GAAP and Earnings Management

In the United States, firms must adhere to a set of accounting principles commonly referred to as Generally Accepted Accounting Principles, or GAAP.[3] Even so, there is considerable room for a company's managers to actively influence the firm's reported earnings. Corporate executives have an incentive to manage the firm's earnings, both because their pay depends upon earnings and because investors pay close attention to the firm's quarterly earnings announcements. Executives sometimes "smooth out" reported earnings, by making choices that, for example, transfer earnings from years when they are abnormally high to future years when earnings would otherwise be low. The specifics of how this is done can be very complex and are beyond the scope of this book.[4] However, in extreme cases, earnings management can lead to fraudulent efforts to create earnings where none exist.

Companies hire accountants to maintain the firm's financial records and prepare the firm's quarterly and annual financial statements. P Principle 5: **Individuals Respond to Incentives** serves to remind us that managers may at times find themselves in situations where they would like to be less than forthcoming in describing the firm's financial condition to investors and may be tempted to stretch the rules of financial reporting to disguise the firm's current circumstances. Although the incentive to misreport the firm's financial condition is ever present (remember Enron?), investors (stockholders) in publicly held companies, whose bonds and/or stock can be bought and sold in the public markets, do not have to depend on the honesty of the firm's accountants for assurance that the firm has followed GAAP. The reason is that public firms are required to have their financial statements audited by an independent accounting firm. The audit of the financial statements provides a verification of the financial statements of the firm and an audit opinion. The audit opinion is intended to provide *reasonable assurance that the financial statements are presented fairly, in all material respects, and/or give a true and fair view in accordance with the financial reporting framework.* As such, the audit serves to enhance the degree of confidence that investors and others have when they use the financial statements. In essence, the audit by an independent accounting firm serves as a check and balance to control management's incentive to disguise the firm's true financial condition.

Checkpoint 3.1

Constructing an Income Statement

Use the following information to construct an income statement for Gap, Inc. (GPS). The Gap is a specialty retailing company that sells clothing, accessories, and personal-care products under the Gap, Old Navy, Banana Republic, Piperlime, and Athleta brand names. Use the scrambled information below to calculate the firm's gross profits, operating income, and net income for the year ended January 31, 2009. Calculate the firm's earnings per share and dividends per share.

Interest expense	$74,000,000	Revenues (sales)	$14,549,000,000
Cost of goods sold	$9,079,000,000	Common stock dividends	$243,000,000
Operating expenses	$3,836,000,000	Income taxes	$536,000,000
Shares outstanding	716,296,296	Other income or expense	$5,000,000

STEP 1: Picture the problem

The income statement can be visualized as a mathematical equation using Equation (3–1) as follows:

$$\text{Revenues} - \text{Expenses} = \text{Profits} \tag{3–1}$$

(3.1 CONTINUED >> ON NEXT PAGE)

[3]GAAP represents the compilation of a voluminous set of standards that guides the construction of the firm's financial statements. These standards are set by governmental entities such as the Securities and Exchange Commission and the Accounting Oversight Board, as well as by industry groups from the accounting profession, including the American Institute of Certified Public Accountants.

[4]If you want to learn more about this and other tools of earnings management (i.e., manipulation), see Howard M. Schilit, *Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports*, 2nd ed. (McGraw-Hill, 2002).

However, this equation belies the level of detail normally included in the income statement. That is, expenses are typically broken down into multiple categories, including cost of goods sold, operating expenses (including such things as selling expenses, administrative expenses, and depreciation expenses), finance charges or expenses (interest), and income taxes. After subtracting each of these general categories of expenses, a new profit number is calculated. The following template provides a useful guide for reviewing the format of the income statement:

Revenues
Less: Cost of Goods Sold
Equals: Gross Profit
Less: Operating Expenses
Equals: Net Operating Income
Less: Interest Expense
Equals: Earnings before Taxes
Less: Income Taxes
Equals: Net Income

STEP 2: Decide on a solution strategy

Given the account balances provided, constructing the income statement simply entails substituting the appropriate balances into the template found above.

STEP 3: Solve

Revenues = **$14,549,000,000**
Less: Cost of Goods Sold = $9,275,000,000
Equals: Gross Profit = $5,274,000,000
Less: Operating Expenses = $3,836,000,000
Equals: Net Operating Income = $1,438,000,000
Less: Interest Expense = $74,000,000
Equals: Earnings before Taxes = $1,364,000,000
Less: Income Taxes = $536,000,000
Equals: Net Income = $828,000,000

Earnings per share ($930,000,000 net income ÷ 716,296,296 shares) = **$1.16**
Dividends per share ($243,000,000 dividends ÷ 716,296,296 shares) = **$0.34**

STEP 4: Analyze

There are some important observations we can make about Gap's income statement. First, the firm is profitable because it earned net income of $828,000,000 over the year ended January 31, 2012. Second, the firm earned more net income than it distributed to its shareholders in dividends.

STEP 5: Check yourself

Reconstruct Gap's income statement assuming the firm is able to cut its cost of goods sold by 10 percent and that the firm pays taxes at a 40 percent rate. What is the firm's net income and earnings per share?

ANSWER: $1,374,900,000 and $1.92.

Your Turn: For more practice, do related **Study Problem** 3–1 at the end of this chapter.

>> **END Checkpoint 3.1**