AGGRESSIVE EARNINGS MANAGEMENT

The APB has decided to issue this Consultation Paper to:

- alert executive directors, non-executive directors, auditors, regulators, and users of financial statements to the potential threat that increasing commercial and economic pressures may cause 'aggressive earnings management'; and

- seek views on the steps that auditors should take to identify and respond to it.

To put aggressive earnings management into context, this Paper:

- explains why, even in a properly prepared profit and loss account, there is no such thing as a single "right" earnings figure;

- demonstrates, by use of an example, how legitimate business practices can develop into unacceptable financial reporting; and

- explores some of the steps auditors might take to identify and respond to aggressive earnings management.

Responses to the questions raised will assist the APB in deciding whether to take forward these ideas and, if so, the best way of doing so.

In addition to responses to the specific questions raised in this Paper the APB would welcome any other comments on what can be done, by the APB or others, to counter aggressive earnings management.

Responses should be addressed to:

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to reach the APB by 30 September 2001.

All responses will be regarded as being on the public record unless confidentiality is requested.

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CONSULTATION PAPER

Aggressive Earnings Management

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A WHAT IS THE PROBLEM?

1. During the last decade the environment surrounding financial reporting in the United Kingdom and Ireland has been strengthened very substantially by increasingly tough regimes of corporate governance, accounting standards and Auditing Standards. Furthermore, in the United Kingdom, there is the threat, for listed and large private companies, of action by the Financial Reporting Review Panel.

2. However, the consequential improvements in quality and reliability of financial reporting may be undermined by the increasing commercial pressures on those responsible for preparing financial statements.

3. Examples of these commercial pressures are:

   - Adverse market reactions to the share price of a listed entity when results fail to meet the market's expectations (which directors and management may have encouraged), whether or not the expectations were reasonable;
   - Directors and management's incomes being highly geared to results and/or heavily supplemented by stock options and other possibilities for large capital gains;
   - The importance of meeting targets to ensure protection of the jobs of directors, management and other employees;
   - The desire to understate profits to reduce taxation liabilities;
   - Legal and regulatory requirements to meet specific financial thresholds or ratios; and
   - The need to ensure compliance with loan covenants or to pacify bankers.

4. In the United States there have been a number of high profile cases where companies have adopted aggressive accounting practices including the selection of inappropriate accounting policies and/or unduly stretching judgments as to what is acceptable when forming accounting estimates.

5. These practices, while presenting the financial performance of the companies in a favourable light, did not necessarily reflect the underlying reality[1]. The APB terms the use of such practices "aggressive earnings management".

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1 In the United States the Chairman of the Securities and Exchange Commission highlighted the problem of earnings management in a speech entitled 'The numbers game'.

6. Aggressive earnings management results in stakeholders, and the capital markets generally, being misled to some extent about an entity's performance and profitability. At the extreme, aggressive earnings management can involve acts that may constitute a criminal offence. The APB makes no judgment about when acts of aggressive earnings management become criminal offences; it is for the courts to determine that based on the particular facts.

7. The APB is concerned to help auditors respond appropriately to the risk of aggressive earnings management in any type of entity in the United Kingdom and Ireland[2]. It is also concerned about the issue because history shows that, when economic conditions become difficult, the likelihood of aggressive earnings management and misleading financial reporting increases.

8. The continuing development of good corporate governance and accounting standards, together with Auditing Standards, will help to counter the threat of aggressive earnings management. While the APB recognises that the primary responsibility for preparing financial statements that give a true and fair view rests with directors and management, it believes that it would be helpful to discuss what else might be done by auditors to identify, and respond to, aggressive earnings management.

2 Aggressive earnings management can occur in any entity, including in the public sector following the introduction of accruals accounting and the increased use of financial and performance information for making economic decisions.

B HOW RIGHT IS A PROFIT AND LOSS ACCOUNT?

9. Directors are required to issue financial statements that give a true and fair view of the state of a company's affairs at the balance sheet date and its profit or loss for the period. Auditors are required to give an independent opinion on whether they do so. If they decide they do not, they qualify their audit opinion.

10. These requirements do not, however, produce a profit and loss account that is "right" in the sense that there is only one possible answer. In reality, a "true and fair view" can encompass a range of different figures. Factors causing this include:

    - Alternative accounting policies can produce different results;
    - Valuations and estimates, inevitably requiring judgment, are needed in relation to many elements of an entity's financial statements, particularly in respect of transactions that span the year-end or several years; and
    - Businesses are often highly complex, operate in many countries and undertake transactions for which the accounting is also complex (e.g. the use of derivatives).

11. The range of different figures may, however, be narrowed in respect of accounting periods ending on or after 22 June 2001 by Financial Reporting Standard (FRS) 18 'Accounting Policies', published in December 2000.

12. On accounting policies FRS 18 requires that 'Where it is necessary to choose between accounting policies … an entity should select whichever of those accounting policies is judged by the entity to be most appropriate to its particular circumstances for the purpose of giving a true and fair view.'

13. Judgments on valuations and estimates may be influenced by the statements in FRS 18 that 'it is not necessary to exercise prudence where there is no uncertainty. Nor is it appropriate to use prudence as a reason for, for example, creating hidden reserves or excessive provisions, deliberately understating assets or gains, or deliberately overstating liabilities or losses, because that would mean that the financial statements are not neutral[3] and are therefore not reliable.'

14. Some areas remain, such as revenue recognition and materiality, where standards or other guidance for the preparers of financial statements may help to prevent aggressive earnings management. On revenue recognition, the ASB has a project in progress and aims to publish a Discussion Paper on the principles involved in mid 2001. No project is currently planned by the ASB on materiality.

3 Free from deliberate or systematic bias.

15. It is unrealistic, however, to expect accounting standards to eliminate completely the need for judgment to be made in the preparation, and audit, of financial statements. Indeed, one impact of some recent accounting standards may be to increase the need for judgment, which itself increases the subjectivity of financial statements.

16. An important aspect of financial reporting is that it involves a considerable amount of judgment and estimation; auditors endeavour to satisfy themselves that those judgments and estimates are reasonable in the circumstances and, when necessary, are appropriately disclosed.

17. When there is a difference between the auditors' estimate of the amount best supported by the available audit evidence and the amount included in the financial statements, auditors consider whether the estimate falls within a range of acceptable results or requires adjustment. When considering such matters auditors apply the existing professional standards on "materiality"[4].

18. Materiality is influenced by a large number of quantitative and qualitative factors and no amounts or percentages can be prescribed or predetermined so as to result in an approach that is incontrovertibly acceptable. As a consequence, determining what is material is a matter of judgment having regard to both the amount involved and to the circumstances in each situation. Traditionally, auditors have regarded differences between their views and the views of directors as not material even if the amounts involved would change the profit or loss by 5%. Indeed, there may be some circumstances in which auditors would consider differences approaching 10% as not to be material[5].

19. It is clear, therefore, that, while company law and accounting standards provide the framework for financial statements, the judgment as to what is a true and fair view can be a matter of debate firstly for directors and secondly for auditors.

Question 1: *Do you think there are areas on which the APB and the ASB should work together to consider whether further guidance is needed for preparers and auditors of financial statements to reduce the risk of aggressive earnings management? If so, what areas?*

Question 2: *Do you think there is anything any other bodies should be doing to reduce the risk of aggressive earnings management? If so, what?*

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4 A misstatement is material if knowledge of it would influence the decisions of an addressee of the auditors' report. (SAS 220 paragraph 3)

5 In the US the staff of the SEC has issued guidance that it has no objection to a "rule of thumb" use of a percentage as a numerical threshold, such as 5%, as an initial step in assessing materiality, though it cannot be used as a substitute for a full analysis of all relevant considerations. The SEC staff believes that there are numerous circumstances in which misstatements below 5% could well be material. (SEC Staff Accounting Bulletin: No. 99 – Materiality)

C HOW AGGRESSIVE EARNINGS MANAGEMENT CAN DEVELOP

20. The following example illustrates how, in response to commercial pressures, problems can start with small legitimate acts that grow over time, increasing reported profit at the expense of future periods, until they cross the border of acceptability[6].

A simple example to demonstrate how legitimate business practices can develop into unacceptable financial reporting[7].

Year ended 31 December XXX1.

A listed manufacturing company has thrived in an economic expansion and announced a series of record-breaking results. Analysts believe earnings will continue their strong upward trend and have forecast the results for the year and the earnings per share to the penny. Shareholders see these increased earnings producing an ever-higher share price.

Management perceives a slow-down in its business and is very concerned about the impact on the share price if the analysts' forecasts are not met. Departmental heads are told to pull out all the stops; targets are set; management will see missing the target as a failure. The pressure is on.

Being a manufacturing company, earnings are based on completed items shipped and invoiced. In this instance, for the earnings target to be met, overtime is authorised and worked to accelerate completions so that the necessary shipments are made, and invoices raised, before the year-end.

Year ended 31 December XXX2.

The analysts, seeing their forecast met by the company at December XXX1, project a further increase in the company's earnings in line with its record-breaking past. Management, believing, or hoping, that any slow-down will be temporary, issues departments with new targets to enable it to meet the analysts' forecast for the next year-end.

Unfortunately the business slow-down turns out not to be temporary. Not only have completions and shipments failed to increase to meet the new forecast but some method has to be

6 Manipulation of the financial statements is not always done to enhance profits. For example, the year end cash position can be 'improved' by deferring payment of creditors. This may be done to show a better than normal cash position to influence bankers or to meet regulatory ratios or lending covenants.

7 We are grateful to Aspen Publishers Inc. for giving permission to use this example which is derived from an example in the book 'Accounting Irregularities and Financial Fraud: A Corporate Governance Guide', ed. Michael R. Young, Aspen Law and Business (formerly Harcourt Professional Publishing). ISBN 0-15-606998-9. Additional information may be obtained from Aspen Publishers, Inc.'s web site, www.aspenpublishers.com

found to make up in this year for the sales and profit which were accelerated into the previous year. The pressure is now greater than at the previous year-end.

Overtime is again authorised to increase shipments but will not be enough to meet the target. To further stimulate sales the company announces a price discount that will apply to sales and shipments made in December. In addition to the continued efforts to accelerate shipments for completed goods, the provisions for bad debts, returns and warranty costs are also reduced. While individually each provision can be justified, each has been calculated on the basis of the most optimistic view of the ranges of possible outcomes. No disclosures are given in the financial statements, nor in the other information published with the financial statements, of the actions taken to stimulate sales or the fact that each provision is determined on the most optimistic basis.

Year ended 31 December XXX3.

A year later the position has escalated out of control and many employees are now involved. In addition to all the actions taken in XXX2, goods are now being shipped on sale or return (without a provision for returns) and fictitious shipments are made close to the year end on the basis of false documentation, both being designed to deceive the auditors.

At some point the 'balloon goes up', the police are called in and, inevitably, the cry goes up 'what were the directors doing and where were the auditors?'

Question 3: *With respect to the matters described in the above example:*

- *what disclosures, if any, should the directors have given in the financial statements for the years ended 31 December XXX1 and XXX2 in order for them to give a true and fair view?*
- *what should the auditors have done, if anything, in these circumstances?*

D DO EXISTING AUDITING STANDARDS AND GUIDANCE ON THIS ISSUE NEED TO BE STRENGTHENED FURTHER?

21. The APB wishes auditors to be alert to, and respond to, the risk of aggressive earnings management. While the 'bold type' paragraphs contained within Statements of Auditing Standards[8] already address aspects of aggressive earnings management, the APB, or its successor[9], will consider whether they need to be strengthened or supplemented[10] in order to ensure that auditors:

    (i) Understand even better the pressures on directors and management to deliver a specific level of earnings;

    (ii) Act with even greater scepticism[11] when circumstances are encountered that may be indicative of aggressive earnings management;

    (iii) Place greater emphasis on the broader factors influencing materiality when reviewing their audit findings;

    (iv) Take an even more robust attitude with directors and management in seeking adjustments for misstatements[12] identified by the audit; and

    (v) Communicate openly and frankly with those charged with governance.

    ***Question 4:** Are there other actions that the APB should take to ensure that auditors are alert to, and respond to, the risk of aggressive earnings management? If so, what?*

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8 Auditing Standards are the basic principles and essential procedures with which auditors are required to comply in the conduct of an audit of financial statements.

9 A new framework for audit regulation will shortly be in place. This framework will involve a 'New' APB, constituted as a limited company owned by The Accountancy Foundation, replacing the existing APB, which is a committee of the accountancy bodies.

10 The APB has an ongoing review programme to ensure SASs are both current and effective.

11 Scepticism is a personal quality that relates to the attitude of individual auditors: it is characterised by a questioning, probing – almost suspicious – approach being applied throughout the audit.

12 Misstatements include (1) errors, (2) other inaccuracies (whether intentional or not), and (3) with regard to estimates and amounts dependent upon an exercise of judgment, unreasonable differences between (a) the amount intended to be included in the financial statements and (b) the auditors' assessment of what that amount should be based on the available audit evidence.

(i) Understand even better the pressures on directors and management to deliver a specific level of earnings

22. The APB would welcome views on whether Auditing Standards should place a greater emphasis on auditors seeking to identify pressures on the directors and management of the entity being audited that may lead to aggressive earnings management[13].

23. In practice those pressures, and the motivations of the individuals involved, will vary. Factors that auditors may need to consider include:

- Analysts' expectations of the entity's forthcoming earnings and the actions that directors and management have taken to influence them;
- The relationship between those expectations and the entity's share price;
- Any linkage between the level of the entity's earnings and/or share price and the consequential remuneration for directors and management, including large bonuses, or benefits under stock options etc;
- Regulatory requirements to meet rates of return on capital;
- Trigger points to secure future funding or avoid breaching loan covenants;
- Future plans for selling or listing the entity;
- The allocation of profits or losses arising from different entities with common owners trading with each other; and
- The motivation to reduce tax paid by the entity.

24. Where company briefings of investment analysts are given by directors and management, there may be benefit in auditors attending to hear the messages being given and the reaction to them. There may also be benefit in the auditors discussing with the audit committee the commercial pressures that are on directors and management. The audit committee may consider it appropriate to encourage the board of directors to seek ways of reducing those pressures and, thereby, reduce the possibility of aggressive earnings management.

Question 5: *Do you believe that there should be more emphasis in Auditing Standards requiring auditors to identify the pressures on directors and management and plan how to respond to them? If so, what factors should be emphasised?*

(ii) Act with even greater scepticism when circumstances are encountered that may be indicative of aggressive earnings management

25. In the view of the APB, auditor scepticism is driven more by auditor training and the cultures and attitudes within audit firms than by Auditing Standards. That said, scepticism can usefully be reinforced by Auditing Standards.

26. Auditor scepticism may be increased if Auditing Standards were to include a specific requirement for auditors to consider whether there are circumstances that could be indicative of aggressive earnings management. Circumstances may include:

- Directors or management deciding many of the amounts for provisions at the time the profit and loss account is finalised rather than the amounts being determined by others as part of the routine processing of the entity's accounting system;
- The final draft figure for earnings being significantly changed by journal entries generated at head office;
- Non-standard journal entries being made close to the year end;
- A profit and loss account which the auditors find contains many misstatements;
- Contracts or transactions, especially if undertaken close to the year end, the commercial rationale for which is unclear;

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13 SAS 210 "Knowledge of the business" refers in an appendix to auditors considering the pressures on management but does not contain a 'bold type' paragraph mandating that.

- Earnings' outcomes that are different from industry trends;
- A pattern whereby accounting policies and/or the judgments and estimates made in the preparation of the profit and loss account are all biased in the direction directors or management desires or are pushing the boundaries of acceptability;
- Directors or management unreasonably seeking to bring forward the reporting date making it difficult for the auditors to obtain the quantity and quality of the audit evidence that they may seek[14]; and
- Delays in providing the auditors with the necessary information and explanations that they require to complete the audit by the reporting date[15].

27. If circumstances like these are identified, or if the auditors' experience and knowledge of other, previous or current, factors leads them to consider that there is a significant risk of aggressive earnings management, Auditing Standards could require auditors to consider whether an attempt is being made to 'manage' the true earnings of the entity or, in extremis, to deceive the auditors. In such circumstances they could require auditors to consider the implications for the audit (for example, whether particular audit procedures need to be changed or extended). Auditors may also find it of benefit to undertake an analysis of the practices or policies that they would adopt in order to perpetrate aggressive earnings management, if they were responsible for preparing the financial statements, and then devise and implement procedures to respond to such practices.

    Question 6: *Do you believe that it would be beneficial if Auditing Standards were to include a specific requirement for auditors to consider, both at the planning stage and at the end of the audit, whether there are circumstances that could be indicative of aggressive earnings management and, if so, consider the implications for the audit? If so, what other circumstances, if any, in addition to those described in paragraph 26 above should be highlighted for consideration?*

(iii) Place greater emphasis on the broader factors influencing materiality when reviewing their audit findings

28. The APB believes that some auditors may, when considering whether an audit adjustment is material, overemphasise the importance of an amount that represents a simple percentage of earnings. Directors, knowing this, may adopt the attitude that auditors are unlikely to require adjustments to the financial statements unless the effect on earnings exceeds such a percentage.

29. There may be benefit in Auditing Standards emphasising the importance of auditors considering more widely the other factors affecting decisions about materiality when deciding whether amounts, and non-financial disclosures, are material.

30. Factors that are particularly relevant to decisions about materiality in the context of aggressive earnings management are those that:

    - Change trends, such as the trend of earnings;
    - Affect key financial indicators, such as earnings per share;
    - Change a profit into a loss;
    - Hide, or lessen, a failure to meet expectations developed by investment analysts or by previously published forecasts by the entity;
    - Increase directors' or senior management's remuneration (e.g. by just satisfying the requirements for the award of bonuses or other forms of incentive compensation); and
    - Ensure compliance with regulatory requirements and/or loan covenants.

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14 Where the auditors believe the directors are seeking to impose a limitation on the scope of their audit work, they have regard to the standards and guidance set out in SAS 601 'Imposed limitation of audit scope'.

15 In 'Fraud and audit: choices for society' APB highlighted this tactic as frequently used by those involved in fraudulent financial reporting.

31. If one or more of the above factors was present an identified misstatement of even a very small amount might be material.

Question 7: *Do you believe that SAS 220 'Materiality and the audit' should give greater emphasis to the importance of auditors considering other factors, in addition to quantitative measures, influencing materiality when deciding whether amounts are material? If so, what other factors, if any, in addition to those described in paragraph 30 above should be emphasised?*

(iv) Take an even more robust attitude with directors and management in seeking adjustments for misstatements identified by the audit

32. When auditors have completed their work, they discuss with management the results including any misstatements that have been identified. Frequently, management argue that there is nothing to be gained from insisting on immaterial misstatements being adjusted because of the subjectivity inherent in the preparation of the financial statements. In addition, auditors may find that a concern with immaterial items may divert attention from more significant items.

33. On the other hand it can be argued that not requesting immaterial misstatements to be adjusted can give the wrong sign to directors and management and inadvertently create an environment conducive to aggressive earnings management.

34. An approach to financial reporting which involves all misstatements being corrected may also improve current practice, particularly with respect to:

    (a) The offsetting of adjustments

    Sometimes a number of individually material misstatements are not adjusted on the grounds that they 'net-off' to having an immaterial effect on the profit and loss account. This practice creates a risk that proper consideration may not be given to the impact of the individual misstatements on other account balances, analyses or disclosures in the financial statements.

    (b) Impact of prior year misstatements

    Sometimes material misstatements are not adjusted on the grounds that an unadjusted misstatement in the prior year has the effect of reducing the impact on the current period's results to an immaterial amount.

35. As a matter of principle the APB believes that directors and management should correct all misstatements identified by the auditors. The APB, however, recognises that there may be some very small adjustments (described in SAS 610 (Revised) as 'clearly trifling'[16]) which it would not be practical to adjust (e.g. because the cost of making the adjustment would be significantly disproportionate to the benefit) or which would get lost in the rounding.

Question 8: *Do you agree that, as a matter of principle, directors and management should correct all misstatements identified by the auditors? If so, what actions, if any, need to be taken to ensure directors and management follow this principle?*

(v) Communicate openly and frankly with those charged with governance

36. Communication between the auditor and those charged with corporate governance (including, where it exists, the audit committee), is an important aspect of a quality audit and can help the auditor address concerns regarding aggressive earnings management.

37. The APB has just revised SAS 610 'Communication of audit matters to those charged with governance'[17] regarding the obligations of auditors to communicate relevant matters relating to the audit of financial statements, including their views about the qualitative aspects of the entity's accounting practices and financial reporting, to those charged with governance of an entity.

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16 This is not another expression for 'immaterial'. Matters which are 'clearly trifling' will be of an wholly different (smaller) order of magnitude than the materiality thresholds used in the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any quantitative and/or qualitative criteria. Further, whenever there is any uncertainty about whether one or more items are 'clearly trifling' (in accordance with this definition), the presumption should be that the matter is not 'clearly trifling'.

17 Formerly titled 'Reports to directors or management'.

38. Such communications may include:

- The appropriateness of accounting policies to the particular circumstances of the entity;
- The appropriateness of accounting estimates and judgments, for example in relation to provisions, including the consistency of assumptions and degree of prudence reflected in the recorded amounts;
- The timing of transactions and the period in which they are recorded; and
- The extent to which the financial statements are affected by any unusual transactions including non-recurring profits and losses recognised during the period and the extent to which such transactions are separately disclosed in the financial statements.

39. These communications, especially to the extent that they involve audit committees, will mean that concerns the auditors may have about qualitative aspects of the entity's accounting practices and financial reporting are made known to those charged with governance.

40. SAS 610 (Revised) also makes clear that if management does not adjust misstatements drawn to their attention by the auditors, the auditors ask those charged with governance to make the adjustments. If they refuse, the auditors discuss with them the reasons for, and appropriateness of, not making those adjustments, having regard to qualitative as well as quantitative considerations, and consider the implications for their audit report of the effect of misstatements that remain unadjusted.

41. In addition, to reduce the possibility of misunderstandings, the auditors obtain a written representation from those charged with governance that explains their reasons for not adjusting misstatements brought to their attention by the auditors. Obtaining the representation does not relieve the auditors of the need to form their own opinion as to the materiality of unadjusted misstatements.

42. Auditors are required to comply with the Auditing Standards contained in SAS 610 (Revised) in respect of audits of financial statements for periods commencing on or after 23 December 2001. The APB encourages earlier adoption.

E CLOSE

43. This Paper has highlighted the types of pressure that can lead to aggressive earnings management. It has also tried to convey the extent of subjectivity and estimation that is inevitably involved in financial reporting to put into context the difficulty, as shown by the example, of differentiating between practices that are legitimate and those that cross the line into aggressive earnings management, or even into fraudulent financial reporting.

44. APB believes that, in the majority of cases, directors and management aim to prepare financial statements which show a true and fair view; and auditors assist this aim by discussing with them during the audit any matters of concern the auditors may have about the financial statements.

45. From time to time, however, and in particular when economic conditions are difficult, some directors and management adopt aggressive earnings management practices when preparing financial statements. On these occasions it is for all those charged with governance to apply the objectivity required to ensure the financial statements for which they are collectively responsible show a true and fair view, and that they present a balanced and understandable assessment of the entity's position.

46. SAS 610 (Revised) will assist those charged with governance to carry out their responsibilities in connection with the financial statements by requiring auditors to communicate their views on the qualitative aspects of the entity's accounting practices, some of which may constitute aggressive earnings management.

47. Ultimately, however, it is for the auditors to decide, on the basis of all their knowledge from the audit and their accumulated experience, whether the financial statements of the entity show a true and fair view. When evaluating the results of the audit, the auditors consider whether judgments and decisions made by the directors and management, including any resistance to adjusting misstatements identified by the auditors, could be part of a pattern of bias, even though individually they may appear reasonable, to avoid the financial statements reflecting the underlying reality.

48. For the purposes of SAS 240 'Quality control for audit work' (Revised), if the auditors believe they have identified instances of aggressive earnings management during the audit and have any doubts whether directors or management have responded adequately to their concerns, this may constitute a situation requiring a review of the audit to be performed by an independent partner[18].

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18 SAS 240.11. 'Firms should ensure that an independent review is undertaken for all audit engagements where the audited entity is a listed company. In addition, firms should establish policies setting out the circumstances in which an independent review should be performed for other audit engagements, whether on the grounds of the public interest or audit risk.'

49. If, following a full review of the audit findings by an independent partner in accordance with SAS 240, the auditors conclude that the financial statements do incorporate the results of aggressive earnings management they should discuss their concerns with those charged with governance and consider the implications for their audit report.

Question 9: *Are there any other steps you believe auditors should take if they conclude an entity has adopted aggressive earnings management practices in preparing its financial statements? If so, what steps?*

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