

Earnings Management

SEC documents indicate that, in many cases, once the abusive earnings management practices become firmly entrenched at a company, high-level managers spend a great deal of time devising methods to ensure that the abusive practices continue. Because outsiders cannot observe management's day-to-day activities, investors and auditors should look carefully for warning signs that abusive earnings management is present:

- Cash flows that are not correlated with earnings
- Receivables that are not correlated with revenues
- Allowances for uncollectible accounts that are not correlated with receivables
- Reserves that are not correlated with balance sheet items
- Questionable acquisition reserves
- Earnings that consistently and precisely meet analysts' expectations.

Cash flows. One of the most obvious warning signs that companies are engaging in improper revenue recognition is a lack of correlation between cash flow from operations and earnings. If revenue is properly recognized, cash flows should closely follow revenue recognition; that is, the business cycle will be completed and cash will be available for reinvestment when customers discharge their obligations in a timely manner. Cash flow lagging significantly behind revenues could be a sign that companies are inflating revenues by recognizing sales in inappropriate periods, making sales to non-creditworthy customers, or recording fictitious sales.

Receivables. Investors should also compare receivables and cash flow from operations with revenues and earnings. Receivables rising more quickly than revenues could be a sign that customers are experiencing financial distress. It could also be a sign that a company is engaging in abusive earnings management by recording fictitious sales or otherwise inflating revenues and accounts receivable. For example, a June 2000 *Wall Street Journal* article suggested that Lucent Technologies might be engaging in creative accounting practices, noting that Lucent's receivables were rising at 49% while revenues were rising at only 20%.

Allowance for uncollectible accounts. Analyzing reserves for uncollectible accounts could also provide clues of abusive earnings management. Receivables growth not also reflected in the allowance could be a sign that managers are aware that revenues were recorded prematurely. It could also be a sign that managers have deliberately understated their reserves for uncollectible accounts or recorded fictitious revenues. Both Lucent and Cendant decreased their reserves for uncollectible accounts at times when revenues and receivables were rising.

Other reserves. Using reserves to appropriately match earnings with associated costs is a fundamental accrual accounting concept. GAAP requires that reserves be established for uncollectible accounts, warranties and guarantees, future commissions, and a host of other legitimate business purposes. These reserves are designed to ensure proper matching of revenues (or gains) and related costs. GAAP also allows, under stringent

criteria, the establishment of restructuring reserves to reflect the beneficial effect of the restructuring on income in future periods. Reserves are established before circumstances requiring their use are known with certainty and, therefore, require informed judgments. High-level managers, who are in the best position to understand their customers, company, and industry, frequently control the terms and conditions by which reserve accounts are changed. Investors should carefully scrutinize all disclosure notes and other discussion materials related to reserves to determine if changes in reserve accounts are consistent with good business practices. For example, Cendant manipulated its cancellation and commission reserves downward at a time when revenues were increasing. Lucent manipulated its pension reserves and significantly inflated earnings by changing its accounting policies. Both companies manipulated or overstated acquisition and purchase reserves.

Acquisition reserves. Investors and auditors should carefully review the circumstances surrounding acquisitions. Escalating abusive earnings management practices often provide incentives for companies to seek business combinations that can be used to strengthen their “cookie jar.” If there is no apparent business purpose for a business combination, investors and auditors should carefully analyze the transaction. If restructuring charges or reserves set aside for disposals are created, investors and auditors should question the legitimacy of the business combination or acquisition. For example, SEC documents indicate that Cendant management intentionally overstated merger and purchase reserves, which were subsequently reversed directly into operating expenses and revenues.

Consistent earnings. Finally, investors and auditors should carefully examine the accounting practices of companies that consistently and precisely meet analysts’ expectations, particularly growth expectations. Analysts’ expectations are based in part on information obtained from company management; therefore, companies strive to meet analysts’ expectations to protect their reputations as well as the market value of their stock. Although many companies employ legitimate means to meet or exceed analysts’ expectations, other companies may engage in abusive earnings management practices to cover failures resulting from overly optimistic predictions, economic downturns, or business setbacks. For example, Cendant manipulated its financial reports to ensure that revenues and expenses were consistently reported at approximately the same percentages each quarter. While all businesses strive for smooth earnings, consistencies such as those reported by Cendant should trigger closer analysis of financial reports.