

(CASE 2-1 CONTINUED)

alternatives may result in changing an accounting method, but since the new auditing standards were issued, his company could still receive an unqualified opinion from his auditors, with only a passing reference to any accounting changes in the auditor's opinion and its effects disclosed in the footnotes. As long as the alternative was allowed by generally accepted accounting principles, and the justification for the change was reasonable, the auditors should not object. If there were objections, Dan could always threaten to change auditors. But still the best avenue to pursue would be a change in accounting estimates, since those changes did not even need to be explicitly disclosed.

So Dan began to mull over what changes in estimates or methods he could employ in order to maximize his firm's financial appearance. In the area of accounting estimates, Dan could lower the rate of estimated default on his accounts receivable, thus lowering bad debt expense. The estimated useful lives of his plant and equipment could be extended, thus lowering depreciation expense. In arguing that quality improvements have been implemented in the manufacturing process, the warranty expense on the products sold could also be lowered. In examining pension expense, he noted that the assumed rate of return on pension assets was at a modest 6.5%, so if that rate could be increased, the corresponding pension expense could be reduced.

Other possibilities occurred to Dan. Perhaps items normally expensed, such as repairs, could be capitalized. Those repairs that could not be capitalized could simply be deferred. The company could also defer short-term expenses for the training of staff. Since research and development costs must now be fully expensed as incurred; a reduction in those expenditures would increase net income. Return on assets would be increased by not acquiring any new fixed assets. Production levels for inventory could be increased, thus spreading fixed costs over a greater number of units and reducing the total average cost per unit. Therefore, gross profit per unit will increase. Inventory levels would be a little bloated, but that should be easily handled by Dan's successor.

The prior examples are subtle changes that could be made. As a last resort, a change in accounting methods could be employed. This would require explicit footnote disclosure and a comment in the auditor's report, but if it came to that, it would still be tolerable. Examples of such changes would be to switch from accelerated to straight-line depreciation or to change from LIFO to FIFO.

How to make changes to the financial results of the company appeared easier than he first thought. Now back to the other potential problem of "getting away with it." At first thought, Dan considered the degree of resistance by the other members of top management. Mike Harrington, Dan's chief financial officer, would have to review any accounting changes that he suggested. Since Dan had brought Mike up the organization with him, Dan didn't foresee any strong resistance from Mike. As for the others, Dan believed he had two things going for him. One was their ambition. Dan knew that they all coveted his job, and a clear successor to Dan had yet to be chosen. Dan would only make a recommendation to the promotion committee of the Board of Directors, but everyone knew his recommendation carried a great deal of weight. Therefore, resistance to any accounting changes by any individual would surely end his or her hope to succeed him as CEO. Secondly, although not as lucrative as Dan's, their bonus package is tied to the exact same accounting numbers. So any actions taken by Dan to increase his compensation will also increase theirs.

Dan was actually beginning to enjoy this situation, even considering it one of his final challenges. Dan realized that any changes he implemented would have the tendency to reverse themselves over time. That would undoubtedly hurt the company's performance down the road, but all of his potential successors were in their mid-to-late 50s, so there would be plenty of time for them to turn things around in the years ahead. Besides, any near-term reversals would merely enhance his reputation as an excellent corporate leader, as problems would arise after his departure.

At that moment, his secretary called to inform him that Mike Harrington wanted to see him. Mike was just the man Dan wanted to see.

What are the ethical issues?

What should Mike do?

Required

- Determine the facts—what, who, where, when, and how.
- Define the ethical issues.
- Identify major principles, rules, and values.
- Specify the alternatives.
- Compare norms, principles, and values with alternatives to see if a clear decision can be reached.
- Assess the consequences.
- Make your decision.

CASE 2-2 THE DANGEROUS MORALITY OF MANAGING EARNINGS***The Majority of Managers Surveyed Say It's Not Wrong to Manage Earnings**

Occasionally, the morals and ethics executives use to manage their businesses are examined and discussed. Unfortunately, the morals that guide the timing of nonoperating events and choices of accounting policies have largely been ignored.

The ethical framework used by managers in reporting short-term earnings probably has received less attention than its operating counterpart because accountants prepare financial disclosures consistent with laws and generally accepted accounting principles (GAAP). Those disclosures are reviewed by objective auditors.

Managers determine the short-term reported earnings of their companies by:

- Managing, providing leadership, and directing the use of resources in operations.
- Selecting the timing of some nonoperating events, such as the sale of excess assets or the placement of gains or losses into a particular reporting period.
- Choosing the accounting methods that are used to measure short-term earnings.

Casual observers of the financial reporting process may assume that time, laws, regulation, and professional standards have restricted accounting practices to those that are moral, ethical, fair, and precise. But most managers and their accountants know otherwise—that managing short-term earnings can be part of a manager's job.

To understand the morals of short-term earnings management, we surveyed general managers and finance, control, and audit managers. The results are frightening.

We found striking disagreements among managers in all groups. Furthermore, the liberal definitions revealed in many responses of what is moral or ethical should raise profound questions about the quality of financial information that is used for decision-making purposes by parties both inside and outside a company. It seems many managers are convinced that if a practice is not explicitly prohibited or is only a slight deviation from rules, it is an ethical practice regardless of who might be affected either by the practice or the information that flows from it. This means that anyone who uses information on short-term earnings is vulnerable to misinterpretation, manipulation, or deliberate deception.

The Morals of Managing Earnings

To find a "revealed" consensus concerning the morality of engaging in earnings-management activities, we prepared a questionnaire describing 13 earnings-management situations we had observed either directly or indirectly. The actions described in the incidents were all legal (although some were in violation of GAAP), but each could be construed as involving short-term earnings management.

A total of 649 managers completed our questionnaire. Table 2-1 classifies respondents by job function, and Table 2-2 summarizes the views on the acceptability of various earnings-management practices.

A major finding of the survey was a striking lack of agreement. None of the respondent groups viewed any of the 13 practices unanimously as an ethical or unethical practice. The

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