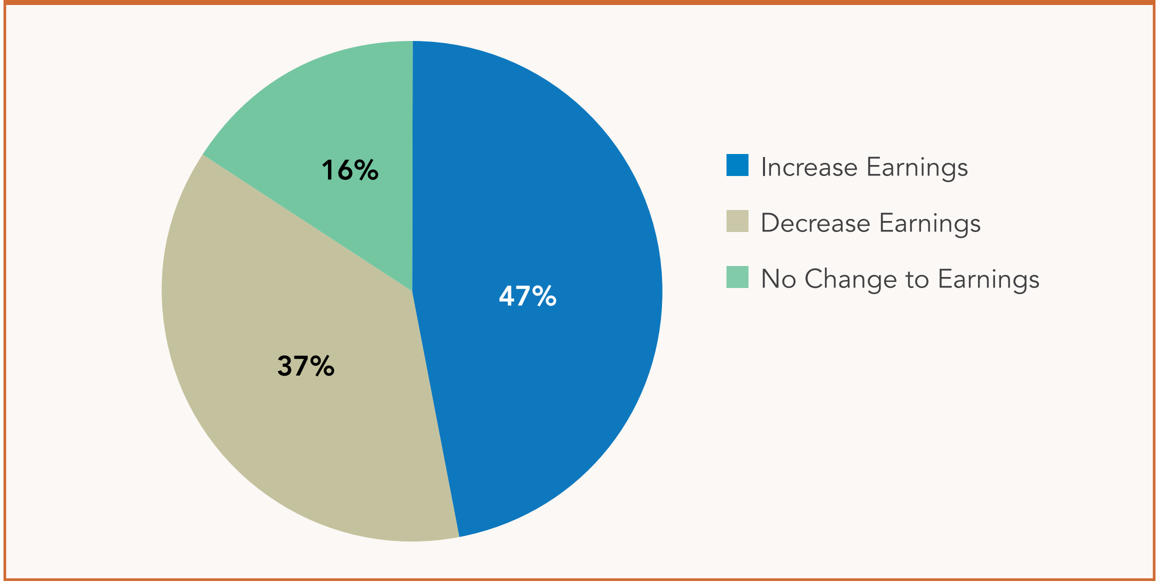
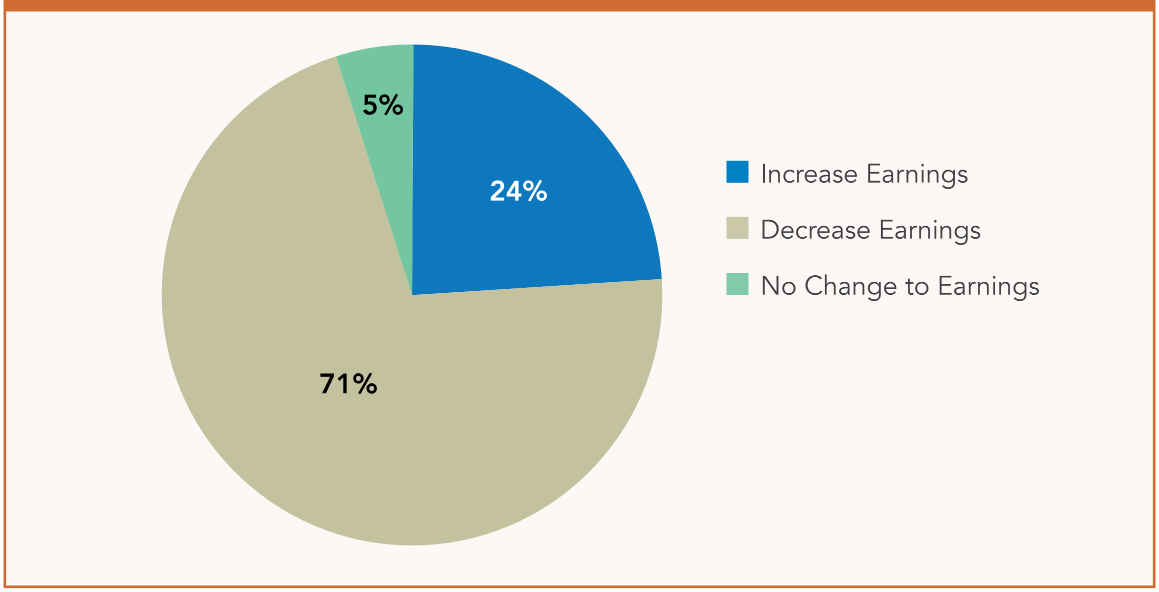


Figure 5: Earnings Management Decisions When *Beating* Analysts' Forecasts and Actions Publicized (via Inclusion on a Watch List)



The Naughty List or the Nice List?

As children, we're often told to be wary of our behavior around the holidays to ensure we are classified as "nice" as opposed to "naughty" and will reap the rewards of our good behavior. Similarly, managers appear to moderate their aggressive accounting behavior when they believe their behavior will be observed and evaluated by the public. Yet what are the disincentives ("punishments") managers anticipate from being included on a watch list? To obtain some insight into this question, we asked the managers in our survey to describe what they believe the negative outcomes would be if their company was included on a watch list that identifies companies engaged in aggressive (or potentially fraudulent) accounting practices. The consequence most frequently cited was the damage that would be done to the company's reputation. Other frequently cited consequences include damaged shareholder perceptions, loss of trust, negative stock market reactions, and damaged relationships with customers and suppliers. See the results in Table 2.

Table 2: Consequences of Being Included on a Watch List

(N = 122 financial reporting managers)

Negative Consequences of Being included on a Watch List of Aggressive Companies	Percentage of Managers Citing this Consequence	Sample Participant Quote
Damage to company reputation	22.1%	"It would harm our reputation and negatively impact our ability to attract investors."
Shareholder perceptions of company would be negatively affected	19.7%	"It would be less attractive to investors. The pillars of our brand would be undermined in the public's eye."
Loss of trust in company	16.4%	"Shareholders and our clients would not have the same level of trust (and faith) in us that we will do the right thing."
Negative stock market reaction (e.g., stock price decline, selling of shares)	15.6%	"Decreased investors/analyst trust. Resulting share price declines."
Damage to customer and vendor perceptions of (and relationship with) company	13.9%	"People would be less likely to do business with us."
Increased scrutiny/oversight (in general)	4.9%	"More scrutiny from all parties (creditors, analysts. etc.)."
Increased scrutiny/oversight by regulators	3.3%	"You would open yourself up to more attention from the SEC about possible fraud."
Increased scrutiny/oversight by auditors	1.6%	"Ding to credibility; heightened auditor scrutiny."
Employee perceptions (and retention) would be negatively affected	1.6%	"Would potentially show that the company is manipulating the books and would have an adverse affect on the company in the view of stockholders and employees."

Consistent with some of the concerns expressed by managers in our survey, other research has found that companies typically face severe stock market declines when faced with allegations of accounting fraud (such as by the SEC or the business press).[6] This suggests that investors lose confidence or trust in companies when the ethicality of their accounting practices is called into question. For example, several years ago, fraudster Barry Minkow alleged that Lennar Corporation, a home builder based in South Florida, was committing fraud. Based solely on Minkow's allegations, Lennar's stock lost $500 million in value. Minkow knew that the decline in stock value would happen, and his scheme was to short-sell the stock in anticipation of the decline. Lennar's stock eventually regained its value after authorities uncovered Minkow's scheme, but this example shows just how much a single allegation of fraud can affect a company. We posit similar effects might occur for companies being placed on a corporate watch list that identifies companies most likely to be engaged in aggressive and/or fraudulent accounting practices.

How to Avoid Being Flagged

Given what we know about existing accounting risk metrics, here are some suggestions for how corporate managers can avoid receiving an "aggressive" AGR score, avoid being flagged by the SEC's AQM or Audit Analytics' AQRM model, and increase their likelihood of making it onto *Forbes*' "100 Most Trustworthy Companies in America" list:

- Be aware of the accounting practices and ratios considered typical or average for your industry. Risk metrics flag companies that employ practices and ratios different than those from their peers.
- Avoid unusual fluctuations in account balances and financial ratios when compared to prior periods.
- Avoid abnormal levels or changes in discretionary accruals (such as sales return allowance, allowance for doubtful accounts, and reserve for inventory obsolescence) when compared to prior periods and industry peers.
- Avoid onetime adjustments (such as changes in accounting estimates and out-of-period adjustments).
- Avoid late filings, restatements, material weaknesses, and unusual changes in audit fees.
- Avoid abnormal levels of share repurchases and issuances of debt or equity.
- Avoid CEO and CFO turnover and excessive levels of executive incentive compensation as a percentage of overall compensation.
- Avoid accounting policies that result in relatively high reported book earnings while at the same time selecting alternative tax treatments that minimize taxable income.
- Avoid off-balance-sheet transactions.

[6] For example, the most recent Committee of Sponsoring Organizations (COSO) fraud report indicates that the initial news of an alleged fraud results in an abnormal stock price decline of approximately 17% in the two days surrounding the announcement within the business press. See "Fraudulent Financial Reporting: 1998–2007" by Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, available at https://www.coso.org/Documents/COSO-Fraud-Study-2010-001.pdf.

Implications for CFOs

Our survey found that managers are more willing to engage in income-increasing earnings management when they believe they can do so without being observed. This tendency toward aggressive accounting decreases when managers believe their accounting decisions will be revealed to the public (via inclusion on a watch list). In fact, managers are even willing to *decrease* their company's earnings by making overly conservative accounting decisions (i.e., income-decreasing earnings management) in order to avoid being placed on a watch list—even if that behavior will cause the company to miss the analysts' earnings forecast for the period.

Based on these results, it appears that the decision to engage in earnings management involves a trade-off between the incentive to meet the earnings expectations of stakeholders and the incentive to avoid appearing overly aggressive. Managers indicated that when both incentives are present, they are more concerned with avoiding the appearance of engaging in aggressive or fraudulent accounting practices. These findings suggest that earnings management behavior is largely contingent on the extent to which the public is able to detect such behavior through the use of investment tools, company watch lists, and other means. Specifically, the more observable a company's accounting practices are to the public, the less likely managers are to engage in aggressive (or potentially fraudulent) financial reporting.

In this report, we have also provided information to make corporate managers aware of the kinds of technologies that exist for evaluating and comparing companies' accounting practices and how these technologies work. Specifically, we documented several of the metrics used to calculate accounting risk metrics (such as AGR scores) as well as several activities that managers should avoid in order to achieve a score indicative of more conservative, trustworthy accounting practices. Being aware of the types of activities that may cause a company to be flagged as aggressive may give managers pause when considering one of these "high-risk" activities. Managers interested in being included in a list of trustworthy companies can increase their chances by using the information we provided to avoid high-risk activities and select more conservative accounting practices. Managers should keep in mind, however, that some of the events that negatively impact accounting risk metrics (such as issuance of debt or equity, officer changes, and large fluctuations in account balances) simply occur in the normal course of a business. As such, it isn't always possible for managers to avoid the appearance of aggressiveness. Nonetheless, managers should consider how their accounting choices may be perceived by the public because, in today's environment, someone is always watching.

Appendix: Participant Demographics and Survey Procedures

Survey participants were recruited using Qualtrics Panels, and the survey was administered online in July 2015 using the Qualtrics platform. To qualify for the study, participants needed to work for a publicly traded company; hold a mid-, upper-, or executive-level management position; and have experience making financial reporting decisions. A total of 122 qualifying managers participated in the study. Participants had an average of 15.2 years of management experience and 8.2 years of experience making financial reporting decisions. Approximately 40% of participants had earned a graduate degree. Additionally, 39% of participants had majored in accounting or finance, 25% majored in a business area other than accounting or finance, and 13% held an MBA.