Essay on earnings management

Business, Management

At a basic level, It Involves allocating the right Inventory to the right customer at the right price. This is also known as yield management. In the Indian context application of revenue management can be seen in many fields: * Travel and Tourism: * Advance purchase of tickets offered by airlines * Weekend discount by hotels * Attack service by Indian Railways Different tariffs charged by power generation and distribution companies * Software companies Revenue management has been named as the " number one emerging business strategy' by the Wall Street Journal.

Application of managementsciencemodels based on linear programming has improved the contribution to profit for a major steel company (Data Steel) in India by $73 million In 1986-87 and given a cumulative Earnings Management It covers a wide variety of legitimate and illegitimate actions by management that affects the earnings of a company. It is strategy used by the management to elaborately manipulate the company's earnings in order to smooth earnings over two or more interim or accrual accounting periods or to achieve a designated earnings level to meet security analysts' forecasts.

Companies prefer to smooth earnings in contrast to having years of exceptionally good or bad earnings. It includes legitimate discretionary choices of when to enter into transactions that require accounting recognition, adding a product line, selling a division, decreasing expenditures. For example, implementation of a decision to enhance the entity's credit and collection activities may legitimately support reducing the estimate of bad bet expense. Abusive earnings management is deemed by

the Securities & Exchange Commission to be " a material and intentional misrepresentation of results".

This is the case when the management circumvents GAP in an effort to influence reported earnings. Accounting records may be falsified, all the legal liabilities may not be reported, and fictitious transactions may be entered. In many cases, leadershipis responsible for employing techniques to manage and smooth earnings. It should however, be noted that earnings management that constitutes fraud is distinctly different from earnings management perceived to reduce the laity of earnings.

While the pure-fraud cases are to be dealt with through criminal law, issues such as earnings management are also to be dealt with through stringent provisions securities regulation and corporate governance norms. The current evidence indicates a greater incidence of the former type of cases rather than the latter, but beyond a point the distinction between the two gets somewhat blurred (as in Satyr's case) and hence caution must be exercised to prevent both types of occurrences. A major area of concern regarding practice of earnings management is the effect it has on destabilize the stock markets.

Motives The major drivers which motivate the management to resort to techniques of earnings management may be discussed as follows: * Achieve targeted results * Emphasis on quarterly reporting * Analyst recommendations * High expectation of shareholders * Performance based pay and stock options * Pressure on Board of Directors and top management to showcase their leadership Instruments Some common techniques of

revenue management are described below: * Vendor Financing Vendor financing occurs when a company loansmoneyto a company to a customer to purchase goods from the company.

The result is increase in sales revenue on the income statement and an increase in notes receivables on the Balance Sheet. The increase in revenues improves earnings and the related ratios that have operating industries such as telecommunications. For example, in early 2000, Motorola loaned more than $ 2 billion via vendor financing to Titles, a Turkish telecommunication company. Subsequent to the financing, Titles defaulted on the principal and interest payments, forcing Motorola to write off the receivable and recognize a loss.

The concern here is that financial analysis and subsequent decisions made about a many based on the current period revenues and earnings are immediately distorted. * Booking a Sale before its time Another way of increasing revenues is to record sales in the accounting records before they are earned. One technique is stuffing the sales channel. Managers ship inventory to customers and recorded the corresponding revenues in spite of clauses of returning the goods without cause beyond year end. Another commonly used technique is to record the sale and leave the delivery date open for the customer.

Not reducing sales for promised rebates is yet another instrument of revenue management. Revenue can also be increase by shipping and recording as a sale goods delivered on consignment. Companies in the service industry frequently resort to revenue management. Software support and

maintenance contracts, engineering updates, equipment maintenance contracts, and other may call for a long term agreement between the service provider and customer. In order to increase revenues a service provider may record as revenue the entire or a substantial portion of the contract in the first year.

Many internet retailers and advertising agencies use the gross method of recording revenues. Under the gross approach, revenues collected and the cost of the ticket are recorded separately, thus creating an appearance of high revenue business. Earnings are generally managed by selecting the amount and time period an expense is recorded on the income statement. Commonly used techniques may be describes as follows: * Cookie Jars This is a technique where managers selectively record or fail to record certain expenses on the income statement, using an offsetting Balance Sheet account (cookie jar) to absorb the impact on earnings.

This technique is employed on one or more expense categories. Such as bad debt expense, inventory write downs, warranty expenses, sales return, depreciation and others. For example in periods of low earnings, the amount recorded as bad debt expense may be reduced and in periods of high earnings this amount may be increased. The cookie Jar, the allowance for doubtful accounts, simply floats up and down to accommodate the desired expense accrual. The company will rarely report the Justification for changes to the allowance account.

This leaves open the allowance for a doubtful accounts cookie Jar for the executives to manage earnings. * Non Recurring Charges and the Big Bath

The use of non recurring charges is an extension of the cookie Jar concept. It is common for businesses to close plants, reposition operating units, reduce labor counts, outsource non core business functions, and more. The entire amount is recorded as an expense in the current period as a no recurring charge (also known as restructuring charge).

A restructuring reserve account is established as a liability on the Balance Sheet to offset the actual cash payments for restructuring the business, which may occur over one or more subsequent accounting periods. Executives practicing earnings management underestimate these restructuring structuring charges hit the income statement in the current year. Management uses the restructuring charge to establish a restructuring reserve cookie Jar on the Balance Sheet by overstating the current period restructuring expense, thus reducing earnings in excess for the current period.

Off Balance Sheet Financing Off Balance Sheet financing is defined as debt obligations that are not recorded on the Balance Sheet. Although technically, they do not alter the earnings, they do affect they do affect the ratios that use debt in the numerator or denominator. Examples of off Balance Sheet financing include: * Operating Leases Limited Partnerships Anoint Ventures) * Pension Obligations * Receivables that have been factored (sold) Project Methodology Objective To identify the various factors affecting Revenue ; Earnings Management in the Indian IT Industry.

Scope The scope of our study was the 85 listed Indian IT companies with data in the public domain for the last 5 years. Methodology The Discretionary

accruals have been taken as a proxy of earnings management by a number of researchers. Discretionary accruals are calculated as the difference between total accruals and non discretionary accruals. Firms having high investments tend to report more discretionary accruals in their earnings.

The nondiscriminatory component reflects business conditions (such as growth and the length of the operating cycle) that naturally create and destroy accruals, while the discretionary component identifies management choices. The result of pulling discretionary accrual amounts from the total accrual amount is a metric that reflects accruals that are due to management's choices alone; in other words, there appears to be no business reason for these accruals. So, discretionary accruals are a better proxy for earnings quality.

The Modified Seasons Model (1991) has been used in estimating the discretionary accruals: * Net Operating Accruals = Net Income - cash Flow from operations * NOAA/ go + ; 2(Sales - / ATA)+ ; 3(GAPE / ATA)+E * AND/ATA=; O+; 2(Sales - Arc / ATA)+ ; 3 (GAPE / ATA)+E *TAD = ATA-AND/ATA Where, NOAA = Net Operating Accruals ATA = Average Total Assets A Sales = Change in Sales A Rice = Change in Accounts Receivables GAPE = Gross Property, Plant and Equipment AND = Non Discretionary Accruals TAD = Total Discretionary Accruals 3 different models of explaining the Earnings Management were applied and aggression models were generated.

Model 1 The value of the firm depends on its earnings. It represents the value adding services in which the firm is involved. The management

emphasizes a lot on the earnings shown by the company as the stock prices react sharply to the quarterly results posted by a company. Earnings thus become a determinant of the overall value of the firm. Major institutional investors expect a steady flow of dividends. Dividends are also believed to address the issue of agency problem between corporate insiders and outsiders.

Outside investors always prefer dividends over retained earnings because hey fear that retained earnings might be used by insiders for their own benefits against the interest of outsiders. So, firms resort to earnings management to show high enough income for dividend payout. As much the reported earnings off firm are, as much the dividend expected by the shareholders and thus an overall increase in share value. However if dividend payment becomes a constraint for managers, they might manage to show reduced earnings A lot of research has been conducted to determine the nature of relationship between dividends and earnings of a firm.

One view is that dividends can be used as a predictor of earnings whereas another IEEE is that earnings can also be used as a predictor of dividends. The study outlined in the research paper tried to establish the relationship between dividend payout policy and earnings management. The major factors affecting earnings management as identified in this study is stated below: * Dividend Policy: Earnings management is also practices in order to maintain the Dividend Payout ratio as it is considered a signal of the future growth perspectives of a firm in the market. Corporate Governance: Strong corporate governance practices in a country reduce the chances of earnings

management. Legal provisions governing decisions of the company * Presence of outside investor protection limits the chances of earnings management as it confines the abilities and incentives of insider managers to obtain private control benefits * Shareholding pattern: In large corporations where ownership and control rests with afamilyand its members agency problem exists between the management (controlling family) and the minority stakeholders.

In such cases there is ample opportunity for managers to adopt earnings management in order to benefit themselves at the cost of shareholders. * Tunneling: The term kneeling refers to taking away of firm's resources for personal benefits by controlling shareholders. This includes the activities like absolute theft from funds, loan guarantees, selling of assets or products at lower than market prices etc Controlling shareholders, willing to tunnel the firm value, have a very strong reason for earnings management as their prime objective is to hide their private control benefits from outside investors.

Earnings management is intrinsically related to tunneling in an atmosphere where chances of getting control benefits is high and chances to detect hem is low * Other factors which motivate the management to resort to earnings management may b stated as follows: * Valuation for PIP * Rationed share acquisition * Escape from getting deleted * Special treatment * Inside dealing * Manipulation of Stock Prices The control variables used in this model are: * Return on Equity * Size of the Firm * SelfFinanceRatio Size of

the firm is measured as a natural logarithm of the total assets of the firm following Scott and Martin (1975).

Self finance ratio (SF) is the relation between retained earnings and change in capital employed following John and Williams (1985) ND Aimed and Tatty (2009). Regression Equation Data = a + (Tepid) + (Sprit) + ; 3 (Route) + 134 (Size of the Fit) + Pit Where: DIP is dividend payout DAD is discretionary accruals ROE is Return on equity Size of the f is size of the firm. Output Coefficients I Model I Unsubstantiated Coefficients I Standardized Coefficients It I Sigh. 1 B I Stud. Error 1 | (constant) | -. 777 | . 136 | I DIP I-. 163 1. 284 1-. 053 1 I SF 1. 000 1 . Oho | -. 056 I ROE | -. 014 1. 003 | -. 394 I Size | . 166 | . 25 | . 632 a. Dependent Variable: DAD Interpretation of Output | -5. 727 | . Oho -. 576 1. 567 1 | -. 627 | . 532 | -4. 70 | . Oho | 6. 545 | . Oho Size of the firm is positively correlated to earnings management. This signifies that as the firm grows in size, the management has a higher incentive to resort to earnings management The Return on Equity is negatively correlated to earnings management. This implies that firms which are making losses or are generating lower profits have a higher incentive to adopt the techniques of earnings management in order to report a better picture of the financial results of the company.

According to this model, Dividend Payout Ratio and Self Finance ratio are not significantly related to the occurrence of earnings management in a firm. They do not have affect earnings management in a significant manner. Model 2 The level of earnings management also depends upon the corporate structure. So we tried to study the effect of the ownership structure on

discretionary accruals and hence, earnings management. Main dimensions of ownership structure - insiders, institutions and external block-holders. 1.

Insider ownership: There are 2 theories Theory: This theory suggests that shareholdings held by managers help align their interests with those of shareholders. Therefore by this theory discretionary accruals are negatively correlated to earnings management b. Entrenchment Effect: This effect states that high levels of insider ownership can become ineffective in aligning insiders to take value-maximizing decisions. 2. Institutional investors: Effect of Institutional Investors on earnings management can also be explained by 2 theories. A.

Active monitoring hypothesis - This theory states that because institutional investors are better informed than individual investors due to their large-scale development and analysis of private pre-disclosure information about firm, the information asymmetry between shareholders and managers will decline thereby making it more difficult for managers to manipulate earnings. Thus, earnings management and institutional ownership is negatively correlated. B. Passive hands-off hypothesis - Under this hypothesis, the institutional investors are inherently short-term oriented.