

Notes

*Earnings Management
and Fair Value
Accounting
351*

Spring 2011

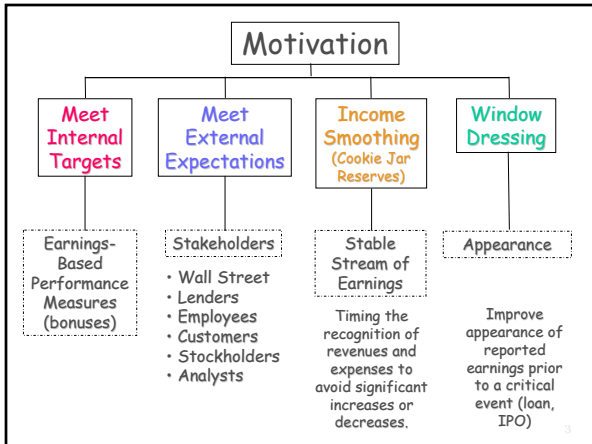
California State University, Northridge

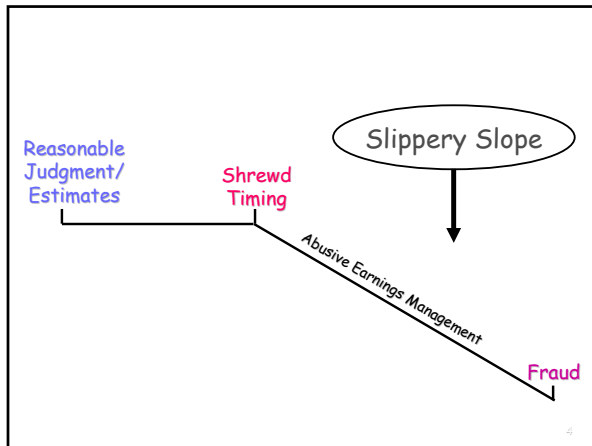
Earnings Management

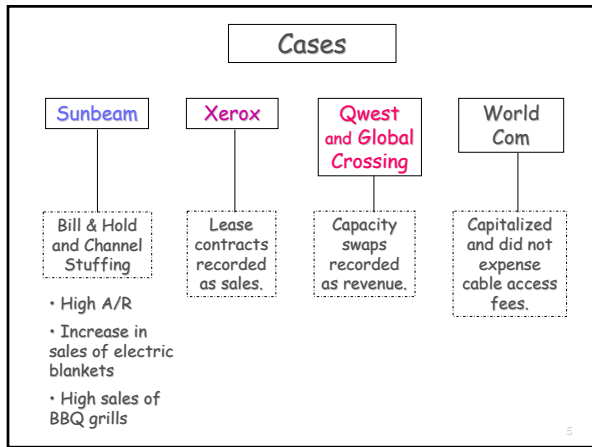
Quality of Earnings - Ability of reported earnings to predict future earnings and cash flow.

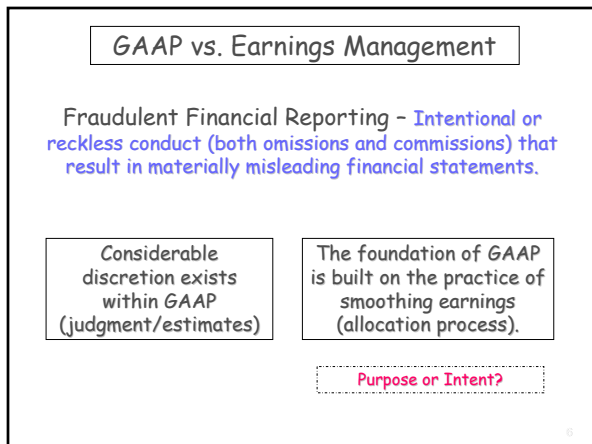
Earnings Management - manipulation of reported earnings.

2









Pro Forma Statements

Reports GAAP earnings, but excludes certain revenues, expenses, gains, and losses.

Justification: Better insight into the fundamental operations of the business.

Problems:

(1) No existing standards - Difficult to compare one company to another (each having a different interpretation as to what is fundamental);

(2) Risk of companies covering up bad news.

Examples of exclusions: Write-off of acquired R&D, impairment charges, amortization of intangible assets, equity in losses of investees, and stock-based compensation.

SEC Regulation G: Requires companies to reconcile non-GAAP financial measures to GAAP. Section 401 of SOX: Requires reconciliation for any report filed with the SEC or any public disclosure or press release.

Accounting scandals by year first reported

Nugan Hand Bank (1980)
 ZZZZ Best (1986)
 MiniScribe (1989)
 Polly Peck (1990)
 Bank of Credit and Commerce International (1991)
 Phar-Mor (1992)
 Bio Clinic (1994 to 1995)
 Sunrise Medical (1994 to 1995)
 Cendant (1998)
 Xerox (2000)
 Unify Corporation (2000)
 Enron (2001)

2002

AOL Adelphia Bristol-Myers Squibb CMS Energy Computer Associates Duke Energy Dynegy El Paso Corporation Enron Freddie Mac Global Crossing Halliburton	Harken Energy Homestore.com ImClone Systems Kmart Liberate Technologies Lucent Technologies Merck & Co. Merrill Lynch Mirant Nicor Energy, LLC Peregrine Systems Qwest Communications Reliant Energy Sunbeam Tyco International Waste Management, Inc. WorldCom
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Bad Debt Expense

- The lower the historical percent, the higher NI.

LIFO Liquidation

- Decreases CGS and increases NI.

Receiving Non-interest Bearing Notes

- The lower the imputed interest rate, the higher NI.

Depreciation Methods

- SL, long life, high salvage value increases NI.

Nonmonetary Exchange (Commercial Substance?)

- If CS, report gain (if not CS, depends on boot).

10

Percentage of Completion Method

- Lower estimate (or revision) of total contract cost increases net income.

Lower of Cost or Market

- Estimating a higher RC, floor, or ceiling increases NI by avoiding write-downs.

Dollar Value LIFO Retail

- The lower the index, the higher the NI.

Warranty Expense

- The lower the historical estimate, the higher the NI.

Asset Retirement Obligation

- The lower the estimated FV, the higher the NI.

11

Equity Method Securities

- Increasing book value of assets to FV by selecting assets that don't affect income statement (not depreciable assets and inventory) increases NI.

Testing for Impairment of Tangibles/Intangibles and Goodwill

- Higher expected future cash flow = less loss.
- Lower BV because of accelerated depreciation method = less loss.
- Lower risk adjusted interest rate used to discount the expected future cash flow = less loss.
- Higher fair value of the entity for goodwill impairment testing = less loss

Investments in Securities

- AFSS (if loss in value) vs. TS (if gain in value) vs. Fair Value Option.

12

Fair Value - FAS 157; ASC 820-10-35

Over **40** accounting standards permit or require fair value measurement.

- Defines fair value
- Establishes a framework for measuring fair value within generally accepted accounting principles (GAAP)
- Expands the disclosure requirements for fair value measurements

Definition: The price [exit price] that would be received to sell assets or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

This differs from the **entry** price, defined as the price that would be paid to acquire the asset or received to assume the liability.

13

Valuation Techniques

- The Market Approach - reliance on observable prices and other information generated by market transactions involving identical or comparable assets.

- The Income Approach - based upon the present value of future amounts such as cash flows or earnings.

- The Cost Approach - commonly referred to as replacement cost (the cost to obtain an identical or similar asset).

14

Fair Value Hierarchy (Reliability)

- Level 1 - The highest pricing level. Pricing through the use of active market price quotes of assets and liabilities that are identical to the asset or liability owned. Example: Stock market exchanges.

- Level 2 - Inputs that may not be directly observable for a specific asset or liability such as nonmonetary exchanges. Example: If one of the assets in the exchange is a building, the quoted market prices for similar buildings recently sold could be used to value the building or, if there were no similar buildings recently exchanged from which to obtain a comparable market price, valuation could be based on the price per square foot derived from observable market data.

- Level 3 - These are "unobservable inputs" consisting of the reporting entity's own assumptions. Example: Asset retirement obligations (AROs) are measured at fair value. Fair value estimate would include the expected cash flows. This level 3 input would be used in a present value calculation together with other inputs such as the credit adjusted risk free interest rate.

15
