Trends

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Teaching Judgment and Ethics in First-year Accounting: A Good Lecture

Students in first-year accounting often leave with the impression that the numbers in financial statements are fixed and would be the same regardless who was producing them. This impression is fostered by assignments that always result in a right or wrong answer with no room for variation. Most students understand that GAAP are the set of rules, practices, and conventions that describe what is acceptable financial reporting for external stakeholders, but they may find it surprising that a single, normal, everyday accounting choice may be either ethical or unethical. The difference between an ethical and an unethical accounting choice is often merely the degree to which the choice is carried out. The problem with many accounting judgments is that there is no clear limit beyond which a choice is obviously unethical. Thus, a perfect routine accounting decision, such as expense estimation, may be illegal if the estimated amount is extreme but perfectly ethical if it is reasonable. GAAP does not tell managers what specifically is normal and what is extreme. It is more like a speed limit sign that just says "Don't Drive Too Fast!" Here is an example lecture in six steps that illustrates the role of judgment in ethical financial reporting that you can use in class that any first-year student can understand

Step 1: Introduction Uncollectible accounts estimation is a prime example of an accounting decision many managers have to make. Since a company extends credit as an incentive for customers to buy, estimated losses from those who do not pay are considered a cost of the current period even though it will not be known which customers will not pay until future periods and what the amount of non-payment will be. GAAP requires that an estimate of uncollectible accounts be recorded as an expense in the same fiscal year as the revenue from the product us recorded. This follows a basic accrual accounting concept of matching expenses with related revenue. However, even small changes in estimates can have important effects on reported earnings.

Step 2: Illustration Assume that a company has operating income of $100,000 before the estimate of uncollectible accounts. Also, assume management estimates uncollectible accounts to be $6,000 (2 percent of sales of $300,000). The income statement would look like this:

Revenue	$100,000
Less: Estimated Uncollectible accounts expense	6,000
Net	$ 94,000

However, the fact that uncollectible accounts will be $6,000 is not always so clear. In real life.

Step 3: Further Assumptions Assume that for the past five years, average uncollectible accounts costs on $300,000 of sales have ranged from $4,000 to $8,000, with no specific pattern being apparent. Thus, a financial manager

- Who wanted to report the highest possible current period income would be justified in using $4,000 amount for the current year's expense estimate even though $4,000 is the bottom of the historical range.

- Or might use $8,000 to be conservative in a year when the economy is weak.

- Or might even be justified in using $3,000 if there was evidence that improved customer credit investigation and improved economy during the current fiscal year would be expected to lower future losses from uncollectible accounts.

- But what if an estimate of $1,000 simply because that figure would make it possible to achieve a desired net income target for the fiscal year? Since the $1,000 has no reasonable support, using it would be crossing the ethical line to possible financial fraud even though GAAP does not draw the clear line ethical use of judgment and unethical use.

- Or, on the other end of the spectrum, the highly conservative estimate of $11,000 was chosen because the manager for whatever reason (perhaps to avoid taxes or to appear unattractive to a take over) did not want to show higher income Since the $1,000 or $11,000 have no reasonable support, using it would be crossing the ethical line to possible financial fraud even though GAAP does not draw the clear line ethical use of judgment and unethical use.

Step 4: Illustration of the Range of Ethical and Unethical Reporting As may be seen in Figure 1, the concept of a reporting earnings continuum from questionable conservative to conservative to neutral to aggressive to fraudulent. The question becomes as to where to draw the lines. Should they be wide latitude as in figure 1a or more narrow as in Figure 1b? The answer does make a difference. In this one example of a rather modest difference in estimate from $1,000 to $11,000, it make a difference of $.10 per share or approximately 10 percent of earnings per share (EPS). Given that EPS is the most commonly quoted performance measure for companies and that when companies miss analysts' earnings estimates by $.01, 75 percent of the time it is by more than the estimate. Finally, consider that the estimate of uncollectible accounts is only one of dozens of estimates made by management in preparing the financial statements.

We see here as our estimate changes by what may appear to be a relatively small amount in relation to total revenues the effect of bottom line is great. Assume there was absolutely no evidence, merely management optimism, that the economy would improve and that improved credit checks would be effective during the year and would lower costs associated with future uncollectible accounts to or under the historical $4,000 low point of the historical range. Now management has no real support for estimating that uncollectible accounts losses will be $3,000. The $0.70 EPS figure (and highly suspect $0.60 EPS) should now be considered overly aggressive and beyond the bound of GAAP.

This scenario is illustrated in Figure 1b. Nevertheless, management has considerable latitude within the historical range that can produce EPS as low as $0.20 up to $0.60, a range of 300%.

Figure 2: Where Do You Draw the Line?

2a: The Earnings Management Continuum of Ethical Financial Reporting [1]

Questionable Conservative	**Conservative**	**Neutral**	**Aggressive**	**Fraudulent**
$0.89	**$0.92**	**$0.94**	**$0.96**	**$0.99**
Violates GAAP		**Within GAAP**		**Violates GAAP**

2b: Overly Aggressive Earnings on the Continuum [2]

Highly Conservative	**Overly Conservative**	**Neutral**	**Overly Aggressive**	**Fraudulent**
$0.89	**$0.92**	**$0.94**	**$0.96**	**$0.99**
Violates GAAP		**Within GAAP**		**Violates GAAP**

Step 5: Other Examples Uncollectible accounts expense is only one of the numerous financial reporting judgments made by accountants and managers that have an impact on reported earnings. Other examples of these financial reporting judgments that could subtly shade earnings in one direction or another include:

- Depreciation computations require estimates of useful lives and salvage values. Managers could use optimistic estimates of the life and salvage value of depreciable assets, reducing depreciation expense.
- Accounts receivable must be stated at net realizable value. Managers could use optimistic estimates of collectability to overstate earnings.
- Costs must be classified as product costs or period costs. By classifying some borderline costs as product rather than period costs, managers can reduce expenses during times of inventory growth.

[1] Adapted from Dechow, P.M., Skinner, D.J. (2000). "Earnings management: reconciling the views of accounting academics, practitioners, and regulators," *Accounting Horizons* 14 (2): 239.

[2] Ibid.

- Gains on asset dispositions may be fully recognized in the period of sale. Managers could time the sale of appreciated assets such as marketable securities and fixed assets to bolster earnings.

- Software development companies must estimate the point at which technological feasibility is reached for software products and capitalize software development costs after that point. Managers could accelerate this date to avoid immediately expensing some software development costs.

- Anticipated costs of satisfying warranty obligations must be accrued and matched to revenues. By making optimistic estimates of product warranty costs, managers could reduce current expenses.

- Ordinary repairs are expensed as incurred, while major repairs are capitalized. By treating ordinary repairs as major repairs, managers could bolster current earnings.

- Inventories must be stated at the lower of cost or market. Managers could use optimistic market values, resulting in reduced inventory write-downs.

- Long-term construction contracts require estimates of progress toward completion and costs to complete. Managers could use optimistic estimates of progress toward completion to inflate earnings. [3]

<u>Step 6: Motivations for Influencing The Estimates</u> If students now ask why would management be so interested in influencing the estimates accountants make, a study of 347 cases of fraudulent financial reporting over the last decade is helpful. The Committee of Sponsoring Organizations (COSO) identified numerous motivations for falsifying the financial reports, including to:

- Meet external earnings expectations of analysts and others

- Meet internally set financial targets or make the company look better

- Conceal the company's deteriorating financial condition

- Increase the stock price

- Bolster financial position for pending equity or debt financing

- Increase management compensation through achievement of bonus targets and through enhanced stock appreciation

- Cover up assets misappropriated for person gain[4]

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[3] Jackson, S.B., and Pitman, M.K. (2001, July). "Auditors and Earnings Management," *The CPA Journal.* <http://www.nysscpa.org/cpajournal/2001/0700/features/f073801.htm>

Conclusion

There you have a complete lecture that demonstrates conclusively why accounting is important, why accounting does not always results in the same numbers, why judgment is important in accounting, why ethics should be a component of all accounting classes, and why everyone should have a basic knowledge of accounting.

[4] Beasley, M.S., Carcello, J.V., Hermanson, D.R., & Neal, T.L. (2010, May). *Fraudulent Financial reporting 1998-2007: An Analysis of U.S. Public Companies.* Committee of Sponsoring Organizations of the Treadway Commission (COSO), 14.