International accounting issues

Business, Accounting

1. Executive Summary:

Due to the global business expansion, management opportunities have grown and enhanced each day and issues and abuses have occurred. Therefore, I will try to explore how Earning Management works withinfinanceand, will relate it with the principles of accounting. According to the IASB, there are many ways escape and create opportunities. Throughout my study I will present how a total impact is made, by explaining the different accounting standards and by relating them to Earning Management.

2. Earning Management:

Earning Management is the practice of producing financial accounts that suit a particular purpose without really showing the true and fair views. Sometimes the accountant might want to show profits which are favorable e. g. to get a bonus, and sometimes losses e. g. to pay less tax. At other times the accountant may wish to show a healthy balance sheet e. g. to get a bank loan, whereas at other times an unhealthy balance sheet e. g. before a management buy-out to get a bargain. Various types of definitions have been produced to explain Earning Management as a special form of ‘’design’’ rather than ‘’principled accounting’’.

2. 1 Definitions ofEarning Management:

Earning management is also referred to as income smoothing, earnings management, earnings smoothing, financial engineering and cosmetic accounting. Definitions of earning management vary, and include the following:

‘ Is any action on the part of management which affects reported income and which provides no true economic advantage to the organization and may in fact, in the long-term, be detrimental’. (Merchant and Rockness, 1994)

‘ Involves the repetitive selection of accounting measurement or reporting rules in a particular pattern, the effect of which is to report a stream of income with a smaller variation from trend than would otherwise have appeared’.(Copeland, 1968)

2. 2 Motivations for Earning Management:

Why earning management comes into beingHow can earning management come into beingIn this part motivations of the appearance of creative accounting will be worked over.

To Show Growth Trends:

Generally companies prefer reporting steady trends of growth in profit rather than showing volatile profit with series of dramatic rises and falls. Making unnecessarily high provisions for liabilities and against asset values in good years is achieved so that the provisions can be reduced thereby improving reported profits in bad years.

Directors Bonuses:

In most cases, bonuses of the management of the company are based on profits, so the higher the profit the higher the bonus or, if a certain level of profit is achieved only then the bonus is payable. Directors and employees have an incentive to use earning management practices in an effort to maximize the bonuses received when such bonus schemes are tied to reported earnings.

Manipulating Share Price:

Creative accounting may help maintain or boost share price, both by reducing apparent levels of borrowing, making the company appear subjected to less risk, and by creating the appearance of a good profit trend. By doing so the company is able to raise capital from new share issues, offer their own shares in takeover bids and, resist takeover by other companies.

Financial Problems:

The business needs additional financing; that is, it requires a loan or aspires one at a favorable rate. Normally, less risk perceived by the lender leads to lower interest rate charged. High reported earnings, high assets, low liabilities and high shareholder equity amounts accompanied by high earnings, convey the impression of improved credit quality as well as, high debt rating to a lender, or bond investor. As a result, creative accounting practices used to improve reported financial measures can lead to lower corporate borrowing costs.

Insider Trading:

If directors engage in ‘ insider dealing’ in the shares of company , they can then use earning management to delay the release of information for the market enhancing opportunities to benefit from inside knowledge.

3. Abuses of Earning Management and International Accounting Standards:

In most cases where earning management is done, accounting policy choice and application simply fall within the range of flexibility inherent in international accounting standards, and GAAP. Whilst it can be argued that

the manner in which the accounting policies is employed are largely a function of management judgment , in most cases this judgment results in the biasing of reported financial results and position in one direction or another. It presses the envelope of what is permitted under IAS and GAAP, although it remains within boundaries, and it is not fraudulent financial reporting.

At some point, a line is crossed and accounting practices being employed move beyond boundaries of IAS and GAAP. Financial statements that result are not considered to provide a fair presentation of a subject company's financial results and position once the line is crossed, and adjustments become necessary. Here are some common abuses and the particular international accounting standard.

3. 1 Revenue Recognition (IAS 18):

Faced with the slow growth, a company may overstate operating revenues by recognizing them too early . For example if item issued to distributers on a ''sale or return'' basis are recorded as sales (even though they may be returned) this will inflate sales and profits.

Since the sales have not yet been paid for, this will also increase the receivable figure in balance sheet. The increased receivable figures (longer debt collection period) is one way that analysts may be able to spot this kind of manipulation. The receivable figure tends to increase over time until the manipulation is discovered. Other examples include holding the books open and continuing to record shipments that clearly belong in subsequent periods and recording sales without the shipment of goods. If reported profit

is significantly higher than the operating cash flow for the period, this may be another indicator that profits are being overstated.

Sybase's shares dropped an additional 20% when the company reported improper practices at the Japanese subsidiary, which Sybase said included booking revenue for purported sales that were accompanied by side letters allowing customers to return software later without penalty.

The accounting standards dealing with this (principally IAS 18) has prescribed the criteria to decide when revenue should be recognized:

In case of goods, that ownership has genuinely been transferred; that the economic benefits and risks of ownership lie with the buyer.
The revenue that seller gains must be measurable.
The costs of supplying the goods or services can be measured.
It is probable that the revenue will be received.
The completion stage of partially completed contract of services can be determined.

According to IAS 18, the notes to the accounts should explain the revenue recognition policy. Although new rules and regulations imposed by IASB and other accounting bodies have improved the situation, revenues remain one of the most easily manipulated numbers in the accounts.

3. 2 Unusual Assets (IAS 16/38)

Capitalizing expenditure involves posting transactions to the fixed assets in the Balance Sheet rather than the expenditure section in the Profit & Loss or by amortizing capitalized amounts over extended periods. If the true and fair

view would be to post it to the expenses then to post it to fixed assets (i. e. to capitalize it) could be classed as earning management . Result of this would be that both the profits and asset values will be inflated.

In the case of WorldCom, a large us telecommunication business, it was alleged that operating profits had been overstated by treating certain operating expenses, such as basic network maintenance, as capital expenditure during 2001 and 2002. To correct this overstatement , net profit had to be reduced by $ 3. 8 billion.

Under IAS 16, costs such as servicing should be treated as an expense and should be recognized in the income statement. Subsequent expenditure should be capitalized only if it results in an enhancement of economic benefit beyond those previously recognized.

A common charge seen at the time of the combination oftechnologyfirms is a charge for purchased in-process research and development. As the name suggests, purchased in process R&D is an unfinished R&D effort that is acquired from another firm. It might be an unfinished clinical study on the efficacy of a new drug or an unfinished prototype of a new electronics product.

According to IAS 38, if the acquired R&D has an alternative future use beyond a current research and development project, the expended amount should be capitalized. Capitalization also would be appropriate for purchased in process software development, a form of R&D, if the software project has reached technological feasibility.

3. 2 Profit Smoothing (IAS 37)

Income smoothing refers more specifically to the preference of reporting steadily rising profits. A form of earnings management designed to remove peaks and valleys from a normal earnings series, including steps to reduce and " store" profits during good years for use during slower years. For example, deliberately not disclosing a contingent liability, or significant going concern problems, in the notes to the financial statements means that the disclosures required (under IAS 37 and IAS 1 respectively) have intentionally not been made.

From the preceding examples, it can be seen readily why earnings management is also known as income or profit smoothing. It is because the practice of earnings management often is designed to produce a smoother earnings stream, one that suggests a lower level of earnings uncertainty and risk.

Earnings at General Electric Co. (GE) have grown steadily for decades. It is tough to expect such a smooth and growing earnings stream. Certainly the diverse nature of the company's product and service mix provides a diversification effect that yields a more stable earnings stream. Beyond its product and service diversification, however, the company has in the past demonstrated a willingness to take steps that appear to manage its earnings to a smoother series. Analysts, noted that GE is " certainly a relatively aggressive practitioner of earnings management."

Sometimes in a bad year a company may decide to write-down assets in a wholesale fashion. Earnings expectations have not been met. The implicit

view is that there will be no additional penalties for making the year even worse. By writing down assets now, taking a “ big bath,” as it is called—the balance sheet can be cleaned up and made particularly conservative. As such, there will be fewer expenses to serve as a drag on earnings in future years.

3. 3 Change in accounting Policy (IAS 8):

Another way of earning management is through a firm’s selection of the accounting policies it employs in the preparation of its financial statements or in the manner in which those accounting policies are applied. The companies involved are simply using available flexibility in accounting principles.

It does not mean that the applicable financial reporting framework has not been followed. It may be that the manipulation of published figures is the result of selecting an accounting policy which is allowed under the financial reporting framework, but which does not reflect economic reality. For example, changing the estimated life of a non-current asset is allowed under financial reporting standards, but if it is done purely to manipulate the depreciation charge (and therefore earnings), then it becomes an example of earnings management.

IASB in international accounting standard 8 has prescribed the criteria for selecting and changing accounting policies together with the disclosure and accounting treatment of changes in a reporting entity’s accounting policies, accounting estimates and corrections of errors. An enterprise may voluntarily change the accounting policy only if believes that the change will

improve the presentation of the financial statements. An enterprise discloses any change in accounting policy that has a material effect in the current period or is reasonably expected to have a material effect in later periods. It should also disclose, to the extent ascertainable, the amount by which any item in the financial statements is affected by a change that has a material effect in the current period. Where the enterprise is unable to ascertain the amount with reasonable efforts, the fact should be disclosed.

Entities must adopt consistent accounting policies for similar transactions unless an IFRS/IAS requires a more specific policy to be adopted. Entities are only allowed to change an accounting policy if it is required by an IFRS or IAS; or, it results in financial statements providing more reliable and relevant information about the effects of transactions on the entity's financial position, performance or cash flows.

3. 5 Off Balance Sheet Financing (IAS 1):

" Off balance sheet financing" is when debt financing is not shown on the face of the balance sheet. This allows a company to borrow without calculations being affected of measures of indebtedness such as gearing. Motives for this may be to mislead investors and remain within the terms of debt covenants. It may also sometimes be a side effect of the method for raising capital chosen therefore, it is probably best to be suspicious of the motives for raising debt in a manner that is not visible to investors. As standards have caught up with loopholes that allowed off balance sheet financing.

The scope for off balance sheet financing has reduced over the years which in the past have included leasing and borrowing through special purpose vehicles.

Conclusion and Recommendations:

It is a difficult task for the regulators to cope with earning management. They need to update the rules to control earning management on one hand, allow flexibility and promote thecultureof voluntary disclosure on the other hand. The danger of over regulation is that companies will assume it is the regulators’ responsibilities to ensure transparency rather than their own. By a mixture of regulations aimed at special abuses and more fundamental accounting and auditing standards that require the application of the spirit of the law rather than merely the letter, regulators have been successful in eradicating many of these practice.

It is to be stated that the impact of creative and fraudulent accounting can be reduced by streamlining the accounting and auditing system and more effective corporate governance. Earning management can be reduced by:

1. Introduction of forensic accounting for white collar fraud detection and fraud prevention;

2. Minimizing the alternative choices of accounting treatment in accounting standards;

3. Enhancing the quality of corporate governance;

4. Amending Companies Act;

5. Enforcing strong regulation, and

6. Increasing the effectiveness of audit.

References: