not change the overall standard (of what qualifies as extraordinary). Obviously, the reason for the concession is the magnitude of the numbers involved.

EARNINGS MANAGEMENT

Earnings management has been defined by Schipper as

> . . . purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say, merely facilitating the neutral operation of the process).[67]

Obviously, agency theory studies frequently fall under the category of earnings management since a firm's management may attempt to influence earnings in order to (1) maximize its compensation, (2) avoid the breaching of debt covenants of bond liabilities, which would prevent the payment of dividends, and (3) minimize reported income to lessen the possibility of governmental interference if the enterprise has high political visibility.

The accounting literature has many examples of purported earnings management for a variety of reasons. In mergers where stock is exchanged between enterprises, Erickson and Wang find evidence that acquiring firms attempt to increase income prior to the acquisition in the hope that higher income will raise the acquiring firm's stock price thus lowering the number of shares needed for the acquisition (the share exchange ratio is based upon the prices of the two securities).[68] In a similar vein (but going in the opposite direction) Wu found evidence that earnings was manipulated downward just prior to leveraged management buyouts.[69] However, Wu's study contradicted previous work by DeAngelo, who did not find understatement of earnings by means of accrual manipulations, possibly due to potential intense scrutiny of management prior to buyouts and the severe penalties that could result.[70] In addition, some evidence has been found of firms lowering income in situations where import protection is being sought through means such as tariffs, quotas, and marketing agreements.[71] Kasznik has found evidence that firms which provide voluntary earnings forecasts tend to

67 Schipper (1989, p. 92).

68 Erickson and Wang (1999).

69 Wu (1997).

70 DeAngelo (1986).

71 Jones (1991).

increase earnings by decreasing discretionary accruals (see following) if earnings forecasts are overestimated.[72] However, he did not find evidence that actual earnings are decreased if earnings forecasts are underestimated. If these and other earnings management effects are present, the management of earnings constitutes inside information because the market would not be aware of the manipulation. However, researchers concede that whether earnings has been managed is difficult to detect.[73] Nevertheless, earnings management is seen as a very serious problem by the SEC.[74]

Perhaps the most common earnings management situations involve management compensation and income smoothing. Unfortunately earnings management for compensation purposes often overlaps with income smoothing so these two topics cannot be easily separated. We commence with the management compensation problem.

Management Compensation

Management compensation contracts attempt to align management behavior with the interests of shareholders because the interests of these two groups can conflict. Compensation contracts of management can be quite complex. In addition to cash compensation, they often include bonus incentives based on income and/or share price, and longer-term incentives often utilizing stock option plans. For bonuses, earnings are generally more important than security prices.

Bonus plans that are based on earnings often have a top or ceiling and a floor or bogey. Between the ceiling and the floor, the bonus is often a percentage of income. At the ceiling, the bonus is maximized and below the floor, there is no bonus. Healy, in an often cited study, found that above the ceiling and below the floor, income was deferred until the following periods.[75] In particular, the timing of transactions, especially year-end accruals, can be used to shift income from one period to the next. Holthausen, Larcker, and Sloan largely agreed with Healy except that they did not find income decreasing tactics being used when firms were below the floor.[76] Another study, by Gaver, Gaver, and Austin, was also largely in agreement with Healy except that they found the presence of earnings-increasing discretionary accruals when firms were below the floor.[77]

72 Kasznik (1999).

73 See the comments of DeAngelo (1988) and Dechow, Sloan, and Sweeney (1995).

74 Healy and Wahlen (1999, p. 366).

75 Healy (1985). For a good discussion of management compensation arrangements within an accounting framework, see Scott (1997), pp. 263–283.

76 Holthausen, Larcker, and Sloan (1995).

77 Gaver, Gaver, and Austin (1995).

Income might be managed by manipulating **discretionary accruals**. *Discretionary accruals* are accruals that management would have the ability to control in the short-run. These include changing bad debt expense percentages, increasing production to inventory fixed manufacturing overhead (which involves real costs of carrying inventories), and changing estimates of warranty expense. Discretionary accruals are somewhat limited and they are also difficult to estimate and differentiate from **nondiscretionary accruals**: accruals not easy to change in the short-run. A group of costs that are not discretionary accruals are expenses where *control* is somewhat discretionary in the short-run. These include advertising and research and development costs. Unlike discretionary accruals, these costs are **performance oriented**: real factors are involved rather than simply allocations between periods. It is quite likely that the distinction between these two types of costs cannot easily be made in accounting research.[78] Earnings management for compensation purposes cannot be easily distinguished from income smoothing, a topic to which we next turn.

Income Smoothing

Given the importance of reported accounting income, one hypothesis has been that managers seek to smooth income over time so that a more stable earnings stream with less year-to-year variance would lead to higher firm valuation. In some ways, this argument suggests a naive stock market that cannot unravel accounting data correctly. Notice also that income smoothing diminishes unsystematic risk which a diversified portfolio can also eliminate (Chapter 8). However, Ronen and Sadan suggest alternatively that managers smooth income to facilitate better predictions (by outsiders) of future cash flows on which firm value is based.[79]

There are three ways that smoothing can be achieved:

1. The timing of transactions.
2. The choice of allocation methods/procedures.
3. Classificatory smoothing between operating and nonoperating income.

The timing of transactions is a managerial choice rather than an accounting choice, but it is probably the most direct and influential method of manipulating accounting income. Accounting research has focused mainly on the other two approaches. Smoothing can be achieved

78 For difficulties of distinguishing between discretionary and nondiscretionary accruals, see Bernard and Skinner (1996) and Dechow, Sloan, and Sweeney (1995).

79 Ronen and Sadan (1981).

through the choice of accounting allocation methods, and, prior to APB Opinion No. 30, through the classification of income as operating/nonoperating (it is assumed that the desire is to smooth operating income). After APB Opinion No. 30, little discretion existed in classifying operating and nonoperating income. Several empirical studies have supported the hypothesis that income smoothing is achieved through both accounting method choice (allocations) and classifications. This latter finding may help to explain why the APB elected to use rigid uniformity in APB Opinion No. 30 concerning nonoperating items rather than the finite uniformity approach used in APB Opinion No. 9.

Chaney and Jeter find that income-smoothing firms tend to be larger than non-smoothing enterprises. They have higher stock market returns, and larger absolute discretionary accruals.[80] Firms in the lowest industry deciles, Chaney and Jeter find, are least likely to smooth. Other researchers have also found smoothing-type behavior. DeFond and Park, for example, found that where current earnings are poor, the tendency was to "borrow" from the future by adjusting accruals.[81] They also found the converse occurring: if current earnings are good and future prospects are poor, current earnings are "saved" for the future. Yet questions exist about the income-smoothing literature.

Although the empirical tests have confirmed income-smoothing behavior, there are several problems with this body of research. First, the underlying theory or motivation for smoothing is not specified clearly enough to make strong predictions as to what smoothed income would look like. Thus, the approach has been to use fairly simple time-series models of income trends over time, but this could mis-specify the smoothed income series and produce misleading results. Second, we cannot readily determine what the unsmoothed-income series looks like since the firm's entire set of accounting methods, as well as transaction timing, produces the aggregate income results. If we cannot calculate unsmoothed income, it is not easy to determine how, if at all, income has been smoothed. Third, there may be a built-in bias that overstates income smoothing due to inflation. That is, there is likely to be an upward year-to-year drift in the income series due solely to general inflationary effects. So, in light of these possible problems, the evidence in support of widespread income-smoothing practices is less convincing than it appears to be at first glance.

More general studies of the time-series properties of accounting income numbers indicate that the series are best described as a random

80 Chaney and Jeter (1997).

81 DeFond and Park (1997).

walk with slight upward drift.[82] This means that although there is a slight upward trend from year to year, the best prediction of current-period income is last-period income. These more general time-series studies are not supportive of the smoothing hypothesis. If smoothing were occurring, the trend-line effect should dominate and random-walk prediction models would be inferior to moving-average time-series models in explaining accounting income series.

SUMMARY

The income statement is based on the historical cost model of revenue recognition and expense matching. That does not mean, however, that it will not change. Some of the changes in the income statement that have occurred in the past 15 years provide a hint as to what might be expected in the future. It is safe to say, regarding the recognition of revenue, that the FASB is moving toward rigid uniformity. Likewise, in expense recognition, which is largely based on a system of arbitrary allocation, it would not be surprising to see the FASB move toward rigid uniformity. However, the role of future events in revenue and expense recognition needs to be more closely examined. While too flexible in presentation, the FASB's requirement for a comprehensive income measure pushes us further down the all-inclusive income statement track.

For the past 50 years, the income statement has been viewed by users of financial statements, as well as by standard setters, as the predominant financial statement. A review of past ARBs and APBs clearly indicates that more time and effort was placed on refining the income statement to the detriment of the balance sheet. Since the inception of the FASB, however, there appears to have been a shift toward "cleaning up" the balance sheet and a movement toward more of an asset-liability approach to the financial statements consistent with the conceptual framework project.

Earnings management has become an important subject for researchers. An important aspect of earnings management is income smoothing, by which management attempts to reduce the variance in year-to-year measurements of reported income with the hope of raising security prices. Although some evidence supports the smoothing hypothesis, it is an extremely difficult phenomenon to measure, so we cannot be certain of how widespread the practice is. Manipulation by management of earnings to maximize compensation is another important aspect of earnings management.

82 See Watts and Leftwich (1977) and Albrecht, Lookabill, and McKeown (1977)