

**(CASE 2-2 CONTINUED)**

dispersion of judgments about many of the incidents was great. For example, here is one hypothetical earnings-management practice described in the questionnaire:

In September, a general manager realized that his division would need a strong performance in the last quarter of the year in order to reach its budget targets. He decided to implement a sales program offering liberal payment terms to pull some sales that would normally occur next year into the current year. Customers accepting delivery in the fourth quarter would not have to pay the invoice for 120 days.

The survey respondents' judgments of the acceptability of this practice were distributed as follows:

Ethical	279
Questionable	288
Unethical	82
Total	649

Total Sample	
General Managers	119
Finance, Control, & Audit Managers	262
Others or Position Not Known	268
<b>Total</b>	<b>649</b>

Perhaps you are not surprised by these data. The ethical basis of an early shipment/liberal payment program may not be something you have considered, but, with the prevalence of such diverse views, how can any user of a short-term earnings report know the quality of the information?

Although the judgments about all earnings-management practices varied considerably, there are some other generalizations that can be made from the findings summarized in Table 2-2.

- On average, the respondents viewed management of short-term earnings by *accounting* methods as significantly less acceptable than accomplishing the same ends by changing or manipulating *operating decisions or procedures*.
- The direction of the effect on earnings matters. *Increasing* earnings is judged less acceptable than *reducing* earnings.
- Materiality matters. Short-term earnings management is judged less acceptable if the earnings effect is *large* rather than *small*.
- The time period of the effect may affect ethical judgments. Managing short-term earnings at the end of an interim *quarterly* reporting period is viewed as somewhat more acceptable than engaging in the same activity at the end of an *annual* reporting period.
- The method of managing earnings has an effect. Increasing profits by offering *extended credit terms* is seen as less acceptable than accomplishing the same end by *selling excess assets or using overtime* to increase shipments.

### Managers Interviewed

Were the survey results simply hypothetical, or did managers recognize they can manage earnings and choose to do so? To find the answers, we talked to a large number of the respondents. What they told us was rarely reassuring.

On accounting manipulations, a profit center controller reported:

Accounting is grey. Very little is absolute.... You can save your company by doing things with sales and expenses, and, if it's legal, then you are justified in doing it.

Proportion of Managers Who Judge the Practice*	Ethical	Questionable, or a Minor Infraction	Unethical, a Serious Infraction
	1. Managing short-term earnings by changing or manipulating operating decisions or procedures:		
When the result is to reduce earnings	79%	19%	2%
When the result is to increase earnings	57%	31%	12%
2. Managing short-term earnings by changing or manipulating accounting methods:			
When the change to earnings is small	5%	45%	50%
When the change to earnings is large	3%	21%	76%
3. Managing short-term earnings by deferring discretionary expenditures into the next accounting period:			
To meet an interim quarterly budget target	47%	41%	12%
To meet an annual budget target	41%	35%	24%
4. Increasing short-term earnings to meet a budget target:			
By selling excess assets and realizing a profit	80%	16%	4%
By ordering overtime work at year-end to ship as much as possible	74%	21%	5%
By offering customers special credit terms to accept delivery without obligation to pay until the following year	43%	44%	15%

\*Percentages are calculated from *Harvard Business Review* readers' sample.

A divisional general manager spoke to us about squeezing reserves to generate additional reported profit:

If we get a call asking for additional profit, and that's not inconceivable, I would look at our reserves. Our reserves tend to be realistic, but we may have a product claim that could range from \$50,000 to \$500,000. Who knows what the right amount for something like that is? We would review our reserves, and if we felt some were on the high side, we would not be uncomfortable reducing them.

We also heard about operating manipulations. One corporate group controller noted:

[To boost sales] we have paid overtime and shipped on Saturday, the last day of the fiscal quarter. If we totally left responsibility for the shipping function to the divisions, it could even slip over to 12:30 A.M. Sunday. There are people who would do that and not know it's wrong.

Managers often recognize that such actions "move" earnings from one period to another. For example, a division controller told us:

Last year we called our customers and asked if they would take early delivery. We generated an extra \$300,000 in sales at the last minute. We were scratching for everything. We made our plans, but we cleaned out our backlog and started in the hole this year. We missed our first quarter sales plan. We will catch up by the end of the second quarter.

And a group vice president said:

I recently was involved in a situation where the manager wanted to delay the production costs for the advertising that would appear in the fall [so that he could meet his quarterly budget].

Thus, in practice, it appears that a large majority of managers use at least some methods to manage short-term earnings. Though legal, these methods do not seem to be consistent with a strict ethical framework. While the managers' actions have the desired effect on reported earnings, the managers know there are no real positive economic benefits, and the

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