Enron case

Business

Question I Give definition of earning management. Discuss in what instances is earnings managementacceptable and in what instances is it not acceptable.

Before defining what earnings management is, it is important to understand the meaningof earnings first. Earnings are the profits of a company. Investors and analysts look to earningsto determine the attractiveness of a particular share. Companies with poor earnings prospectswill typically have lower share prices than those with good prospects. Remember that acompany’s ability to generate profit in the future plays a very important role in determining ashare’s price. Earnings management may be defined as reasonable and legal management decisionmaking and reporting intended to achieve stable and predictable financial results.

Referred toFinancial Accounting Theory book, third edition wrote by William R. Scott, earningsmanagement is the choice by a manager of accounting policies so as to achieve some specificobjective. So, it is not surprise that company management has an interest in how they arereported. The manager of the company needs to understand the effects of the accountingreporting that they reported so they can make the best decision on behalf of the company. In addition, earnings management is a strategy used by the management of a companyto deliberately manipulate the company’s earnings so that the figures match a pre-determinedtarget. This practice is carried out for the purpose of income smoothing.

Thus, rather thanhaving years of exceptionally good or bad earnings, companies will try to keep the figuresrelatively stable by adding and removing cash from reserve accounts. So, the financialstatements of the company will be seen smoothly over the years with the smooth earnings or net profits. The reasons for many companies using earnings management within the company arewhether to maintain steady earnings growth or to avoid reporting in losses. So, people useearnings management in different ways and with different degrees of appreciation to cover their variety of activities, whether the activities are acceptable or not acceptable. The earningsmanagement is not be called as not acceptable activities if the activities not manipulate financialstatements and report results that do not reflect economic reality. In other word, the earningsmanagement will be not acceptable if it misrepresenting financial results.

Some earnings management can be classified as acceptable and some can beclassified as not acceptable. The instance of acceptable earnings management is advertisingexpenditures, which generally should be expensed when incurred, may be accelerated in thefourth quarter if the company is exceeding its earning target or deferred if it is failing to meet thattarget. Other than that, it particularly involves accounting estimates and judgments, inconformity with generally accepted accounting principle (GAAP). For example, theimplementation of a decision to enhance the company’s collection activities may be acceptablein supporting the reducing of estimate bad debt expenses. These are acceptable managementdecisions that affect reported earnings whose consequences are accounted for in conformitywith GAAP. For not acceptable earnings management, the instances are the management inflatedfigures for cash and bank balances to increase the revenue of the company.

Other than that, themanagers whose financial statements reflect any of the activities that may be committing fraudeven if they do not think of their actions as earning management not acceptable activities. Itincludes recording unavailable sales, backdating sales invoices, failing to properly recordexpenses and overvaluing assets. In other word, the not acceptable earnings management isthe activities that committed fraud