

A letter from prison accounting essay



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Computer Associates International, Inc. (CA) is a software company which sells software products for business. In the case, according to the Generally Accepted Accounting Principles, revenues for the software licensing should be recognized once a contract was signed, the software was delivered, and payment was reasonably assured. In Computer Associates, when the revenue recognition principles were met, it recognized the whole value of the licensing revenues quarterly. However, from the fourth quarter of the fiscal year 1988 to the second quarter of the fiscal year 2001, Computer Associates has backdated some contracts and allows its accountants to record these contracts in the present financial statements. In accordance with the Generally Accepted Accounting Principles, these contracts should be recognized in the next quarter. The future revenues which have been recorded in the present financial statements lead to the higher profits and return on investments currently. What Computer Associates does is in the violation of the Generally Accepted Accounting Principles. What Computer Associates has done is a kind of ethical elitism and ethical parochialism. Ethical elitism means that it is significant to maximize the interest of the top stratum or the elite no matter what to sacrifice and the ethical parochialism refers to that it is important to protect the interests of the individual's 'in-group'. The executives of Computer Associates take their effort to recognize the revenues against the Generally Accepted Accounting Principles in order to protect the reputation of the company and meet the analyst's estimation and make the investors confident to the company. However, the investors and shareholders cannot make a good decision by using the improper financial statements.

In the case, as the former senior manager of the Computer Associates, Richards try to defense against the crime which makes him in jail. Richards considers that Computer Associates lacks of the information to justify whether the accounting operation in Computer Associates is legal or not. As to him, it is not a big deal for doing this and it is just a timing issue in the revenue recognition. Nevertheless, the revenue recognition in Computer Associates is against the Generally Accepted Accounting Principles. Computer Associates recorded the future revenue in the current financial statements to make the company seems to be profitable. The main function of the financial statements is to show how the company operates and offer the information about the company to the managers and investors. The financial statements are the tools in helping the managers and investors to make the decision. Computer Associates cloud the investors and shareholders about its accurate sales revenues within the current quarter. By using the inaccurate financial statements, strategies and investment are made incorrectly.

From the Exhibit 4 in the case, the percentages that properly recorded revenue was inflated by improperly accelerated revenue in every quarter from 2000 to 20001 were all above 10%. Moreover, there are large differences between the announced EPS and EPS without improperly recognized revenue in every quarter from 2000 to 2001. The announced EPS were much higher than the EPS without improperly recognized revenue. Comparing to the analyst EPS estimated, Computer Associates cannot reach the analyst EPS estimated without improperly recognized revenue which is mentioned before. In order to make the financial statements more profitable,

Computer Associates use the improper recognized revenue method to make the company seem more profitable. It is unethical for Computer Associates to use ‘allowed accounting flexibility’ for its revenue recognition.

What is accounting flexibility? Accounting flexibility refers to the process that the accountants use their knowledge of accounting rules and standards to manipulate the figures in the financial statement in order to meet some specific purposes. It is about the transformation of the figures in the financial reports from actual figures to the figure which were needed by the preparers, by taking the advantages of the accounting rules and standards. (Naser, 1993). It can help the management to manage the reported figures to be higher or lower. Examples of accounting standards which can use accounting flexibility are as follow:

The revaluation of the assets. While in estimation of the assets’ current value through the depreciation, the estimations are usually made inside the business. It is subjective for the company to estimate the value of the assets. The management has the opportunity to estimate the value on the side of caution or optimism. When doing the estimation in the value of the assets, it refers to the change of the assets, depreciation expenses and the impairment losses. Therefore, the measurement of the assets and income change.

The fair value recognition of the plan asset. According to IASB, fair value is defined as the market-based value. It means that the fair value of the plan asset is on the basis of the market transaction. it can be manipulated. When

changing the fair value of the plan asset, changes will be recorded in the financial statements.

Q2. Richards mentions how difficult it is to operate in the “grey areas of accounting” and indicated that he might have benefitted from more guidance from senior management. Critically indicate who in a listed firm is responsible for the content of the final accounting reports.

Corporate governance is the processes, structures and information which use for coordinating the relations in the management of the corporation. It guarantees the efficiency and the accountability for the mechanism in the corporation to protect the interests of the shareholders. Good corporate governance can help the company to create good corporation culture. The corporation culture creates through the process of the management practices and values which directly come from corporate governance.

As in the company, the responsibilities of the major office holders are as follow:

Implementing the strategy of the company to make the company operation in the healthy way.

Advising the board about the structures of the company and making sure the quality and the quantity of the staff in the company.

Providing the accurate information about the company to the board and making the proper prediction for the company.

Preparing the accurate financial statements within the Generally Accepted Accounting Principles

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In the company, the management should take the responsibility for the accounting reports which is in accordance with the IFRS adopted in Australia. The management should make sure the financial statements are fairly present the financial position and performances of the company. In addition, management must guarantee the financial statements with the accounting standards and prevent them to being fraud. In IFRS 8, management must consider that ‘ the most recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices’. Even though accountants prepare the financial statements in company, the management determines in what ways the financial position illustrate and whether make changes in the financial statements. In conclusion, the management is responsible for the content of the final accounting reports.

In Computer Associates case, as a senior manager, Richards did not take his responsibilities to correct the manipulation of the revenues in the financial statements and applied to the sales-driven culture in Computer Associates. He paid more attention to the sales and the revenues in the company. Therefore, with the support of the management included Richards, the improper revenue recognition method was implemented in the company.

As for me, possible alternatives can be taken as follow:

Changing the accounting policies. The company can use the legal way to manipulate the revenues. For instance, Computer Associates can change the depreciation calculation and change the allocation of the research and

development expenses within the Generally Accepted Accounting Principles to reduce the expenses so that the profits can be higher.

Changing the time of the transactions. It is helpful for delaying the expenses and the anticipation of the income, which will avoid fighting against the law and the accounting standard.

Changing the terms of manipulation. Within Generally Accepted Accounting Principles, some other terms relative to the profits of the company can be manipulated in legal ways. For example, the calculation of the doubtful debts and allowance for uncollectible accounts.

Changing the closing date policy of the sales target. As it is mentioned in the case, the customers use delaying tactics to negotiate with Computer Associates to get the better deal. Large proportions of the contract are booked in the final week of the quarter. That makes Computer Associates hard to recognize these contract in the current period and it makes Computer Associates to backdate the contracts. Changing the closing date policy of the sales target is helpful. Computer Associates can short the period for the sales target. For example, it can be closed monthly so that the contracts can be recognized in time.

Q3. Consider management's incentives and choices in their actions. What are Computer Associate's motivations to manage earnings and the financial ratios as represented in the accounting statements?

Internal motivations

As Richards mentions in the letter, the company culture in the Computer Associates is a ' sales-driven culture'. It means that the more you sell, the more commissions you can get. The culture leads the company to be aggressive in operation. The goal of the company is to make profit as it can so that it can maximize the shareholders' benefits. In addition, the compensations of the executives are on the basis of the sales. The executives would have high compensations when sales associates have reached the goals. According to a study of Massachusetts Institute of Technology in 1983 by Healy, there is a high possibility for choosing and changing accounting procedures in a sales-driven culture with bonus schemes. It is easily to manipulate the accounting figures to maximize the bonus awards. The study also that it is high incidence of voluntary changes in accounting operations in years following the adoption or modification of the bonus reward plan. In Computer Associates, it is so attractive to get the high quantity of compensations by manipulated the revenues. What is more, in Computer Associates, performance in business is a vital criterion. Non-performance is not acceptable in the business. Performance in non-revenue areas should be paid less attentions. In order to perform well, it is reasonable for Computer Associates to manipulate the improper revenue.

External motivations

The main reason for Computer Associates to manipulate the revenues is to meet the expectations of the market. According to the study of Kasznik and McNichols, the consequences of not meeting the expectations lead to lower future earnings, lower share price, lower market premium and penalization

of the markets. Therefore, for Computer Associates, the motivations in order to meet the expectations can be concluded as follows:

Future earnings. It is about the stakeholders. The Computer Associates needs to enhance its reputation in their stakeholders, such as distributors and customers. High earnings in the financial reports make the stakeholders more confident for the company. Therefore, the stakeholders would like to do business with the company.

Share prices. According to the study of Amat, Blake and Dowds, the accounting flexibility can help to boost the share prices of the company and make the company appeared to less risks for the investors. From the Exhibit 4, it is obvious to see that the EPS without improperly revenue recognition is much lower than the expectation. That means the market will decrease the share price for Computer Associates because of the low revenues. In order to change the situation, Computer Associates should manipulate the revenues to meet the expectations to maintain or increase the share price so that the confidence of the investors can be enhanced.

The analysts. As it is mentioned in the case, investors gain information about investments from the analysts instead of the company. The main method which Analysts gather the information about the company is to analyze the financial reports. If the company fails to meet the expectation of the market, the analysts will doubt about the company's future earnings and the credibility. Computer Associates do not want to make the analysts feel doubtful about the company's development so that it tries to manipulate the revenues to meet the expectation of the markets.

Q4. All issues related to revenue eventually affect the calculation and recognition of income. Making specific reference to the Comprehensive Income Project initiated by the International Accounting Standards Board (IASB), carefully outline the concept of income that has been proposed by this project and the major issues highlighted.

According to IASB, income refers to the increases in the benefits in the accounting period in the form of increases of the assets or the decreases of the liabilities which lead to the increase in equity. Comprehensive income is the changes in equity in a period of transactions and other events and circumstances from sources which are not owned by someone. All the changes in equity should be included in comprehensive income while the investment by owners and distributions to owners should be excluded. Comprehensive income is the sum of historic transaction income and unrealized fair value of the other items. For the historic transaction income, it refers to the entity's income during an accounting period which relative to the company's operation. In IFRS 13, fair value is the value which can be received when selling the assets or paying to transfer a liability in fairly transaction between knowledgeable and willingness parties. Fair value measurement defines as a market-based measurement and it is not an entity-specific measurement.

Hard income refers to budgeted income that should be recognized during the operations and soft income is the actual income which recognized after the operation.

In 2004, a Joint International Working Group on Performance Reporting was established (IASB 2004a). It is helpful in Comprehensive Income Project to

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establish the standards of the comprehensive income presentation in financial reports. (IASB 2005b) Comprehensive income requires the entity to present all the items relative to income and expense during the period. One single or two statements are accepted. When the Accounting Handbook 2009 was released, the definition of comprehensive income was published. However, income statement was still useful. Therefore, there is a confusion that as the income statement is useful, it seems the comprehensive income approach is quite inconsistent. The comprehensive income requires all the changes in the revenues and expenses and the disclosure items haven been changed.

Q5. Critically review and provide an overview summary of a minimum of at least two (2) academic research papers that asses the price relevance of comprehensive income. Show how this research may have influenced subsequent releases and changes in focus by the IASB.

In the study of Biddle and Choi, they focused on the debate about the fundamental definition in accounting, the comprehensive income and the consideration of IASB relative to the question. In order to justify those issues, information content, predictive ability and executive compensation contraction were used to examine. The study drew a conclusion that different definition of income makes different decisions and applications and disclosing separately comprehensive income components is useful for making decision. This study is the first study to examine this kind of issue.

Another study which had done by Cahan, Courtenay, Gronewoller and Upton, suggested that, to some extent comprehensive income more value relevant than net income. Nevertheless, when doing the asset revaluation increments <https://assignbuster.com/a-letter-from-prison-accounting-essay/>

and foreign currency translation, the effect of comprehensive income was weak and there was no benefit in reporting the separate components of comprehensive income. In conclusion, as for the authors, in the comprehensive income approach, some information was useless, which lead to the comprehensive income did not really benefit the investors.

As in a study of comprehensive income, Hanlon had the similar opinion with Cahan, Courtenay, Gronewoller and Upton. In Hanlon's study, he mentioned the value relevance of mandated comprehensive income disclosures and discussed whether to choose reported in comprehensive income basis or reported in net income basis. He found that there is no evidence to support the value relevance which would be affected by the comprehensive income. Thus, he suggested that components of comprehensive income were not really value relevant after the controlling for the net income.

From my point of view, after reading three essays above, IASB need to focus more on the uses of comprehensive income which IASB makes the entity to report. There are many differences between the different situations so that it leads to different adoptions. Revenue recognition is quite complex. IASB should do more researches to find out whether to use the comprehensive income approach or not when facing different situations.