The Ethics of Earnings Management: The Case of Income Smoothing

James Gaa
University of Alberta

May 2007

Information Asymmetry

In Most Situations, People Do Not Have the Same Information

Management Inevitably Has Information that Would be Useful to Investors – and other Stakeholders

In Financial Reporting:
Information Asymmetry Follows Immediately from the Separation of Ownership and Management
Corporate Transparency (OECD)

“The Corporate Governance Framework Should Ensure that Timely and Accurate Disclosure is made on All Material Matters regarding the Corporation, Including the Financial Situation, Performance, Ownership, and Governance of the Company.”

OECD, “Corporate Governance Principles: 2004”

Corporate Secrecy (OECD)

“Disclosure Requirements are Not Expected to Place Unreasonable Administrative or Cost Burdens on Enterprises.

Nor are Companies Expected to Disclose Information that May Endanger their Competitive Position

Unless Disclosure is Necessary to Fully Inform the Investment Decision and to Avoid Misleading the Investor”

OECD, “Corporate Governance Principles: 2004”
Corporate Secrecy

Corporations Have Secrets

Some are Legitimate
Corporations Should be Able to Keep them secret
   Trade Secrets
   Other Proprietary Information

Some are Not Legitimate
Corporations Should Not be Able to keep them secret
   Secrets about Harmful Products or Substances
   in the Workplace

Secrets

“To keep a Secret from Someone … is

to Block Information about it or Evidence of it
from Reaching that Person, and
to do so Intentionally:

to Prevent Him from Learning it, and thus
from Possessing it, Making Use of it, or Revealing it.

The word ‘Secrecy’ Refers to the Resulting Concealment.”

(Bok, Secrecy 1983, pg. 5)
Secrecy and Information Asymmetry

There are Two Cases:
- Decreasing Information Asymmetry
  - Truthful Disclosures Reduce Asymmetry
  - Maintaining or Increasing Information Asymmetry
    - Secrecy Maintains Asymmetry

In the Setting of Publicly Accountable Entities, Transparency – Disclosure of All Material Information – is the Standard Case

In this Setting, Secrecy Needs to be Justified

The Basic Ethical Problem

Every Company Needs to
- Make Disclosures
- Keep Secrets

So, Every Company Needs a Strategy for Disclosing Information about Itself
  - Often: to Maximize Secrecy / Minimize Disclosure
  - May Include Earnings Management

Is Earnings Management a Legitimate Part of a Company’s Disclosure Strategy?
The Problem of Earnings Management

Earnings Management
The Alteration of Financial Reports
In Order to Affect the Behaviour of Others

For Me: the Biggest Issue in Financial Accounting and Reporting

Why: It Strikes at the Core of the Traditional Ideal of Accounting:
The Preparation of Neutral – Unbiased – Information

Empirical Evidence

Earnings Management is Common

Strategies are Often Complex and Multi-period

It is Done for a Variety of Motivations: Often for the Benefit of Management,
Not (Solely) to Benefit Stakeholders

Managers are Willing to Incur Real Economic Costs in Order to Alter Financial Reports
Earnings Management

The Alteration of Financial Information to Produce a Predetermined Result by Intervening or Interfering in the Neutral Operation of the External Financial Reporting Process

Involving the Use of Judgment
in Financial Reporting, or
in Creating or Structuring Transactions in Ways that have No Business Purpose Other than to Alter Financial Reports
to Alter the Distribution of Information, for the Purpose of either
Affecting Some Stakeholders’ Evaluation of the Underlying Economic Performance of the Company or
Influencing Contractual Outcomes that Depend on Reported Accounting Numbers.

May 2007
The Ethics of Earnings Management

Earnings Management: What

The Alteration of Financial Information to Produce a Predetermined Result
by Intervening or Interfering
in the Neutral Operation of the External Financial Reporting Process

May 2007
The Ethics of Earnings Management
Neutrality – FASB

100. … It is, above all, the Predetermination of a Desired Result, and the Consequential Selection of Information to Induce that Result, that is the Negation of Neutrality in Accounting.

To be Neutral, Accounting Information Must Report Economic Activity as Faithfully as Possible, Without Coloring the Image it Communicates for the Purpose of Influencing Behavior in Some Particular Direction.

(FASB, SFAC No. 2, 1980)

Neutrality – IASB

36 To Be Reliable, the Information Contained in Financial Statements Must be Neutral, that is, Free from Bias.

Financial Statements are Not Neutral If, by the Selection or Presentation of Information, they Influence the Making of a Decision or Judgement in order to Achieve a Predetermined Result or Outcome.

IASB, Framework of IAS Financial Statements, 1989
Earnings Management: How

... Involving the Use of Judgment

in Financial Reporting, or

in Creating or Structuring Transactions in Ways that have No Business Purpose Other Than to Alter Financial Reports ...

Use of Judgment

in Financial Reporting

Accrual-Based Earnings Management
  Choice of Accounting Principles
  Discretionary Accruals

in Creating or Structuring Transactions in Ways that have No Business Purpose ...

Real Earnings Management
  Transactions are Altered or Created for this Purpose in order to Alter Financial Reports
Earnings Management: Why

… to Alter the Distribution of Information, for the Purpose of Either

Affecting Some Stakeholders’ Evaluation of the Underlying Economic Performance of the Company
   -- Adverse Selection

or

Influencing Contractual Outcomes that Depend on Reported Accounting Numbers.
   -- Moral Hazard

Earnings Management: Transparency and Secrecy

The Intentional Alteration of Financial Reports in order to Affect People’s Behaviour

Can Be Done in the Interest of

Transparency – Reducing Information Asymmetry

Secrecy – Maintaining or Increasing Information Asymmetry
## Information Asymmetry, Contract Timing and Motivation

<table>
<thead>
<tr>
<th>Decrease Information Asymmetry (Transparency)</th>
<th>Adverse Selection (pre-contract)</th>
<th>Increase Information Asymmetry (Secrecy)</th>
<th>Moral Hazard (post-contract)</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Provide Useful Information to Stakeholders</td>
<td>To Issue Financing</td>
<td>To Maximize Executive Compensation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Engage in Insider Trading</td>
<td>To Avoid Debt Covenant</td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Influence Legal/Political</td>
<td>Violations</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Issues</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Motivation to Decrease Information Asymmetry

Stakeholders are Interested in Transparency

They Want Information in Order to Evaluate the Underlying Economic Performance of the Company

Stakeholders Want to Evaluate Its Ability to Earn Income

- Over the Long Run
- Over the Short Run

Plus:

Variability over Time
The Focus of this Paper

The Alteration: Income Smoothing

The Motivation: to Affect Stakeholders’ Evaluations
   By Reducing Information Asymmetry
   about Long-term profitability

Assume: Earnings Managers Have no Other Motivation

Is Earnings Management with this Intention Ethically Justifiable?

Why This Specific Case?

It's been Practiced for a Long Time

Many People Accept Income Smoothing as a Justifiable Activity

Common Claim: Smoothed Income Presents Management’s Best Estimate (within the Financial Reporting System)

of the Company’s Long-Term Profitability
Why This Specific Case?

This is the Most Favourable Case for Justifying Earnings Management

Why:
Management Intends to Benefit Recipients of Financial Reports,
by Improving their Ability to Make Informed and Rational Judgments relating to Economic Performance

Management May Benefit, But
Benefiting is Incidental, Not Part of Motivation

Why This Specific Case?

Conversely: If Earnings Management is Not Justifiable in this Most Favourable Case

The Justifiability of Other Types of Earnings Management in which the Purpose of Earnings Management is to Maintain or Increase Information Asymmetry

Is Doubtful
But Beyond the Scope of this Paper
Summary of Analysis

1. Is Income Smoothing Lying?
   My answer: Not Necessarily

2. Is Income Smoothing Deception in Some Other Form?
   My answer: Not Necessarily

3. If Income Smoothing is Not Deceptive,
   There is No Ethical Problem

   If It is Deceptive in Some Way, is it Ethically Justifiable?
   My answer: No

Deception and Lying

Deception: “When We Undertake to Deceive Others, We Communicate Messages Meant to Mislead Them, Meant to Make Them Believe What We Ourselves Do Not Believe.”

Lying: “A Lie is simply a Message in the Form of a Statement which is Intended to Deceive Others.”

   (Bok, 1999, pg. 13)

So, Lying is a Particular Form of Deception
Deception and Secrecy

Information can be Concealed by:

Lying: Assertions Intended to Mislead

Silence: Not Disclosing Information / Preserving Secrecy

Silence Can be Deceptive

Note: NZICA Code of Ethics Recognizes Both Forms of Deception – Discussed Later

1. Is Income Smoothing Lying?

The Altered Income Statement is an Assertion
   It is Not Neutral

But: It is Not Lying

Why: If Conducted Purely with the Intention of Reducing Information Asymmetry regarding Long-term Profitability

   the Motivation is to Inform, Not to Mislead, with respect to the Company’s Long-run Profitability
Is Income Smoothing Lying?

Smoothed Income Could be a Lie

If the Motivation is Mixed, and Includes Increasing Information Asymmetry about Long-run Profitability, or Some Other Aspect of Economic Performance

So, Income Smoothing is Not Necessarily Lying Whether it is Depends on Management’s Intentions

Current Income Smoothing Practice

Income Smoothing is Done in Secrecy:

Management is Silent or Lies about its Earnings Management Strategy the Methods Used the Magnitude of Departures from Neutrality
2. Is Income Smoothing Deceptive? Current Practice

Assuming that Management is Attempting to Reduce Information Asymmetry

the Ethical Problem is not Lying about Income
Lying is Not Taking Place

The Ethical Problem is Secrecy about the Process
Via Lying or Silence

Is Secret Income Smoothing Deceptive?

The Current Practice is Deceptive

Management is Intentionally Keeping Secret Neutral Information about Current Income Variability of Income over Time

So, Stakeholders Lack the Information Needed to Undo the Alteration and Obtain the Original Neutral Information

They are Prevented from Acting as They Would Have, If They Had Had the Unaltered Income Statement
3. Is Income Smoothing Justified?

Three Simple Ethical Principles

The Perspective of the Deceived

The Principle of Veracity

The Principle of Publicity

The Perspective of the Deceived

“Those who Learn that They have been Lied to in an Important Matter … See that They were Manipulated, that the Deceit Made Them Unable to Make Choices for Themselves according to the Most Adequate Information Available, Unable to Act as They Would Have Wanted to Act had They Known All Along.”

(Bok, 1999, pg. 20)
The Principle of Veracity

There is an Initial Imbalance in the Evaluation of Truth-telling and Lying.

Lying Requires a Reason, while Truth-telling Does Not.

It Must Be Excused; Reasons Must be Produced. …”

(Bok, 1999, pg. 22)

It Places the Burden of Proof Squarely on Those who Assume the Liar’s Perspective.”

(Bok, 1999, pg. 30)

The Principle of Veracity

“…Truthful Statements are Preferable to Lies in the Absence of Special Considerations. …

So,

“…in Any Situation where a Lie is a Possible Choice, One Must First Seek Truthful Alternatives.”

(Bok, 1999, pg. 30, 31)
The Principle of Veracity

Discussions of Earnings Management Often Suggest that it is Either Always Justifiable or Never Justifiable

In General, Deception is Sometimes Justified

Potential Areas of Justifiable Lies
  White Lies
  Lies to Protect Self or Others
  Lies to Protect National Security

So, Is Income Smoothing Justified?

The Principle of Publicity

An Ethical Principle Must be Publicly Justifiable to Reasonable Persons

So,

Justification of Income Smoothing is Based on Consent of Reasonable Persons

Not Based on Abstract Theory
But Also Not Based on Doing a Survey
  Is Does Not Imply Ought
Justifying Income Smoothing

Can Income Smoothing for the Purpose of Reducing Information Asymmetry with respect to Long-term Profitability be Justified Publicly to Reasonable Persons?

Who are these Reasonable People? Knowledgeable and Sophisticated Take the Perspective of the Deceived Otherwise, Disinterested

Reasonable People Analysts, Investors, Legislators/Regulators?

As the Receivers of Information, they Naturally Take the Perspective of the Deceived

Would these External Stakeholders Consent to Income Smoothing to Reduce Information Asymmetry?
CFA Institute

Smoothing and Normalization are a Function of Analysis, Not of Financial Reporting

Management Should Not Manage Earnings
Not Even to Reduce Information Asymmetry
Smoothing Hides the Variability of Income over Time

CFAs Want Disclosure / Transparency

AIMR (CFA Institute), Financial Accounting and Policy Committee, 1998

Financial Reporting Act 1993

11. Content of Financial Statements of Reporting Entities

(1) The Financial Statements of a Reporting Entity Must Comply with Generally Accepted Accounting Practice.

(2) If, in Complying with Generally Accepted Accounting Practice, the Financial Statements do Not Give a True and Fair View of the Matters to which They Relate,

the Directors of the Reporting Entity Must Add such Information and Explanations as Will Give a True and Fair View of Those Matters.
Securities and Exchange Commission

Legislative Mandate:
To Promote Fair and Efficient Markets
To Protect Investors

The SEC is Mandated to Adopt the Perspective of the Deceived

Policy and Enforcement Actions are Clearly Against Earnings Management
– of all Kinds, for any Reason

Reasonable People: Accountants and Management?
As Preparers, they are Knowledgeable and Sophisticated
But They Naturally take the Perspective of the Deceiver

Accountants Tend to Talk to Each Other
People are Prone to Self-deception about their Own Actions
e.g., Misestimating the Harms and Benefits to Others

People are Prone to Paternalism
Knowing What is Good for Others
International Federation of Accountants

“Managing the Business and its Operations to Achieve a Desired Outcome or Hit a Target is Entirely Appropriate, (the Emphasis here is Placed on Managing the Business);

Managing Earnings as We All Agree, is Not an Acceptable Practice to Hit Earnings Targets.”

(IFAC, Financial and Management Accounting Committee, 2003)

NZICA Code of Ethics, 2006

Rule 2: False or Misleading Statements
21 A Member Must Not Make, Prepare or Certify, or Permit or Direct Another Person to Make, Prepare or Certify, Any Statement

which the Member Knows, Believes or Ought to Know,

to be False, Incorrect or Misleading, or Open to Misconstruction, by Reason of the Misstatement, Omission or Suppression of a Material Fact or Otherwise.
NZICA Code of Ethics, 2006

53 Any Report for which Members in Employment are Responsible … Must be Prepared with Integrity and Objectivity.

This Means, for example, that while

a Report Prepared by a Member in Employment
May Properly Present One Side of a Case and
May Present that Case to its Best Advantage,

the Report Should be Accurate, Truthful and, Within its Scope, both
Complete and Balanced.

It Should Not Rely on Ambiguities or Half truths but Should Be
Objectively Justifiable and Should Be Based on Reasonable
Assumptions.

IFAC Assurance Standards

Misstatements Including Omissions of Amounts or
Disclosures in Financial Statements to Deceive Financial
Statement Users. …

10. Fraudulent Financial Reporting Can Be Caused by the
Efforts of Management to Manage Earnings in order to
Deceive Financial Statement Users by Influencing Their
Perceptions as to the Entity’s Performance and
Profitability. …”

ISA 240: Auditor’s Responsibility To Consider Fraud …
NZICA Assurance Standards
AS-206: Responsibility to Consider Fraud

There are Only Two Kinds of Misstatement:


The Distinguishing Factor between Fraud and Error is Whether the Underlying Action that Results in the Misstatement of the Financial Reports is Intentional or Unintentional.”

Error and Fraud
AS-206

“9. The Term “Error” Refers to an Unintentional Misstatement in Financial Reports, Including the Omission of an Amount or a Disclosure …

10. The Term “Fraud” Refers to an Intentional Act by One or More Individuals …

Involving the Use of Deception to Obtain an Unjust or Illegal Advantage. …”
**Fraud, Deception and Earnings Management: AS-206**


---

**Secret Income Smoothing is Not Justifiable**

These Major Groups are “Reasonable Persons” Some Would be Expected to Take the Perspective of the Deceived They are all Opposed to Earnings Management

Why:

Income Smoothing is a Form of Earnings Management Earnings Management is Deceptive. Therefore, Income Smoothing is Deceptive Deception is Not Justifiable Therefore, Income Smoothing is not Justifiable.
Is Transparent Income Smoothing Justifiable?

Income Smoothing is Deceptive IF it is Done Secretly

There is a Truthful Alternative to Secret Income Smoothing:
Income Smoothing with Full Disclosure:
that Income Smoothing is Occurring
of the Methods Used
of the Magnitudes of the Deviation from Neutrality

The Truthful Alternative Allows the “Deceived”
to Undo the Alterations and
Obtain the Neutral (Unbiased) Information

So, Income Smoothing May be Justifiable if:
Management’s Intention is to Reduce Information
Asymmetry about Long-term Profitability
So, Financial Reports are Altered, But are Not Lies

and

The Process of Smoothing Income is Disclosed

Why: This is a Truthful Alternative to Deceptive Secrecy
Disclose All Material Information
about the Management of Earnings
Is Transparent Income Smoothing Justified?

CFAs Might Agree – They Would Have both the Smoothed Numbers and the Ability to Undo the Alterations

NZICA Might Agree – Transparent Income Smoothing Might Not be a Misstatement

Securities Regulators – They Might
Insist that All Financial Reports be Neutral
Be Unwilling to Rely on Management’s Stated Intention to Reduce Information Asymmetry

Summary

Income Smoothing is Ethically Justifiable If

the Altered Financial Reports are Non-deceptive as Intended (e.g., to Help Evaluate Long-term Profitability),

the Intention for Smoothing Income is to Decrease Information Asymmetry, and

the Details of the Process are Disclosed So that the Income Smoothing Can be Undone
Why Non-Deceptive Income Smoothing is Justifiable

The Complete Reports are Transparent:

The Total information Set
   is Neutral Because the Alterations Can Be Reversed

Can Be Used to Evaluate Profitability
   Long Term
   Short Term
   Variability

Why Smooth Income Secretly?

Since Transparent Income Smoothing is a Truthful Alternative to Secret Income Smoothing

Secrecy involves Intentional Concealment of the Income Smoothing Process

It Appears that Secrecy about the Details of the Process is Essential to Success in Achieving Management’s Motivation
Why Smooth Income Secretly?

Success Must Involve Other Motivations in addition to or Different from Reducing Information Asymmetry

Secrecy May be a Sign that Reducing Information Asymmetry is

Not Management’s Only Motivation

or

Not Management’s Motivation at all

Burden of Proof

Deception is Not Ethically Neutral
   It Needs to be Justified

Secret Income Smoothing is Deceptive

Secret Income Smoothing is Not Justified by my Analysis

Advocates of Secret Income Smoothing Need to Provide a Justification
## Information Asymmetry, Contract Timing and Motivation

<table>
<thead>
<tr>
<th>Decrease Information Asymmetry (Transparency)</th>
<th>Adverse Selection (pre-contract)</th>
<th>Moral Hazard (post-contract)</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Provide Useful Information to Stakeholders</td>
<td>To Maximize Executive Compensation</td>
<td></td>
</tr>
<tr>
<td>Increase Information Asymmetry (Secrecy)</td>
<td>To Engage in Insider Trading</td>
<td>To Avoid Debt Covenant Violations</td>
</tr>
<tr>
<td>To Influence Legal/Political Issues</td>
<td>To Influence Legal/Political Issues</td>
<td></td>
</tr>
</tbody>
</table>

### Further Research: Other Types of Earnings Management

Earnings Management for the Purpose of Maintaining or Increasing Information Asymmetry

I.e., Maintaining or Increasing Secrecy
Not Increasing Transparency

Is This Justifiable?

Why Would External Stakeholders Agree to Increased Disadvantage?
Future Research: Privacy

Theory of Privacy in the Corporate Domain

Privacy is About the Control over Information
  Personal Privacy
  Corporate Privacy

Need: A Theory of Rights and Duties re. Disclosure and Secrecy

Future Research: Information Strategies

Transparency vs. Secrecy

  Earnings Management

  Expectations Management

  Disclosure Management
Earnings Management vs. Disclosure Management

Disclosure Management is Explicitly about

A Company’s Policy and Practices relating to transparency and secrecy

What sorts of information are legitimately secret?
Recall the OECD Statement and the NZX Listing Rule

Future Research: Secrecy

Focus on Secrecy (as opposed to Disclosure)
They’re Closely Linked, But

Rather than Focus on Mandated and Voluntary Disclosure

Assume that Company’s Disclosure Strategy is to Maximize Secrecy

Can we Gain Understanding by Starting from Secrecy?
Future Research: Neutrality

Neutrality and Bias

Their Relationship to
Truth and Truthfulness
Earnings Quality
Reliability and Relevance
esp. Representational Faithfulness
True and Fair View

Future Research: Neutrality

Giving up Neutrality as an Ideal

Implications:
The Effects on the Integrity of an important social institution
Trustworthiness in Financial Information
Trustworthiness of Financial Markets

The Role of Auditors

The Reaction of Regulators
Anything Goes, Unless Altered Reports are Fraudulent?
Future Research: Conflicting Interests of Stakeholders

This Analysis Needs Only One External Stakeholder Group: the Deceived

In Fact, Stakeholder Groups Have Conflicting Interests

E.g.: Investors vs. Creditors

How to Balance or Rank these Interests

Major Problem Area: the Justifiability of earnings management to prevent violations of debt covenants

Future Research: Stakeholder Views

Recall: The Basis for Justification is the Public Justification to Reasonable Persons, from the Perspective of the Deceived

So, the justifiability of earnings management is in Some Sense an empirical question

What Do External Stakeholder Groups Really Think About Earnings Management?

But!
Justifiability is not Just an Empirical Question

The “Empirical” Determination of the Justifiability of Earnings Management is Not Value-Free

We Need to Carefully Consider About Reasonable Persons

They
  Take the Perspective of the Deceived
  Are Sufficiently Knowledgeable, Sophisticated
  Are not Subject to Bias or Self-Deception
  Recognize that the Burden of Proof is on Managers of Earnings to Justify their Practice

Future Research: Types of Earnings Management

Are There Morally Relevant Differences Among

Methods
  Accrual-based vs. Real

Intentions
  Adverse Selection vs. Moral Hazard

Level of Judgment
  Individual Acts vs. General Practices
Individual Actions vs. General Practices

Professional Associations and Regulators: Earnings Management is Not Justifiable as a General Practice

And Yet, Individual Accountants and Managers do it on a Regular Basis

An Example of a Common Phenomenon:
We Know Collectively that a Practice Should Not Exist – No One Should Do it

But Many Individuals Decide to Do it Anyway

Acts vs. Practices

This is a Very Old Problem in the Field of Ethics:
Should We Require People to Do What They “Ought” to Do Even If No One Else Will Do it?
The Person Not Doing it May Be Harmed

“My Company Should Not Engage in Earnings Management Because it Harms the Integrity of the Securities Market”

“But My Company Has a Strong Reason to Do it Anyway – To Prevent Harm to It”